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MEMORANDUM FOR [redacted] GROUP MANAGER 1436
NORTH CENTRAL DISTRICT

FROM: Deputy Assistant Chief Counsel
(Income Tax & Accounting)

SUBJECT: City of Grand Forks, ND, Downtown Commercial Rehabilitation Program

This technical assistance responds to your memorandum dated March 25, 1998, and to your subsequent facsimile inquiry of January 11, 1999. You requested technical assistance on the tax treatment of loans received by business taxpayers under the Business and Industry Disaster Loan Program ("old program") and the Business Assistance Loan/Grant Program ("new program"). Technical Assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be cited as precedent.

ISSUES:

(1) If none of the other tax principles discussed in this memorandum applies to a business that borrows money under the old or new program, what are the federal income tax consequences to a business taxpayer of--

(a) a loan made under the old program (and not refinanced under the new program)?

(b) a loan made under the new program?

(c) a loan made under the old program and refinanced under the new program?

(2) Is § 1033 of the Internal Revenue Code (pertaining to deferral of gain recognition in the event of an involuntary conversion) available to a taxpayer borrowing money under the old or the new program?

(3) Must a taxpayer borrowing money under the old or the new program take any income arising from the loan into account in determining the availability of a loss deduction under § 165?

(4) Is § 118 (pertaining to contributions to capital) applicable to a corporate taxpayer borrowing money under the old or the new program?

(5) Does the City of Grand Forks have any information reporting obligations under the Code with respect to loans under the old or the new program?

CONCLUSIONS:

(1) (a) A loan made under the old program is issued with bond issuance premium equal to 25 percent of the stated principal amount of the loan. In general, the business will take the full amount of the premium into income at maturity.

(b) A loan made under the new program is generally treated the same way as a loan made under the old program except that the bond issuance premium is equal to 40 percent of the stated principal amount of the loan.

(c) When a loan made under the old program is refinanced under the new program, the loan is repurchased for a new loan and then retired. As a result, the business generally will have bond issuance premium income and discharge of indebtedness income at the time of the refinancing, and deductions for unstated interest over the term of the new loan.

(2) Although the amount of the loan forgiven under the old or new program is, in general, gross income to the recipient taxpayers under § 61(a), a loan recipient who incurred physical damage as a result of the flood may treat the amount of the loan forgiveness as received on account of the flood damage and elect, in accordance with § 1033(a)(2), to defer recognition of gain to the extent the recipient expended an amount at least equal to the amount of the loan forgiveness to purchase qualified replacement property. If the taxpayer makes such an election, then under § 1033(b)(2) the basis of the replacement property shall be the cost of such property decreased by the amount of gain not recognized.

(3) Only the amount of loan forgiveness income that is treated as having been received on account of the flood damage must be taken into account in determining whether a loss deduction is available to the taxpayer under § 165.

If, in a prior taxable year, the taxpayer properly took a casualty loss deduction for the flood damage, the amount of loan forgiveness income that is received on account of flood damage is considered a recovery of an amount previously deducted under § 165 and must be included in the taxpayer's income in the taxable year received to the extent required by tax benefit principles.

(4) Whether a government's contemplated forgiveness of loan principal (to the extent not included in income under tax benefit principles) constitutes an excludible nonshareholder contribution to capital under § 118 may vary from taxpayer to taxpayer, depending on the facts and circumstances of the case. We will be happy to provide further assistance if you need it in any specific case. In general, we note both that § 118 applies only to corporate taxpayers and that § 362(c) provides that a corporate taxpayer takes a zero basis in any property purchased with capital contributed by a nonshareholder.

(5) The City of Grand Forks does not have any information reporting obligations under the Code with respect to bond premium income or discharge of indebtedness income of borrowers under the loan programs.

FACTS:

The City of Grand Forks, ND (City) suffered extensive flood and fire damage in April 1997. The area encompassing the City subsequently was declared a Presidential disaster area.

Public Law 105-18, 111 Stat. 158, 198-9, appropriated to the United States Department of Housing and Urban Development an additional amount ("for Community development block grants fund") "for use only for buyouts, relocation, long-term recovery, and mitigation in communities affected by the flooding in the upper Midwest and other disasters in fiscal year 1997... ." The City received funds under this appropriation to assist in its recovery from the flood. Some of those funds were used to establish loan programs to provide financial assistance to Grand Forks businesses as described below. Under the first program, known as the Business and Industry Disaster Assistance Program, loans were first made in June or July of 1997. The old program was closed in June 1998, and was replaced by the Business Assistance Loan/Grant Program.

