

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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Chief, Examination Division

LEGEND:

Taxpayer =

Project A =

City B =

Managing General Partner =

General Partner 2 =

Developer =

Individual 1 =

Individual 2 =

- a =
- b =
- c =
- d =
- e =
- f =
- g =
- h =
- i =
- j =
- k =
- l =

ISSUE:

What costs incurred in the construction of a low-income housing building are included in eligible basis under section 42(d)(1) of the Internal Revenue Code? Specifically, is the amount of a “Developer Fee Note,” provided in part payment for services rendered for the Taxpayer by the Developer, includible in the Taxpayer’s eligible basis for purposes of determining the amount of low-income housing tax credit under section 42(d)(1)?

CONCLUSION:

Eligible Basis

A cost incurred in the construction of a low-income housing building is includible in eligible basis under section 42(d)(1) if the cost is:

- (1) included in the adjusted basis of depreciable property subject to section 168 and the property qualifies as residential rental property under section 103, or

- (2) included in the adjusted basis of depreciable property subject to section 168 that is used in a common area or provided as a comparable amenity to all residential rental units in the building.¹

Developer Fee Note

The amount of the Developer Fee Note is currently includible in the partnership's eligible basis under section 42(d)(1). However, this conclusion is conditioned on certain factual assumptions, as discussed in more detail below.

FACTS:

The Taxpayer was formed to construct, develop, and operate a low-income housing tax credit property (Project A) in City B. The Taxpayer's a percent limited partner is comprised of various corporate entities. The Managing General Partner of the Taxpayer is majority owned by Individual 1 and Individual 2, who also own or control, directly or indirectly, a number of related entities formed to construct residential rental properties. Project A's other general partner is General Partner 2, a non-profit corporation. Project A's Developer is owned b percent by Individual 1 and Individual 2; the remaining c percent is owned by two individuals who are also officers and employees in other Individual 1 and Individual 2 affiliated entities.

In connection with services rendered for the Taxpayer, Developer received a fee of approximately d. In e, when the Taxpayer did not have sufficient cash to pay the entire fee at construction completion, it issued a note (the Developer Fee Note) for the balance, f. The Developer Fee Note was one of three notes making up the Turnkey Development Note; the other two were a General Partner Cost Note and a Construction Cost Note, payable respectively to the Managing General Partner and a construction company owned by Individual 1 and Individual 2. The Taxpayer included the amount of the Developer Fee Note in the eligible basis of Project A for purposes of claiming low-income housing tax credits.

The note provided that the Taxpayer "hereby promises to pay to [Developer] ... the principal amount of ... f ... together with interest, in accordance with the terms and conditions set forth below." It bore interest, compounded monthly, at the greater of g percent or long-term AFR. It was assignable, but nonnegotiable. It was unsecured.

The Developer Fee Note contained source-of-payment restrictions. The payment terms of the Developer Fee Note were as follows:

- (a) Payments shall be made from Development Funds, from Cash Flow, from Capital Transactions proceeds at the times and in the manner set forth in Section 4.1, Section

¹ This test does not exclude the application of other requirements that affect eligible basis under section 42. For example, the cost for constructing a parking area would qualify under this test. However, this cost would not be permitted in eligible basis if a separate fee were charged for use of the area. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-90 (1986), 1986-3 (Vol. 4) C.B. 90.

6.9, and Article X of the Amended and Restated Agreement of Limited Partnership dated as of h of the Partnership (the "Partnership Agreement").

- (b) Any interest not paid currently shall accrue and be added to principal semi-annually. All outstanding principal shall be payable at maturity, which shall be on the 13th anniversary of the occurrence of Full Completion.

Section 6.9 of the Partnership Agreement, referred to in the Developer Fee Note, provided that each of the notes making up the Turnkey Development Note "shall be a debt of the Taxpayer which shall not be secured, ... [and] shall mature on the 13th anniversary of Full Completion." With respect to sources of payment on the notes, it provided that each debt:

shall be repaid only from any Development Funds which become available after Full Completion and otherwise from the sources in the manner set forth in Article X, in Section 4.1 and in the last sentence of Article III.C. Except as expressly provided for otherwise in this Agreement, all payments on said Notes shall be applied first to payment of the General Partner Cost Note, then to the Construction Cost Note and finally to the Development Fee Note.

Section 10.3 of Article X of the Partnership Agreement provided that upon partnership dissolution the assets of the Taxpayer would be distributed to the partners "after payment of, or adequate provision for, the debts and obligations of the Taxpayer (including the Turnkey Development Note ...)."

