Bond Case Briefs

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IRS LTR: Tax-Exempt Orgs' LLC Is Exempt From Mortgage Pool Rules.

The IRS ruled that a nonprofit limited liability company formed by two tax-exempt organizations as part of a program to help individuals obtain affordable housing through direct financing is exempt from the taxable mortgage pool rules.

Citations: LTR 201425001

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact: * * *, ID No. * * *
Telephone Number: * * *

7701.26-00, 115.03-00
Release Date: 6/20/2014
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LEGEND:

Corporation A = * * *
Corporation B = * * *
State = * * *
Area A = * * *
Area B = * * *
Program = * * *
Target Areas = * * *
Entity A = * * *
Program LLC = * * *
Corporation A LLC = * * *
Corporation B LLC = * * *
Date 1 = * * *
a = * * *
b = * * *
c = * * *
d = * * *
e = * * *
f = * * *

Dear * * *:

This responds to a letter dated May 15, 2013, and supplemental correspondence dated August 29, 2013, and November 4, 2013, submitted on behalf of Corporation A requesting a ruling under

section 7701(i) of the Internal Revenue Code (1986) (the "Code") that expansion of Corporation A's joint non-profit home financing program with Corporation B to include the issuance of multiple maturity debt financing by an LLC will not result in treatment of the LLC as a taxable mortgage pool.

FACTS

Corporation A and Corporation B (collectively, the "Corporations") are organizations exempt from taxation under section 501(c)(3) of the Code. The Corporations assist low and moderate income individuals to obtain adequate and affordable housing within certain areas in State that have been identified as in moderate or high need for community stabilization. Corporation A and Corporation B provide assistance in Area A and Area B, respectively. The Corporations implement various programs intended to counteract housing deterioration in these communities. The Corporations operate in cooperation with, or on behalf of, various State and local governmental agencies, and neighborhood organizations.

As of Date 1, the Corporations jointly operate a home ownership program (the "Program") that provides financing directly to low and moderate income borrowers for the purchase of single-family owner-occupied homes (the "Loans"). To qualify for a Loan, a borrower must be ineligible for conforming market rate mortgage financing and must meet certain income requirements. At least a percent of the Loans must be provided to borrowers with incomes less than b percent of the area median income as determined by the U.S. Department of Housing and Urban Development ("HUD"). To date, less than c percent of borrowers had incomes above b percent of HUD area median income and more than d percent had incomes below a percent. Homes purchased through the Program are located in one of several Target Areas identified as in need of community stabilization.

The Loans are currently in the form of contracts for deeds, or land installment contracts, that are treated as mortgages for federal income tax purposes. The Program might be expanded in the future to include conventional mortgages. The maximum principal amount of a Loan is $e, and since inception of the Program, the average principal amount of a Loan has been $f. The Loans have maturities of 10 years and bear fixed interest rates. One of the Program's goals is to assist the borrower in ultimately refinancing into a 30-year mortgage. The Program has implemented safeguards to mitigate a borrower's risk of default on a Loan, including extensive screening, financial counseling through a non-profit community-based counseling service, education, and other assistance in the event that the borrower experiences financial difficulty (including possible modification of a payment plan).

The Program is funded by charitable contributions and debt financing from the State housing finance agency, quasi-governmental and other housing non-profit entities, private sector donors, and investors. Credit enhancement for debt issued to fund the Program is often provided by several cities and counties in State, as well as nonprofit organization Entity A.

The Corporations wish to expand the Program to include the issuance of multiple maturity debt financing (the "Notes") secured by a pledge of the Loans. The Corporations have jointly established a special purpose limited liability company ("Program LLC") in order to issue the Notes. Program LLC is a nonprofit limited liability company organized under the law of State, the membership interests in which are owned by the Corporations through their wholly-owned disregarded entities, Corporation A LLC and Corporation B LLC. The Corporations represent that they may establish additional limited liability companies in the future. The Corporations represent that Program LLC will issue the Notes in multiple tranches with different maturity dates and interest rates in order to attract a broader base of investors with varied investment goals, which will expand the capacity of the Program to originate Loans. Under the related debt financing agreements, the Corporations may be required (or permitted) to repurchase a Loan in the event of a breach of certain representations,

warranties or covenants in the related debt financing agreement if such breach materially affects the value of the Loan. In general, the lenders (or their agent) have the right to enforce the repurchase obligation against the Corporations (or related party). If a Loan is repurchased, it will have no impact on the ability of the borrower to remain in possession of her home. The Corporations have the right to exercise various remedies against the borrower if she is in default under a Loan.

Investors in the Notes are expected to include the State finance agency, quasi-governmental and other housing non-profit entities, and private sector investors. Credit enhancement for the Notes is expected to continue to be provided by several cities and counties in State, as well as nonprofit organization Entity A. The proceeds of the Notes will be used exclusively for the acquisition of homes eligible for inclusion in the Program, and the origination or purchase of Loans. The Corporations request a ruling that Program LLC's financing of pledged Loans with debt instruments having multiple maturities does not cause the LLC to be a taxable mortgage pool under section 7701(i) of the Code.