<u>Eligibility for and terms of the old program</u>. The Business and Industry Disaster Assistance Program ("old program") was established to provide financial assistance to Grand Forks businesses directly affected by the 1997 flood.

Business taxpayers that: (1) were located within the city limits of Grand Forks; and (2) suffered physical loss from the April 1997 flood were eligible under the old program to receive loans. Depending on the number of persons employed by the business, the maximum amounts of the loans ranged from $20,000 to $50,000.[1] The borrowed money was substantially unrestricted and could be used for a variety of business purposes, including a building, equipment, inventory, or working capital.

Loans made under the old program are issued for cash equal to their stated principal amount. The loans have a 3-year term. They accrue interest at 0 percent. Principal is payable at maturity. However, if the business is still located within the city limits of Grand Forks on the maturity date of the loan ("old contingency"), 25 percent of the stated principal amount is forgiven.[2]

<u>Eligibility for and terms of the new program</u>. The Business Assistance Loan/Grant Program ("new program") replaces the old program. The new program requires "economic distress" but not necessarily "physical loss" as a result of the 1997 flood.

A business is eligible for a loan under the new program if: (1) it is located within the city limits of Grand Forks; (2) it existed at the time of the 1997 flood under current ownership; (3) it submits information about employee income (to support an aggregate 38 percent low- to moderate-income requirement); (4) the owners of the business have their primary residences within approximately 50 miles of Grand Forks; (5) the business provides financial information (for example, tax returns) showing it is viable and self-sustaining, and (6) the business provides financial information (for example, sales tax records) showing economic distress resulting from the flood. Businesses that suffered a physical loss will be given priority over those that suffered only an economic loss. Some businesses that borrowed money under the new program had not borrowed money under the old program.

Under the new program, an eligible business may borrow up to $35,000 per employee with a maximum of $100,000. Of this $100,000, the maximum that can come from Community Development Block Grant funds is $40,000 (40 percent of the total assistance).

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[1] An eligible business could borrow a maximum of $20,000 if it had 10 or fewer full time equivalent ("FTE") employees. A business with more than 10 FTE employees could borrow $2,000 per FTE employee, up to a maximum of $50,000.

[2] Under the original terms of the old program, loans under the old program accrued interest at 8 percent, compounded annually with payment of the interest deferred until maturity. All accrued interest (as well as 25 percent of the stated principal amount) would be forgiven upon satisfying the old contingency. In September of 1998, the Grand Forks city council voted to forgive the interest on all of the loans under the old program, even if the old contingency is not subsequently satisfied. (A business should not have taken a deduction for accrued interest for the period before September of 1998.)

Loans originally made under the new program are issued for cash equal to their stated principal amount. The loans have a 15-year term. They accrue interest at 0 percent. Sixty percent of the stated principal amount is payable in 120 equal monthly payments over the last 10 years of the loan's term. The remaining 40 percent of the stated principal amount is payable at maturity. However, if the business continues to satisfy the eligibility requirements for the new program on the 3-year anniversary of the issue date of the loan ("new contingency"), the 40 percent of the stated principal amount payable at maturity is forgiven.[3]

<u>Loans made under the old program and refinanced under the new program</u>. In September of 1998, the Grand Forks city council voted to permit refinancing, under the new program, of old loans upon their maturity if the old contingency is satisfied. If the old contingency is not satisfied, the business will not be eligible to refinance the loan.

Upon refinancing, an additional 15 percent of the original stated principal amount of the old loan will be forgiven and the business will be required to repay the remaining 60 percent of the stated principal amount in 120 equal monthly payments beginning 2 years after the refinancing date. [4]

LAW AND ANALYSIS:

Discussion of Issue (1)(a)
What is the tax treatment of a loan made under the old program?

> **A loan made under the old program is issued with bond issuance premium equal to 25 percent of the stated principal amount. In general, the business will take the full amount of the premium into income at maturity.**[5]

Loans under the old program provide for multiple possible payment schedules. The stated payment schedule consists of a single payment of 100 percent of the loan's stated principal amount on the maturity date. This payment schedule applies if the old contingency is not satisfied. An alternative payment schedule to the stated payment

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[3] If the business ceases operations before the maturity date of the loan, the principal balance becomes due and payable immediately.

[4] If the business ceases operations before the maturity date of the new loan, the principal balance becomes due and payable immediately.

[5] For purposes of this memorandum, we assume that the loans under both the old program and the new program are debt instruments for federal income tax purposes.

schedule consists of a single payment of 75 percent of the loan's stated principal amount on the maturity date. This payment schedule applies if the old contingency is satisfied, resulting in the forgiveness of 25 percent of the loan's stated principal amount otherwise payable at maturity.

