

Office of Chief Counsel
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Memorandum

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to: Kurt Oschsner
TEB Agent, Group 7226
(TEB, Field Operations)

from: Patricia P. Wang
Area Counsel (Pacific Coast Area)
(Tax Exempt & Government Entities Division Counsel)

subject:

This memorandum responds to your request for advice concerning the above bond issues. 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") used proceeds of the _____ (the "Bonds") to fund certain mortgage loans, whether interest received on those mortgage loans may be allocated to a separate issue of bonds that did not fund any portion of the mortgage loans for purposes of determining compliance with I.R.C. § 143(g).

CONCLUSION

Under the facts presented the Issuer's method of allocating the interest on mortgage loans funded with proceeds of the Bonds is not in compliance with the requirements of I.R.C. § 143(g).

FACTS

The Issuer issued the Bonds for purposes of refunding bonds that were issued to provide mortgage loans under the Issuer's (the "Program"), and to make new mortgage loans under the Program. The Issuer identified the bonds issued as part of the Program, including the Bonds at issue, as qualified mortgage bonds under I.R.C. § 143.

of the Bonds' Certificate describes the Issuer's practice with respect to interest it receives from mortgage loans financed under the Program. It states

The Issuer referred to its practice of allocating interest from mortgage loans to bond issues that did not fund the mortgage loan as "interest stripping" or "interest-only participations." The Bond's Certificate describes the interest payments allocated to the Bonds as follows:

In response to inquiries from the agent regarding whether principal and interest participations were undertaken, the Issuer stated that it "generally would utilize the 'interest stripping' participation methodology rather than actual, contemporaneous loan participations between two funding sources (as it may have expended all of the proceeds of an issue by bond closing)."

The Issuer also stated it is only moving the interest for yield computation purposes and not reallocating the expenditure for the mortgage loans.

The Issuer provided information indicating that as of _____, \$ _____ of Bonds remain outstanding.

LAW AND ANALYSIS

I.R.C. § 143(a)(1) defines a qualified mortgage bond as a bond which is issued as part of a qualified mortgage issue. In order for an issue to be a qualified mortgage issue, it must meet the requirements provided under specified subparagraphs of I.R.C. § 143. I.R.C. § 143(g) imposes certain arbitrage requirements. Under I.R.C. § 143(g)(2)(A), the excess of "the effective rate of interest on the mortgages provided under the issue," over the yield on the issue, must not be greater than 1.125 percentage points. See also, Treas. Reg. § 1.143(g)-1(b) ("An issue shall be treated as meeting the requirements...only if the excess of the effective rate of interest on the mortgages

financed by the issue, over the yield on the issue, is not greater over the term of the issue than 1.125 percentage points”).

In the present case, the \$ _____ of mortgage loans identified in the Certificate constitutes “mortgages provided under the issue” within the meaning of I.R.C. § 143(g)(2)(A). Accordingly, the interest on those mortgages must be included in determining whether the effective rate of interest on the mortgages exceeded the bond yield by more than 1.125 percent. Thus, the Issuer’s method of allocating the interest received on the mortgages financed with the Bonds fails to comply with the requirements of I.R.C. § 143(g).

The Issuer has asserted that it is permitted to strip interest from mortgages financed by the Bonds under Treas. Reg. § 6a.103A-2(i)(2)(ii)(D). We disagree. Treas. Reg. § 6a.103A-2(i)(2) 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. 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 a source of funds other than a qualified mortgage bond, the amount of interest and other charges on the portion of a loan funded by the non-qualified bond source is limited to the market rate of interest.¹ 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.” Thus, both Treas. Reg. § 6a.103A-2(i)(2)(ii)(D)(1) and (2) apply to situations where the mortgage loans were funded by two or more sources of financing. Amounts related to a mortgage loan must be allocated to a source of financing which funded the mortgage. Here, the mortgage loans were financed only by the Bonds, and the Issuer is allocating interest to a bond issue that did not finance the mortgages. Thus, Treas. Reg. § 6a.103A-2(i)(2)(ii)(D) does not provide support for the Issuer to allocate the interest on mortgage loans financed by the Bonds to a separate issue of bonds.

The agent argues that the “interest stripping” methodology does not meet the requirements of Treas. Reg. § 1.148-6(d). Treas. Reg. § 1.148-6(d) provides rules for allocating gross proceeds to expenditures. Section 1.148-6(d)(2)(ii) provides that gross proceeds of an issue invested in a purpose investment continue to be allocated to the purpose investment until sale, discharge, or other disposition of the purpose investment. Because here the Issuer is not reallocating the mortgage loans to another issue, the rules provided under Treas. Reg. § 1.148-6(d) are inapplicable to an analysis of the present facts.

¹ 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.”

CONCLUSION

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

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