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Arbitrage - HUD subsidy program

Statute: Section 601 of the Tax Reform Act of 1969 (§103(d) of the Code) provides that a bond issued after October 9, 1969 is not tax exempt if it involves an arbitrage profit. If a major portion of the proceeds of a bond issue are reasonably expected to be used to acquire securities other than tax exempt securities which, over the term of the issue, produce a yield which is materially higher than the yield on the obligation issued, the bond is an arbitrage bond and not tax exempt.

Facts: In summary, the following facts have been presented by HUD and the Michigan State Housing Development Authority.

The Authority is authorized to issue \$50 million of tax exempt notes to finance construction and bonds to finance 40-year mortgages for low and moderate income housing. The mortgage bonds, which will be issued after construction is completed, would have about a 6-1/2 to 6-3/4% interest coupon. New York Housing Finance Agency and New Jersey recently issued such bonds at 6-3/4%. Mortgage money in the current tight money market, when available, bears a 8-1/2 to 9% rate in Michigan, or if insured by FHA costs 7-1/2% plus up to 10 points.

It is the intention of the Authority, which is a qualified mortgagee under FHA regulations, to use the funds raised by issuing notes and bonds, to participate in the FHA mortgage insurance and, in most instances, HUD interest subsidy programs for low and moderate income housing. These programs grant mortgage insurance and subsidies to projects which are planned, developed and financed by independent agencies or developers. The Federal government does not initiate the development of the projects but provides subsidies and mortgage insurance once the development work has been completed.

The interest subsidies under Sections 235 and 236 of the National Housing Act, as amended, operate to reduce interest on a mortgage to as low as 1%. Thus if a project is financed under usual FHA procedures, the interest subsidy can reduce the 7-1/2% mortgage to 1%, amounting to a 6-1/2% interest subsidy. If the Authority is able to finance the project for 6-1/2%, HUD will pay only 5-1/2% interest subsidies. This example will allow subsidy dollars to be stretched to 20% more units.

The Authority intends to make mortgage loans to nonprofit sponsors at the interest rate paid by the Authority plus up to 1/2 of 1% to cover costs of the Authority including paying agent, depositing and trustee fees, interest differential on capital reserve bonds, and an allocable share of operating expenses of the Authority. (Originally the Authority suggested that fees be charged to cover these expenses, rather than providing for an interest differential in the

mortgage, but FHA attorneys advised it would be more convenient to HUD if these changes could be handled by a mortgage interest differential.)

Because of the difficult money market, the Authority is advised by its underwriters that FHA mortgage insurance and feasibility processing is required in order to market the Authority's securities at this time. The Authority is already an approved FHA mortgage and will comply with all FHA regulations.

Several other facts should be noted. An understanding of the HUD subsidy program would be helpful. For the purpose of reducing rentals for lower income families, section 236 authorizes the Secretary of HUD to make periodic interest reduction payments to mortgagees holding mortgages on rental housing projects designed for occupancy by lower income families, which payments are made on behalf of mortgagors obligated under such mortgages.

In order to be eligible for the benefits provided under section 236 of the National Housing Act, a housing project must be subject to a mortgage which is insured by the FHA or, if a project is subject to a mortgage which is not so insured, such project must be financed under a State or local program providing assistance through loans, loan insurance, or tax abatements, and which prior to completion of construction or rehabilitation is approved for receiving such benefits.

Section 236(c) provides that interest reduction payments made by HUD to a mortgagee on behalf of a mortgagor shall be in an amount not exceeding the difference between the monthly payment for principal, interest, and mortgage insurance premium which the mortgagor is obligated to pay under the mortgage and the monthly payment for principal and interest such mortgagor would be obligated to pay if the mortgage were to bear interest at the rate of 1 percent per annum. Thus, with respect to each monthly payment made under the terms of the mortgage, HUD will pay to the mortgagee an amount as prescribed under section 236(c), and the mortgagor will pay to the mortgagees the difference between the amount required under the mortgage terms and the HUD payment.

Under section 236, interest reduction payments may be made with respect to projects subject to mortgages given by nonprofit entities as well as by entities organized to make a profit but which are restricted as to the amount of distributions or disbursements from surplus cash (referred to as limited dividend corporations or other limited dividend entities).

For background purposes only, one other fact should be noted. In November 14, 1969, IRS issued two private letter rulings, one to the City of New York Housing and Development Authority and the other to the Director of the FHA in Fargo, North Dakota. The rulings held that subsidy payments under section 236 are taxable income to the mortgagor and that the total amount of interest (including that portion of the interest paid by HUD) is deductible.

Problem: The arbitrage statute may be construed to deny tax exempt status to these bonds. The HUD subsidy is part of an obligation which will produce a yield materially higher than the yield paid on the bonds issued. At issue, is a construction of the words "materially higher" yield. (If the Policy Committee so decides, the issue can be further narrowed so as to decide only the question of a materially higher yield in the unique factual circumstance of a HUD subsidy program.)

Alternatives: One obvious solution is to construe the term "materially higher" to mean any yield in excess of the yield paid on the issue, other than de minimis amounts, e.g., not in excess of 1/10 or 2/10ths of an interest point. This is a very restrictive approach and it would preclude any investment in federal securities other than those which produce a lower or almost equal yield.

A second solution is to construe materially higher yield by making a comparison of the absolute yields. For example, if the securities purchased yield 7-1/2% and the yield on the issue is 6%, the 1-1/2% differential is a materially higher yield. This rule could permit an absolute yield (including discount on premium) of up to 1/2 of 1% without opening the door for abuse.

Another alternative is to measure materially higher yield as a percentage of the yield on the issue. For example, if the yield is 6% and the yield on the purchased security is not in excess of 10% of 6% or approximately a 1/2% differential on a 6% bond. The issue would not involve a materially higher yield and, therefore, would remain tax exempt.

A further refinement, and one which we suggest, is that the last described approach, i.e., permitting a differential of 10% of the yield on the bond issued, be applied in a narrow manner within the framework of the HUD subsidy program. This would allow the 10% differential if it is established that this amount is required to cover anticipated administrative expenses and that the Housing Authority, after operating expenses, does not reasonably expect to make a profit.

While this last suggestion is in effect a ruling on a narrow set of factual circumstances, it has the double virtue of assuring HUD that it is safe while not precluding further investigation and development of problem situations where materially higher yield may have another meaning. Therefore, I recommend that this last suggestion be adopted and that HUD be permitted to continue its program without opposition from the Treasury Department or the Internal Revenue Service.