If a loan provides for multiple possible payment schedules, the regulations attempt to select one of the payment schedules and use it to determine the yield and maturity of the loan (the "expected payment schedule"). Section 1.1272-1(c) of the Income Tax Regulations. If the loan provides the borrower with an option that will cause an alternative payment schedule to apply, the regulations assume that the borrower will exercise or decline to exercise the option in order to achieve the lowest possible yield. For a loan under the old program, the lowest possible yield is achieved for the payment schedule consisting of a single payment of 75 percent of the loan's stated principal amount on the maturity date. Thus, the regulations select this payment schedule on the assumption that the business will remain within the city limits. Section 1.1272-1(c)(5).

A loan is issued with bond issuance premium if its issue price is greater than its stated redemption price at maturity.[6] The amount of the bond issuance premium is the excess of the issue price over the stated redemption price at maturity. Section 1.163-13(c). If the loan provides for multiple possible payment schedules and has an expected payment schedule under § 1.1272-1(c), the expected payment schedule is used to determine whether the loan is issued with bond issuance premium. Section 1.163-13(e)(3). The issue price of a loan issued for cash is equal to the amount of the cash. Section 1273(b)(2). For a loan under the old program, the issue price is equal to 100 percent of its stated principal amount and, based on its expected payment schedule, the stated redemption price at maturity is equal to 75 percent of its stated principal amount. Thus, the loan has bond issuance premium equal to 25 percent of its stated principal amount.

Bond issuance premium is generally allocated over the term of the loan and taken into account by reducing the borrower's deductions for qualified stated interest. Section 1.163-13(d)(1). For a loan under the old program, however, the expected payment schedule does not provide for any stated interest payments. Thus, allocated bond issuance premium is carried forward until retirement, at which time the business takes it into account as ordinary income. Section 1.163-13(d)(4).

For a loan issued with bond issuance premium, the allocation of the premium over the term of the loan (under § 1.163-13(d)(3)) produces matching reductions in the adjusted

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[6] The stated redemption price at maturity for a loan is the sum of all payments on the loan other than qualified stated interest. In general, qualified stated interest is stated interest that is unconditionally payable at least annually at a single fixed rate over the entire term of the loan. Section 1.1273-1(b) and (c).

issue price of the loan (under § 1.1275-1(b)(2)). As a result, for a loan under the old program, the amount of bond issuance premium income at retirement is equal to the amount by which the adjusted issue price has been reduced below the original issue price. If the old contingency is satisfied, the loan is retired at maturity for a price equal to its adjusted issue price and there is no income or deduction other than the bond issuance premium income.[7]

There are two final points. First, § 7872 does not apply to loans under the old program.[8] Second, the forgiveness of the interest on all of the loans under the old program by the city council in September of 1998 did not produce a deemed exchange of the original loans for modified loans under § 1001.[9]

The following example illustrates the treatment of a loan made under the old program:

> Assume a business borrows $10,000 under the old program and the stated principal amount of the loan is $10,000. If the old contingency is satisfied, only $7,500 will be due at maturity. Otherwise, the full stated principal amount of $10,000 will be due at maturity.

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[7] If the old contingency is not satisfied, the income from the bond issuance premium will be offset by an interest deduction under § 1.163-7(c) in an amount equal to the excess of the retirement price (100 percent of the stated principal amount) over the adjusted issue price (issue price minus bond issuance premium). Thus, the net income and deduction equals $0.

[8] Section 7872 recasts certain below-market loans into a combination of an at-market loan and an up-front cash payment. However, § 7872 will not apply to loans under the old program unless they are determined to be tax avoidance loans under § 7872(c)(1)(D). The old program was established by the City of Grand Forks with federal funds to provide financial assistance to Grand Forks businesses affected by the 1997 flood. Therefore, the interest arrangements of a loan under the new program are not structured with a principal purpose of avoiding federal tax and the loan is not a tax avoidance loan for purposes of § 7872(c)(1)(D).

[9] A deemed § 1001 exchange would have produced income to the business when the interest was forgiven. Section 1.1001-3(b) provides that a significant modification of a loan results in a deemed § 1001 exchange. There was a modification of the loans under the old program, but it was not significant because there was no change in the yield. There was no change in the yield because the payment schedules used in the comparison were the expected payment schedules of the original and modified loans, and they were identical. Sections 1.1001-3(c)(1)(i), 1.1001-3(e)(2), and 1.1001-3(f)(1).