Section 10.2 of Article X of the Partnership Agreement describes repayment of the note out of cash flow and capital transactions. Regarding cash flow, under Section 10.2.A.,

- (1) All cash flow shall first be applied to make any Adjustor Distribution not previously made to the Investor Limited Partner and then second shall be applied to repay first interest and then principal due on first the General Partner Cost Note and then the Construction Cost Note ... [subject to a cap if the amounts due exceed 10% of the principal mortgage].
- (2) Twenty percent (20.0%) of Cash Flow remaining after application pursuant to clause (1) shall be applied to repay any then outstanding Operating Deficit Loans.
- (3) Eighty percent (80.0%) of Cash Flow remaining after application pursuant to clauses (1) and (2) shall be applied in the following priority:
 - (a) To payment (first of interest and then principal) of any amounts still outstanding under the Turnkey Development Note after payments made pursuant to clause (1) until the Turnkey Development Note is paid in full;
 - (b) To the payment of the Incentive Management Fee; and
 - (c) To a distribution to the General Partners.
- (4) Twenty percent (20.0%) of Cash Flow remaining after application pursuant to clauses (1) and (2) shall be distributed 2.0% to the General Partners ... and 98.0% to the Limited Partners.

With respect to repayment from capital transactions, Section 10.2.A. provided:

Prior to dissolution, and subject to any applicable Lender regulations, if the General Partners shall determine from time to time that there is cash proceeds available for distribution from a Capital Transaction, such cash proceeds shall be applied or distributed, as the case may be, as follows:

First, to the discharge, to the extent required by any lender or creditor, of debts and obligations of the Taxpayer, but ... excluding repayment of the Turnkey Development Note unless such cash proceeds arise from a Capital Transaction which is a sale of the entire Property or is a refinancing of the Permanent Mortgage for which no Consent of the Special Limited Partner is required as provided in Article III.C.²

Article III of the Partnership Agreement provided for borrowings by the Taxpayer. Article III.C.—referenced in Article X, Section 10.2.A.—generally restricted the General Partners from modifying a mortgage or otherwise pledging partnership assets without the consent of the Special Limited Partner. However, no consent was required for:

a refinancing of the Permanent Mortgage (or an additional borrowing from a non-Affiliate)³ at any time within one year before the maturity of the Turnkey Development Note if such refinancing (or additional borrowing) shall produce net proceeds sufficient ... to repay in full the Turnkey Development Note

Finally, under Section 4.1, referenced in the Developer Fee Note, the General Partners were:

obligated to make such additional Capital Contributions at the maturity of the Turnkey Development Note in an amount sufficient to enable the Taxpayer to repay the Turnkey Development Note in full.

The financial statements of the Taxpayer for i and j indicate that, after obtaining permanent financing, operating cash flow is available as follows:

80% as payment on the unsecured developer fee notes ... , and 20% first as payment on any outstanding operating deficit guarantee loans ... and then as distributions to the general and limited partners.

Some payments have been made on the Developer Fee Note. The financial statements indicate that, as of k, the balance on the note had been reduced to l, and state: “Payments from operating cash flows were allocated to the developer fee notes on a prorata basis based on original principal balances.”

² Any remaining proceeds were to be applied, in order of priority, to (1) contingent liability reserves; (2) operating deficit loans; (3) undistributed adjustor distributions to the Investment Limited Partner; (4) reimbursement of the General Partners’ obligation to repay the Turnkey Development Note; and (5) various partner distributions.

³ As defined in Article XIV, an “affiliate,” as applied to a general partner, referred to a variety of family members and other related persons and entities.

LAW AND ANALYSIS:

Eligible Basis

Section 42(a) provides that the amount of the low-income housing tax credit determined for any tax year in the credit period is an amount equal to the applicable percentage of the qualified basis of each low-income building.

Section 42(c)(1)(A) defines the qualified basis of any qualified low-income building for any tax year as an amount equal to the applicable fraction, determined as of the close of the tax year, of the eligible basis of the building, determined under section 42(d)(5).

Section 42(c)(2) provides that the term "qualified low-income building" means, in part, any building to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply (the 1986 Act). Section 201(a) of the 1986 Act modified property subject to the accelerated cost recovery system (ACRS) under section 168 for property placed in service after December 31, 1986, except for property covered by transition rules.

Section 42(d)(1) provides that the eligible basis of a new building is its adjusted basis as of the close of the first tax year of the credit period. Section 42(d)(4)(A) provides that, except as provided in section 42(d)(4)(B), the adjusted basis of any building is determined without regard to the adjusted basis of any property that is not residential rental property. Section 42(d)(4)(B) provides that the adjusted basis of any building includes the adjusted basis of property (of a character subject to the allowance for depreciation) used in common areas or provided as comparable amenities to all residential rental units in the building.

