This memorandum responds to your request for advice concerning the above bond issue. This advice may not be used or cited as precedent in other cases. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

**ISSUE**

Where the (the "Issuer") funded mortgages with proceeds of the (the "Bonds") and another issue of bonds identified by the Issuer as qualified mortgage bonds under I.R.C. § 143, whether the interest payments received on the mortgages may be allocated entirely to only one of the issues of bonds.

**CONCLUSION**

**FACTS**

The Issuer issued the Bonds on . On that date, unexpended sale proceeds from a previous issue of bonds – which was issued on (the "Bonds") – remained available. Additionally, sale proceeds of the Bonds
remained unexpended when the Issuer issued bonds on (the "Bonds"). The Issuer identified all of these bond issues as qualified mortgage bonds under I.R.C. § 143.

The Issuer used proceeds of the Bonds to make mortgage loans with a total principal amount of $. Of that amount, $ of the mortgage loans was funded solely by proceeds of the Bonds. The mortgage loans funded by the remaining amount ($) were also funded either by proceeds of the Bonds or proceeds of the Bonds. The Issuer referred to mortgage loans that were funded by more than one issue of bonds as "participated loans."

When the Issuer received payments on participated loans, it allocated the principal payment to the bond issues that funded the mortgage loan in the same proportion as each bond issue funded the loan.\(^1\) The Issuer allocated the interest payments it received on participated loans entirely to one of the bond issues that funded the participated loan. Specifically, the interest payments on participated loans that were funded by the Bonds and the Bonds were allocated to the Bonds. The interest payments on participated loans that were funded by the Bonds and the Bonds were allocated to the Bonds.

The Bonds were redeemed on

**LAW AND ANALYSIS**

Rules applicable to qualified mortgage bonds are provided under Treas. Reg. § 6a.103A-2. Paragraph (i) of that section provides rules on arbitrage and investment gain, including the requirement that the effective rate of mortgage interest not exceed the bond yield by more than a specified percentage. Treas. Reg. § 6a.103A-2(i)(2). The "effective rate of interest" is further explained under Treas. Reg. § 6a.103A-2(i)(2)(ii)(A) through (D). Treas. Reg. § 6a.103A-2(i)(2)(ii)(D)(1) provides that where mortgages are funded by proceeds of a qualified mortgage bond and by another source of funds, the interest on the portion of loans funded by the non-qualified bond source is limited to the market rate of interest.\(^2\) Treas. Reg. § 6a.103A-2(i)(2)(ii)(D)(2) provides that “[i]f any mortgage is allocated to two or more sources of funds, [certain fees paid by the mortgagor], repayments of principal, or payments of interest on such mortgage must be allocated to each source of funds.”

In the current case, the participated loans were funded by two or more sources of funds. The Issuer used proceeds of the Bonds in addition to either the Bonds or

---

\(^1\) The information in the file did not indicate how any fees paid by mortgagors were allocated, and we have not addressed the treatment of fees herein. If there are questions regarding the allocation of fees please let us know.

\(^2\) Specifically, Treas. Reg. § 6a.103A-2(i)(2)(ii)(D)(1) states that it is limited to the "reasonable and customary amount which may be charged where financing is not provided through a qualified bond issue.”
Bonds, to fund the mortgage loans. The Issuer allocated repayments of principal on the participated loans funded in part by Bonds to the sources of funds on the loans in proportion to the amount of proceeds of the two sources used to fund the participated loans. Additionally, the Issuer allocated payments of interest on participated loans funded in part by Bonds to one of the sources of funds on the loan. Specifically, the payments of interest on the participated loans funded by the Bonds and Bonds were allocated to the Bonds, and the payments of interest on the participated loans funded by the Bonds and Bonds were allocated to the Bonds. The Issuer has not allocated any of the interest payments on participated loans to a source of funds that did not fund the loans.
CONCLUSION

If you have any further questions or concerns, please contact Michelle Weigelt at (206) 946-3584.

PATRICIA P. WANG
Area Counsel (Pacific Coast Area Los Angeles)
(Tax Exempt & Government Entities Division Counsel)

By: _________________
Michelle Weigelt
Attorney
(Tax Exempt & Government Entities Division Counsel)