> Under these facts, the issue price of the loan is $10,000, the expected payment schedule consists of a single payment of $7,500 on the maturity date, the stated redemption price at maturity is $7,500, and the loan is issued with bond issuance premium equal to $2,500 ($10,000 issue price minus $7,500 stated redemption price at maturity). The business will take that $2,500 of bond issuance premium into income at maturity. If the old contingency is satisfied, there are no further tax consequences.
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> If the old contingency is not satisfied, the loan is retired at maturity for a price of $10,000, which exceeds its adjusted issue price of $7,500 by $2,500. That excess is deductible as interest. Thus, the net income and deduction equals $0.

Discussion of Issue (1)(b)
What is the tax treatment of a loan made under the new program?

> **A loan made under the new program is generally treated the same way as a loan made under the old program except that the bond issuance premium is equal to 40 percent of the stated principal amount of the loan.**

As under the old program, loans under the new program provide for multiple possible payment schedules. The stated payment schedule of a loan consists of 120 equal monthly payments over the last 10 years of the loan's term and a payment of 40 percent of the stated principal amount on the maturity date. The amount of the monthly payments is equal to 60 percent of the stated principal amount divided by 120. This payment schedule applies if the new contingency is not satisfied and the business continues to operate until maturity. The expected payment schedule for the loan consists of the same 120 equal monthly payments as in the stated payment schedule. This payment schedule applies if the new contingency is satisfied, resulting in the forgiveness of the 40 percent of the stated principal amount payable at maturity, and the business continues to operate until maturity.[10]

The following example illustrates the treatment of a loan originally made under the new program:

> Assume a business borrows $10,000 under the new program and the stated principal amount of the loan is $10,000. If the new contingency is satisfied and the business continues to operate until maturity, the

[10] For every date between the issue date and the maturity date, there is also an alternative payment schedule that applies if the business ceases operations on that date.

business will make monthly payments of $50 ($6,000/120) over the last 10 years of the loan's 15-year term. If the new contingency is not satisfied and the business continues to operate until maturity, the business will make monthly payments of $50 over the last 10 years of the term and a payment of $4,000 at maturity.[11]

Under these facts, the issue price of the loan is $10,000, the expected payment schedule consists of monthly payments of $50 over the last 10 years of the term, the stated redemption price at maturity is $6,000, and the loan is issued with bond issuance premium equal to $4,000 ($10,000 issue price minus $6,000 stated redemption price at maturity). The business will take that $4,000 of bond issuance premium into income at maturity. If the new contingency is satisfied and the business continues to operate until maturity, there are no further tax consequences.

If the new contingency is not satisfied and the business continues to operate until maturity, the loan is retired at maturity for a price of $4,000, which exceeds its adjusted issue price of $0 ($10,000 issue price minus $4,000 bond issuance premium, minus $6,000 of monthly principal payments) by $4,000.[12] That excess is deductible as interest. Thus, the net income and deduction equals $0.

Discussion of Issue (1)(c)
What is the tax treatment of a loan made under the old program and refinanced under the new program?

When a loan made under the old program is refinanced under the new program, the loan is repurchased for a new loan and then retired. As a result, the business generally will have bond issuance premium income and discharge of indebtedness income at the time of the refinancing, and deductions for unstated interest over the term of the new loan.

A loan under the old program ("old loan") can be refinanced under the new program only on its original maturity date and only if the old contingency is satisfied (resulting in forgiveness of 25 percent of its stated principal amount). If an old loan is refinanced (resulting in a "new loan"), an additional 15 percent of the old loan's stated principal

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[11] If the business ceases operations before maturity, the remaining payments become due and payable immediately.

[12] Adjusted issue price is decreased by the amount of payments other than qualified stated interest and allocated bond issuance premium. Section 1.1275-1(b).

amount is forgiven (resulting in a stated principal amount for the new loan equal to 60 percent of the stated principal amount of the old loan). The term of the new loan is 12 years. The stated payment schedule of the new loan consists of 120 equal monthly payments over the last 10 years of its term. The amount of the monthly payments is equal to the stated principal amount of the new loan divided by 120. There is no stated interest.[13]

The regulations view a refinancing as a modification of the old loan regardless of the form of the refinancing. If the modification is significant, the refinancing results in a taxable exchange in which the new loan is issued for the old loan and the old loan is retired. Sections 1.1001-3(a)(1) and 1.1001-3(b).