The legislative history of section 42 states that residential rental property, for purposes of the low-income housing credit, has the same meaning as residential rental property within section 103. The legislative history of section 42 further states that residential rental property thus includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89. Under section 1.103-8(b)(4) of the Income Tax Regulations, facilities that are functionally related and subordinate to residential rental units are considered residential rental property. Section 1.103-8(b)(4)(iii) provides that facilities that are functionally related and subordinate to residential rental units include facilities for use by the tenants, such as swimming pools and similar recreational facilities, parking areas, and other facilities reasonably required for the project. The examples given by section 1.103-8(b)(4)(iii) of facilities reasonably required for a project specifically include units for resident managers or maintenance personnel.

Based on the above, a cost is incurred in the construction of a low-income housing building under section 42(d)(1) if it is:

- (1) included in the adjusted basis of depreciable property subject to section 168 and the property qualifies as residential rental property under section 103, or
- (2) included in the adjusted basis of depreciable property subject to section 168 that is used in a common area or provided as a comparable amenity to all residential rental units in the building.

The Taxpayer contends that each state housing credit agency determines what costs are includible in eligible basis when determining the financial feasibility of a project under section 42(m)(2)(A). Consequently, the Taxpayer concludes that once the Agency has verified and accepted the Taxpayer's costs, the Service is bound by the Agency's determination. We disagree.

Section 42(m)(2)(A) provides, in part, that the housing credit dollar amount allocated to a project shall not exceed the amount the housing credit agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project through the credit period. A state housing credit agency's responsibility under section 42(m)(2)(A) to determine the financial feasibility and viability of a project in no way abrogates the Service's authority and responsibility to administer the low-income housing tax credit and its various provisions.

The Taxpayer also cites Notice 88-116, 1988-2 C.B. 449, as authority for its position that all construction costs are costs includible in eligible basis. Taxpayer's interpretation of Notice 88-116 is misplaced.

Notice 88-116, in part, provides guidance on what costs will be considered construction, reconstruction, or rehabilitation costs for the limited purpose of qualifying certain buildings for post-1989 credits after the (then) section 42(n) statutory sunset of a state's authority to allocate post-1989 credit. For this limited purpose, the notice provides that certain costs would satisfy the definition of construction, reconstruction or rehabilitation costs— but only if these costs are included in the eligible basis of the building. In other words, under the notice, a condition to qualifying a new building for post-1989 credit was that construction costs must also be included in eligible basis. The notice does not define what costs are included in eligible basis nor, as the Taxpayer proposes, does it stand for the proposition that all construction-related costs are included in eligible basis.

Developer Fee Note

Generally, debt, whether recourse or nonrecourse, is includible in the basis of property. Commissioner v. Tufts, 461 U.S. 300 (1983); Crane v. Commissioner, 331 U.S. 1, 11 (1947). However, the obligation must represent genuine, noncontingent debt. Nonrecourse debt is not includible if the property securing the debt does not reasonably approximate the principal amount of the debt, or if the value of the

underlying collateral is so uncertain or elusive that the purported indebtedness must be considered too contingent to be includible in basis.⁴

Recourse liabilities are generally includible in basis because they represent a fixed, unconditional obligation to pay, with interest, a specific sum of money. However, the mere fact that a note is recourse on its face is not determinative.⁵ For example, an obligation, whether recourse or nonrecourse, will not be treated as a true debt where payment, according to its terms, is too contingent, or repayment is otherwise unlikely. A liability is contingent if it is dependent upon the happening of a subsequent event, such as the earning of profits.⁶

In the case of both recourse and nonrecourse debt, the underlying inquiry is the same: whether, in the light of all the facts and circumstances, the debt is reasonably certain to be paid.⁷ In determining whether an obligation represents genuine, noncontingent debt, important factors include: the intent of the parties, as evidenced by subjective and objective factors; the relationship between the parties; the term of the obligation; its interest rate; whether the principal amount is fixed or contingent; payment terms prior to maturity; sources of repayment; and, in general, the ability of the obligor

⁴ See Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); Gibson Products Co. v. United States, 637 F.2d 1041, 1047-48 (5th Cir. 1981); Estate of Baron v. Commissioner, 83 T.C. 542 (1984) aff'd, 798 F.2d 65 (2^d Cir. 1986).

⁵ See Roe v. Commissioner, T.C. Memo. 1986-510, aff'd without published opinion sub nom., Sinclair v. Commissioner, 841 F.2d 394 (5th Cir. 1988).