The Corporations represent that, with respect to any Notes issued by Program LLC that would cause Program LLC to be a taxable mortgage pool but for the requested ruling, Program LLC will hold, either directly or indirectly through an indenture trustee or other custodian who will hold the pledged Loans to satisfy the Notes, the remaining beneficial interest in all assets that support the Notes until they are retired.

LAW AND ANALYSIS

Section 7701(i)(1) provides that a taxable mortgage pool shall be treated as a separate corporation which may not be treated as an includible corporation with any other corporation for purposes of section 1501.

Section 7701(i)(2)(A) provides that in general, a taxable mortgage pool is any entity (other than a REMIC) if (i) substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein), (ii) such entity is the obligor under debt obligations with 2 or more maturities, and (iii) under the terms of the debt obligations referred to in clause (ii) (or underlying arrangement), payments on such debt obligations bear a relationship to payments on the debt obligations (or interests) referred to in clause (i).

Section 7701(i)(2)(B) provides that any portion of an entity which meets the definition of subparagraph (A) shall be treated as a taxable mortgage pool ("TMP").

Section 301.7701(i)-4(a)(1) of the Procedure and Administration Regulations excludes certain governmental bond programs from the TMP rules. It provides that regardless of whether an entity satisfies any of the requirements of section 7701(i)(2)(A), an entity is not classified as a TMP if — (i) The entity is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (within the meaning of § 1.103-1(b) of this chapter), or is empowered to issue obligations on behalf of one of the foregoing; (ii) The entity issues the debt obligations in the performance of a governmental purpose; and (iii) The entity holds the remaining interests in all assets that support those debt obligations until the debt obligations issued by the entity are retired.

The term "governmental purpose" means an essential governmental function within the meaning of section 115 and does not include mere packaging of debt obligations for resale in the secondary market. § 301.7701(i)-4(a)(2).

Section 301.7701(i)-4(a)(3) provides that if an entity is not described in paragraph (a)(1) of this

section, but has a similar purpose, then the Commissioner may determine that the entity is not classified as a taxable mortgage pool.

Neither of the Corporations nor Program LLC are an entity described in section 301.7701(i)-4(a)(1)(i). Nevertheless Program LLC may qualify for an exemption from the TMP rules pursuant to section 301.7701(i)-4(a)(3), if it is found that the issuance of the Notes has a similar purpose as described in section 301.7701(i)-4(a)(1)(ii), that is, Program LLC's purpose in issuing Notes is to issue debt obligations in the performance of a governmental purpose and Program LLC meets the requirements of section 301.7701(i)-4(a)(1)(iii). In order to meet the requirement of "performance of a governmental purpose," Program LLC must satisfy the requirements under section 301.7701(i)-4(a)(2) that the issuance of the Notes (1) is in performance of an essential governmental function within the meaning of section 115 and (2) is not the mere packaging of debt obligations for resale in the secondary market.

In providing an exclusion from gross income, section 115 requires, among other things, that the income be derived in "the exercise of any essential governmental function."

Rev. Rul. 77-261, 1977-2 C.B. 45, holds, "Income from a fund, established under a written declaration of trust by a State, for the temporary investment of cash balances of the State and its political subdivisions . . . is excludable from gross income. . . ." The ruling reasons that the "investment of positive cash balances . . . in order to receive some yield on the funds until needed to meet expenses is a necessary incident of the power of the State or political subdivision to collect taxes and other revenues for use in meeting governmental expenses." In addressing the meaning of an "essential governmental function" for purposes of section 115, the ruling states, "Congress did not desire in any way to restrict a State's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the State government which, on a broad consideration of the question, may be the function of the sovereign to conduct."

CONCLUSION

Based on the information submitted and representations made, we conclude that Corporation A and Corporation B have satisfied the requirements under section 301.7701(i)-4(a)(1) for Program LLC to be exempt from the TMP rules under the facts and circumstances. Program LLC will hold, either directly or indirectly through an indenture trustee or other custodian, the remaining interests in Loans that support Notes issued by Program LLC until those Notes are retired. The activities of the Corporations and Program LLC provide funding to enable low and moderate income individuals to borrow the money they need to purchase housing in communities identified as in need of stabilization. Neither the Corporations nor Program LLC are in the business of purchasing and selling of debt obligations on the secondary market, rather Program LLC will function as the direct issuer of such bonds. Accordingly, Program LLC's issuance of Notes is in the performance of a governmental purpose for purposes of section 301.7701(i)-4(a)(2) because (1) its activities qualify as an "essential governmental function" under section 115, and (2) its issuance of Notes is not "the mere packaging of debt obligations for resale on the secondary market."

This ruling is limited to the exemption of Program LLC's issuance of Notes from the TMP rules under section 301.7701(i)-4. This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. No opinion is expressed with regard to whether Program LLC could meet the requirements of a REMIC under section 860D(a), whether Program LLC would otherwise be a TMP under section 7701(i), whether it is otherwise exempt under section 501(c)(3), or whether Program LLC's issuance of Notes satisfies either the accrual requirement or the private benefit requirement of section 115.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the provisions of a Power of Attorney on file, we are sending a copy of this ruling letter to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely

Mary Brewer
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(Financial Institutions & Products)

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