The modification of the old loan is significant because it results in the material deferral of scheduled payments. When the old loan is refinanced, the 75 percent portion of the stated principal amount that would otherwise be payable at maturity (after forgiveness) is reduced by an additional 15 percent and rescheduled into 120 monthly payments that begin after an additional two years. All of the payments due on the old loan are deferred for periods ranging from 2 to 12 years. This deferral significantly exceeds the deferral protected by the safe-harbor in the regulations, which is one and one-half years for loans under the old program. Therefore, the deferral is material, the modification is a significant modification, and the refinancing results in a taxable exchange for purposes of § 1001. Sections 1.1001-3(e)(3) and 1.1001-3(f)(1).[14]

The regulations thus treat the refinancing as a transaction in which the old loan is repurchased through the issuance of the new loan and the old loan is retired. Because the new loan is issued for nonpublicly traded property (the old loan), its issue price generally would be determined under § 1274. However, § 1274 does not apply because the total payments due under the new loan are less than $250,000. Section 1274(c)(3)(C). Thus, the issue price of the new loan is equal to its stated redemption price at maturity. Section 1273(b)(4). The stated redemption price at maturity of the new loan is equal to its stated principal amount (60 percent of the stated principal amount of the old loan).

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[13] If the business ceases operations prior to maturity, the principal balance of the new loan becomes due and payable immediately.

[14] The modification is also a significant modification under the change-in-yield rule in § 1.1001-3(e)(2).

Although § 1274 will not apply to the new loan, a portion of its stated principal amount might be treated as unstated interest under § 483.[15] That portion is equal to the excess of the sum of the payments due under the new loan over the sum of the present values of those payments. Section 1.483-2(a)(2). The present value of a payment is determined by discounting it from its due date to the refinancing date using a discount rate. That discount rate is the lowest long-term adjusted applicable Federal rate ("AFR") for the month in which the refinancing occurs and for the two prior months.[16] Sections 1.483-2(b)(2), 1.483-3(a), 1.1274-4(a)(i). (The AFRs, including the adjusted AFRs, for each month are published in the Internal Revenue Bulletin.)

If a portion of the stated principal amount of the new loan is treated as unstated interest under § 483, the business will be able to deduct the interest for federal income tax purposes (assuming the interest is otherwise deductible). The timing and amounts of the business's interest deductions will be determined under §§ 1.483-1(a)(2) and 1.446-2.

Under § 108(e)(10), the business will have discharge of indebtedness income on the refinancing equal to 15 percent of the old loan's stated principal amount plus the portion of the new loan's issue price that is treated as unstated interest under § 483. This amount is equal to the excess of the adjusted issue price of the old loan over the repurchase price. Section 1.61-12(c)(2)(ii). As explained in the discussion of Issue (1)(a), the adjusted issue price of the old loan at maturity will be equal to 75 percent of the old loan's stated principal amount because of the downward adjustment for bond issuance premium. The repurchase price is the issue price of the new loan reduced by the portion that is treated as unstated interest under § 483. Sections 1.61-12(c)(2)(ii) and 108(e)(10).

The business will have bond issuance premium income on the retirement of the old loan equal to 25 percent of the old loan's stated principal amount. As explained in the discussion of Issue (1)(a), the old loan was issued with bond issuance premium equal to 25 percent of its stated principal amount. Because the refinancing will occur on the old loan's maturity date, all of the bond issuance premium will have been allocated and carried forward. The business will take the bond issuance premium into account as ordinary income when the old loan is retired.

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[15] This portion might be zero, for instance, if the total payments due under the new loan are less than $3,000. Section 1.483-1(c).

[16] The use of the adjusted AFR for tax-exempt obligations is implied by the legislative history of § 1274. Joint Committee on Taxation Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 116 (1984).

The following example illustrates the treatment of an old loan refinanced under the new program:

> A business borrows $10,000 under the old program and the stated principal amount of the old loan is $10,000. The old contingency is satisfied. As a result, $2,500 of the stated principal amount of the old loan is forgiven. The business refinances the old loan under the new program. As a result, an additional $1,500 of the stated principal amount of the old loan is forgiven. Thus, the stated principal amount for the new loan is $6,000. The stated payment schedule of the new loan consists of 120 monthly payments of $50 beginning two years after the refinancing. The portion of the stated principal amount of the new loan that is treated as unstated interest is $1,600 (assuming a long-term adjusted AFR of 4.53 percent, compounded monthly[17]).
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> Under these facts, the issue price of the old loan is $10,000, the expected payment schedule consists of a single payment of $7,500 on the maturity date, the stated redemption price at maturity is $7,500, the loan is issued with bond issuance premium equal to $2,500 ($10,000 issue price minus $7,500 stated redemption price at maturity), and the adjusted issue price on the refinancing date is $7,500 ($10,000 issue price minus $2,500 bond issuance premium).
>
> The issue price of the new loan is $6,000, the stated payment schedule consists of 120 monthly payments of $50 beginning 2 years after the refinancing, and the stated redemption price at maturity is $6,000.
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> On the refinancing, the business recognizes bond issuance premium income of $2,500 and discharge of indebtedness income computed as follows. For purposes of § 108(e)(10), the issue price of the new loan ($6,000) is reduced by the portion of the stated principal amount of the new loan that is treated as unstated interest under § 483 ($1,600), resulting in a reduced issue price of $4,400. Thus, the business recognizes discharge of indebtedness income of $3,100 ($7,500 adjusted issue price of the old loan minus $4,400 reduced issue price of new loan).
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> Assuming the unstated interest ($1,600) is deductible, the business will deduct it as it accrues over the term of the new loan (assuming the business uses an accrual method of accounting) or as payments are