⁶ See Denver & Rio Grande Western R.R. Co. v. United States, 505 F.2d 1266, 1269 (Ct. Cl. 1974); Rev. Rul. 80-235, 1980-2 C.B. 229; Rev. Rul. 81-262, 1981-2 C.B. 164 (franchise fee). See also, with respect to purportedly recourse debt, Durkin v. Commissioner, 872 F.2d 1271, 1277 (7th Cir. 1989), cert. denied, 493 U.S. 824 (1989) (recourse debt nearly certain to be converted to nonrecourse debt); Graf v. Commissioner, 80 T.C. 944, 948 (1983) (payments made only out of profits); Houchins v. Commissioner, 79 T.C. 570, 600 (1982) (taxpayer's personal liability scheduled to expire two and a half years after execution of agreement); Herrick v. Commissioner, 85 T.C. 237, 251, 255, 260 (1985) (taxpayer lacked a profit motive, purchase price was excessive, no scheduled payments had been made on the notes, and creditor made no demand for payment); Waddell v. Commissioner, 86 T.C. 848, 901-902 (1986), aff'd, 841 F.2d 264 (9th Cir. 1988) (note convertible to nonrecourse); Upham v. Commissioner, 923 F.2d 1328, 1335 (8th Cir. 1991) (none of the partners expected creditor to enforce recourse note).

In a recent case involving the issue of eligible basis under § 42, Corbin West Limited Partnership v. Commissioner, T.C. Memo. 1999-7, the court held that the amount of the note was not includible in basis, even though the note was recourse against the partnership.

⁷ See, e.g., Graf, 80 T.C. at 948; Durkin, 872 F.2d at 1276; Ortmayer v. Commissioner, 265 F.2d 848, 855 (7th Cir. 1959), rev'g. on this issue 28 T.C. 64 (1957).

to make the payments on the obligation. See generally cases cited in notes 4-7 above.

On its face, the Developer Fee Note in the present case is an obligation on the part of the Taxpayer to pay a fixed amount, with interest, at maturity. While, prior to maturity, payments of principal and interest are dependent on cash flow or receipts from capital transactions, all remaining principal and accrued interest are payable at maturity, in 13 years. Neither the note itself nor the Partnership Agreement states explicitly whether the source-of-payment restrictions apply at maturity.

Nevertheless, the note is a debt of the Taxpayer, not just the General Partners, and—while payments are contingent prior to maturity—it is payable at maturity for a fixed amount that is not contingent. Second, although the sources of payment in Article X of the Agreement are contingent, and Developer as creditor could not foreclose on any security interest in any specific asset, at maturity the General Partners “shall be obligated” to contribute to the Taxpayer in an amount sufficient “to enable the Taxpayer to repay the Turnkey Development Note in full” (emphasis added), and the Taxpayer appears to be obligated to reimburse the General Partners if possible. See section 4.1. of the Partnership Agreement. Finally, the last sentence of Article III.C. (which is referenced in section 6.9, which is referenced in the note) grants the General Partners a special power, within one year prior to maturity, to refinance the permanent mortgage, or pledge partnership assets to borrow from a non-affiliate, in order to repay in full the Turnkey Development Note.

While the question is not free from doubt, on balance we believe that—assuming Developer sought to enforce the debt—a court would find either (1) that the note was recourse against the Taxpayer at maturity, or (2) at minimum, the Taxpayer was obligated to use good-faith efforts to refinance the mortgage and/or borrow from “non-affiliates,” if possible, in order to pay off the note at maturity. Since the Taxpayer's ability to refinance or borrow at that point would be largely a function of the value of the Taxpayer's assets, the note would, at minimum, be “recourse” in that sense.

As noted above, whether an obligation is currently includible in basis rests on an evaluation of all the facts and circumstances. On balance, at least from a legal standpoint, we conclude that the Developer Fee Note is sufficiently substantial and noncontingent so as to be includible in basis under sections 1012 and 1016.⁸

Our conclusion that the Developer Fee Note is genuine, noncontingent debt is conditioned, first and foremost, on the fact that repayment of the note is backed

⁸ As an accrual-basis taxpayer, the Taxpayer is subject to the rules for the timing of items such as deductions—and basis—under section 461. For the reasons discussed above, and subject to the factual caveats discussed below, we conclude that the obligation represented by the Developer Fee Note meets the “all-events test,” including the “economic performance” requirement, in section 1.461-(a)(2)(i). The fact of the liability has been established and is not subject to significant contingencies; the amount of the liability is determinable; and, since the liability arose in connection with services already provided to the taxpayer, economic performance has occurred.

by the equity the Taxpayer has in the assets, primarily the real estate in Project A, beyond the General Partners' guarantee—plus cash flow, if any, from operating the project.⁹ Although we do not address the value of the specific assets, the following factors are important for factoring the real estate value into the determination of the overall issue.