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[17] The AFR in the example has been rounded to two decimal places. The exact amount of $1,600 of unstated interest assumes an AFR of 4.53408 percent, compounded monthly.

made on the new loan (assuming the business uses the cash method of accounting). The amount of unstated interest that is deductible each year is determined under § 1.446-2.

Discussion of Questions (2) - (4):
§§ 1033, 165, 111, and 118

It is apparent from the analysis under Questions 1(a) -1(c) that a borrower, in satisfying either the old contingency or the new contingency realizes income. This income -- which we refer to as "loan forgiveness income" -- generally consists of bond issuance premium income alone, although "loan forgiveness income" also includes a component of discharge of indebtedness income in the case of a borrower under the old program who refinances under the new program.

Having established that a borrower realizes loan forgiveness income upon the maturity date of a borrower's original loan (assuming that the borrower satisfied the relevant contingency), we now address the question whether any exclusion or nonrecognition provisions apply to the loan forgiveness income amount. As is detailed below, there are some circumstances in which the provisions of §§ 1033, 165, or 118, as well as the tax benefit rule, may apply to some or all of that amount.

Discussion of Question (2):
Deferral under § 1033

Although the amount of loan forgiveness income is, in general, gross income to the recipient taxpayers under § 61(a), the deferral provisions of § 1033 may apply to some or all of that amount under certain circumstances. In particular, we conclude that a loan recipient who incurred physical damage as a result of the flood may treat the amount of the loan forgiveness income as received on account of the flood damage and elect, in accordance with § 1033, to defer recognition of gain to the extent the recipient expended an amount at least equal to the amount of the loan forgiveness income to purchase qualified replacement property.

Section 1001(a) provides generally that gain or loss from the sale or other disposition of property is measured by the difference between the amount realized on the disposition and the property's adjusted basis. Section 1001(c) provides generally for the current recognition of gains or losses. Section 1033, which allows for the deferral of gain when property is compulsorily or involuntarily converted, is a specific exception to the general rule of § 1001(c).

For § 1033 purposes, an involuntary conversion may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. Floods and fires are instances of involuntary conversions.

An involuntary conversion may include a conversion into money. Section 1033(a)(2)(A) provides that if property, as a result of its destruction in whole or in part, is involuntarily converted into money, the gain, if any, shall be recognized except to the extent that the electing taxpayer (within the period specified in § 1033(a)(2)(B)) purchases qualified replacement property (property similar or related in service or use to the converted property). In that event, the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property.

Section 1033(b)(2) provides that if property is converted into money, and the taxpayer purchases qualified replacement property and elects nonrecognition of gain under § 1033(a)(2), then the basis of the replacement property shall be the cost of such property decreased by the amount of gain not recognized.

The City of Grand Forks established the old and new programs for the purpose of assisting businesses that sustained physical damage as a result of the April, 1997, flood and fire. One goal of both programs is to aid recovery from flood damage. Accordingly, taxpayers who realize loan forgiveness income under the old or new program are eligible to defer recognition of the gain realized if they otherwise comply with the provisions of § 1033.

In order to qualify for full deferral under the provisions of § 1033, the taxpayer must expend the amount of the forgiven principal on replacement property that is similar or related in service or use to the converted property. Expenditures made to repair or replace damaged property are treated as amounts spent to purchase qualifying replacement property. Generally, there is no tracing requirement as to the source of funds spent to purchase qualified replacement property with respect to the application of § 1033. Thus, if a taxpayer obtained a loan from another source, such as the Small Business Administration (SBA), and used the proceeds of that loan (which is not income under § 61(a)) to purchase qualified replacement property, it would be entitled to defer gain under § 1033 with respect to the amount of the principal forgiven under the Program, to the extent of the cost of the replacement property.

It is necessary, however, to ensure that amounts spent to purchase qualified replacement property are not counted twice in applying § 1033. If the taxpayer also received insurance proceeds as a result of the flood (which may be income under § 61(a)) and used those proceeds to purchase replacement property, that property would not also qualify as replacement property for purposes of deferring the gain realized with respect to the loan forgiveness income. Rather, the taxpayer would be required to purchase additional qualifying replacement property in the amount of the loan forgiveness income in order to defer income recognition with respect to it.

However, the amount, if any, by which the taxpayer's total recovery (insurance proceeds, loan forgiveness income, grants, etc.) exceeds its physical damage must be included in income under § 61(a). Income resulting from the recovery of economic losses cannot be deferred under § 1033.

Discussion of Question (3):
Application of § 165

Section 165(a) permits a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." The point at which a loss is "sustained" is governed by § 1.165-1(d)(2)(i) of the Income Tax Regulations, which links the timing of a loss deduction with the possibility of reimbursement. Thus, § 1.165-1(d)(2)(i) provides that if a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of § 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Similarly, § 1.165-1(c)(4) provides that the amount of insurance or other compensation received must be taken into account in determining the amount of loss actually sustained.

Section 1.165-1(d)(2)(iii) links a loss deduction with the tax benefit rule of § 111 in those circumstances in which a taxpayer deducts a loss in one year, derives a tax benefit from the deduction, and receives reimbursement for that loss in a subsequent taxable year. The tax benefit rule ordinarily requires the recognition of gross income in such cases because the receipt of the compensation is fundamentally inconsistent with the prior deduction. Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983), 1983-1 C.B. 50.

Because the existence of "compensation" under § 165(a) affects the extent and timing of a loss deduction (and may trigger tax benefit income), we must determine whether the principal forgiven under the old and new programs is "compensation" to the borrowing businesses. We conclude that it was, to the extent of the business's physical damage. The loans made under the old and new programs were intended, at least in part, to compensate those who have suffered casualty losses. See generally Estate of Bryan v. Commissioner, 74 T.C. 725, 727-28 (1980) (money received from a trust fund established to compensate individuals who had been defrauded by attorneys was compensatory within the meaning of § 165(a) and thus reduced the allowable deduction; statutory language "insurance or otherwise" construed by court as referring to payments that are "structured to replace what was lost" and that are "similar to insurance"); Rev. Rul. 71-160, 1971-1 C.B. 75 (taxpayer received compensation within the meaning of § 165(a) to the extent that an SBA loan was canceled pursuant to the subsequently enacted Disaster Relief Act; casualty loss proper when taken because taxpayer could not have anticipated the debt cancellation, but tax benefit income resulted from debt cancellation); Shanahan v. Commissioner, 63 T.C. 21 (1974) (decision cites, and is consistent with, Rev. Rul. 71-160).

Thus, a taxpayer suffering damage from the 1997 flood and fire would have been precluded from taking a casualty loss deduction to the extent it had a reasonable prospect of having income as a result of participating in the old program. Moreover, a taxpayer who properly took a casualty loss deduction (either because it lacked a reasonable prospect of recovering compensation or because the prospective compensation was insufficient to reimburse the loss) and who has income under the old or new (or both) programs must account for that income under tax benefit principles.

The following example illustrates the interplay of sections 165 and 1033 in this case:

FMV of business prior to flood	$100,000	
FMV of business after flood	(85,000)	
Loss	$15,000	
Basis in business	$10,000	
Casualty loss deduction (lower of loss or basis)	$10,000	
Compensatory income from Programs	$22,000	
Tax Benefit Income (amount of previously-taken deduction)	$10,000	
Gain (potentially deferred under section 1033)		$12,000

Discussion of Question (4)
Can the loan forgiveness income amount be treated as a nonshareholder contribution to capital by corporate borrowers?

As previously noted, § 61(a) provides generally that gross income means all income from whatever source derived, unless excluded by law. Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.[18] Because some of the loan recipients under the old and new programs are corporations, a question arises whether such recipients can treat the

[18] Because § 118 by its terms applies only to corporations, businesses that operate as, for example, sole proprietorships or partnerships may not use the exclusion therein provided.

amount of forgiven principal as an excludible nonshareholder contribution to capital. Given the highly factual nature of contribution-to-capital cases, we cannot provide a blanket answer to that question. We can, however, provide general information which may be useful in determining the outcome of a specific case, and we are available to discuss facts pertaining to particular taxpayers as needed.

The legislative history of section 118 provides, in part, as follows:

> This [§ 118] in effect places in the Code the Court decisions on the subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.

S. Rep. No. 1622, 83d Cong., 2d Sess.18-19 (1954).

Section 1.118-1 provides, in part, that § 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production.