In an influential case in this area, Gibson Products v. United States, 637 F.2d 1041 (5th Cir. 1981), the court, ruling that a note payable from oil and gas well production was too contingent to support a deduction, observed:

We conclude on this record that the nonrecourse note from the McNeil/Midwest joint venture to Galaxy was not a true loan. In a true lending transaction, the borrower normally possesses assets nearly equal or greater in value than the amount of indebtedness, whether or not those assets are hypothecated to secure the debt. In addition, the lender usually expects the borrower to maintain those assets at such a level until the obligation is satisfied. Moreover, in a true lending transaction, there exists the reasonable likelihood that the lender will be repaid in light of all reasonably foreseeable risks. In other words, there must be 'a reasonable basis for the prediction that the ability of the borrower to repay will not be wholly or substantially contingent upon the success or failure of the business venture.'

* * *

The single most important factor dictating our conclusion that the transaction between Galaxy and McNeil/Midwest was not a true loan is the fact that the total combined assets of both joint venturers were not sufficient to pay the note on or before the maturity date, even if McNeil/Midwest was so inclined, absent production from any of the leases.

637 F.2d at 1047 (emphasis added, citations omitted).¹⁰ In our view, this represents the appropriate approach to take with respect to the valuation issue in the present case: if, as a factual matter, the value of the Taxpayer's assets available for the Taxpayer to borrow against—plus the value, if any, of the General Partners' guarantee, and less the value of the obligations to which the Developer Fee Note is subordinate—is less than the amount of the Developer Fee Note, that would be a strong indication that, in the words of the Gibson opinion, there was no "reasonable likelihood that the lender will be

⁹ See, e.g., Chamberlain v. Commissioner, T.C. Memo. 1987-20; Estate of Baron, 83 T.C. 542 at 552:

The transaction involved herein is also distinguishable from a situation where the acquisition of rental real estate or equipment is involved. In such situations, not only are the payments on a nonrecourse note usually fixed in amount, but the obligation to make the payments is not, by its terms, confined to the income produced, and the underlying property has a potential value apart from the income stream which it is expected to generate. Moreover, the value of the underlying property is not so directly and totally dependent upon public acceptance as is the case with a master recording or similar property

¹⁰ See also id. at 1048-49 n. 14 and accompanying text. Note that the court's reasoning in Gibson Products was broad enough to encompass secured and unsecured assets, as well as a hypothetical "recourse" scenario in which the borrower, despite the nonrecourse nature of the note, is nevertheless "inclined" to pay.

repaid in light of all reasonably foreseeable risks.” In such a case, the Developer Fee Note should be treated as contingent unless, and only to the extent that, it is actually paid.

Second, it has been asserted that the Developer does not have the ability to act independently in relation to the Taxpayer and would therefore be unlikely to enforce the Developer Fee Note. The factual finding of Developer independence is contingent on a number of factors, including the prior course of dealings between Individual 1 and Individual 2 and their employees, the likelihood that ownership of the creditor or debtor entities might change, and the consequences arising from the sale of the property and the subsequent payment of the Developer Fee Note. Since the nature of the dealings between the parties is a significant factor under the case law,¹¹ it would clearly affect our conclusion.

Third, it has been asserted that the General Partners would be unlikely to fulfill their potential obligation to contribute to the Taxpayer in order to pay the Developer Fee Note at maturity. However, we do not believe that the General Partners’ guarantee is the sole source of repayment of the note at maturity. It is one factor supporting our conclusion above, and to the extent it is determined that the General Partners’ guarantee is of little or no value, this fact would affect the conclusion that the debt is includible in basis.

Lastly, one factor in determining whether an obligation is likely to be paid is whether the creditor parted with value when the obligation was incurred. In most cases, where the debt is incurred in return for property—as in the case of a purchase-money note—this question is phrased in terms of whether the amount of the note exceeds the true fair market value of the property. In this case, the debt was incurred in return for the provision of services. Accordingly, if it is determined that the amount of the note, combined with the cash previously paid to Developer, exceeded the fair market value of the services provided by Developer, this would be an objective factor indicating that the note was unlikely to be paid.

CAVEAT

No opinion is expressed on whether Project A otherwise qualifies for the low-income housing tax credit under section 42. Similarly, we express no opinion on the allocable portion of the Developer Fee Note that may belong with land versus building costs. A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

-END-

¹¹ See, e.g., Corbin West, T.C. Memo 1999-7.