Much of the authority underlying the contribution to capital concept is found in decisions of the United States Supreme Court. For example, in Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), the Court determined that payments made by prospective customers to an electric utility company to cover the cost of extending the utility's facilities to their homes were not contributions to capital, but rather were part of the price of service (and thus were includible in the company's income). In reaching its decision, the Court noted that the customers intended no contribution to the company's capital.

Later, the Supreme Court determined that payments to a corporation by community groups to induce the location of a factory in their community represented a contribution to capital. Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950). The Court concluded that the contributions made by the citizens were made without anticipation of any direct service or recompense, but rather with the expectation that the contribution would prove advantageous to the community at large. Id. at 591. The contract entered into by the community groups and the corporation provided that in exchange for a contribution of land and cash, the corporation agreed to construct a factory, operate it for at least 10 years and meet a minimum payroll. Id. at 586.

Subsequently, in United States v. Chicago, B. & Q. R. Co., 412 U.S. 401 (1973), the Supreme Court, in determining whether a taxpayer was entitled to depreciate the cost of certain facilities that had been funded by the federal government, held that the governmental subsidies were not contributions to the taxpayer's capital. The Court recognized in Chicago, B. & Q. R. Co. that its holding in Detroit Edison Co. had been qualified by its decision in Brown Shoe Co., with the distinguishing characteristic between those two cases being the differing purposes motivating the respective transfers. Unlike Detroit Edison, the only expectation of the contributors in Brown Shoe Co., was that their contributions might prove advantageous to the community at large. As the Court noted in Chicago, B. & Q. R. Co., the transfers made in Brown Shoe Co. were contributions to the transferee's capital, rather than income to the transferee, because the transfers were not for direct service or recompense, but only for the purpose of obtaining an advantage for the general community.

In Chicago, B. & Q. R. Co., the Court also stated that other characteristics of a nonshareholder contribution to capital were implicit in Detroit Edison Co. and Brown Shoe Co. The Court distilled from the two prior cases some of the characteristics of a nonshareholder contribution to capital.

(1) It must become a permanent part of the transferee's working capital structure;

(2) It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee;

(3) It must be bargained for;

(4) The asset transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value; and

(5) The assets ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

As the foregoing indicates, for a transfer to be a nonshareholder contribution to the capital of a corporation, there must be both a proper motivation on the part of the transferor and requisite effects on the economic position of the transferee. In the present situation, it appears that the transferor motivation test will be met, because the City of Grand Forks apparently is receiving a direct service or recompense in exchange for the forgiven principal. Whether the requisite economic effects on the transferee corporation exist is dependent on the facts of each particular case. The loan proceeds must have been used to acquire capital assets to the extent of the forgiven principal.

Section 362(c)(2) provides that the basis of any property acquired by a corporation is reduced to the extent of any nonshareholder contribution to capital. Thus, if the amount of forgiven principal is treated as a nonshareholder contribution to capital under § 118, that amount would not be included in the basis of the assets acquired. The effect of § 362(c)(2), of course, is to defer rather than permanently exclude the forgiven principal from income.

Discussion of Question (5)
Information reporting

As discussed elsewhere in this memorandum, a borrower under either the old program, the new program, or both, is required to include in gross income bond premium income, discharge of indebtedness income, or both, unless some deferral provision applies specifically to the borrower's situation. This is true whether or not information reporting (that is, filing a return with the Service and sending the taxpayer a statement containing the information included in that return) is required of any person under the Code with respect to the income.

Although the Code requires information reporting by payors of various kinds of income, we do not believe any provision of the Code requires the City to report amounts of bond premium income borrowers realize upon satisfying the old or new contingency.

Section 6050P provides rules requiring an applicable entity that discharges indebtedness of any person to file a return regarding the discharge and send the person a statement containing the information included in that return. Section 6050P generally defines an applicable entity to include various types of financial institutions, such as banks and credit unions, among others, and federal executive, judicial, or legislative agencies. This definition does not include state or local governmental entities.

Section 6050P is the only section requiring information reporting with respect to discharge of indebtedness. No information reporting with respect to discharge of indebtedness is required of the City under § 6050P, however, because it does not fall within the definition of an applicable entity.

This technical assistance is advisory only, and is intended to call attention to well-established principles of tax law that apply in the situation described. Taxpayers uncertain whether these principles or interpretations of tax law should apply to their situations should consider seeking a private letter ruling or, if appropriate, technical advice. Procedures for issuing letter rulings and technical advice are in Rev. Proc. 99-1, 1999-1 I.R.B. 6, and Rev. Proc. 99-2, 1999-1 I.R.B. 73, respectively.