OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Low-income housing credit

This Field Service Advice responds to your memorandum dated May 24, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND</u>:

P	=
Q	=
R	=
S	=
T	=
<u>a</u>	= $
<u>b</u>	= $
<u>c</u>	= $
<u>d</u>	= $
<u>e</u>	= $
<u>f</u>	= $
<u>g</u>	= $
<u>h</u>	= $
<u>i</u>	= $
<u>j</u>	= $
<u>k</u>	= $

l = $
v =
w =
x =
y =
Date 1 =
Date 2 =
Date 3 =
Year 5 =
Year 6 =
Year 7 =
Year 30 =
Year 34 =

ISSUE: Whether three promissory notes executed by P are includible in eligible basis for purposes of calculating the allowable amount of low-income housing tax credits.

CONCLUSION:

The three promissory notes are includible in eligible basis for purposes of calculating the allowable amount of low-income housing tax credit.

FACTS:

On Date 1, P purchased a v-unit apartment building for $a, with $b allocated to the buildings and $c allocated to the land. In addition to the partner's cash capital contributions, P financed the construction of the building through three loans entered into on Date 1 for a total principal amount of $d. First, P executed a nonrecourse promissory note to Q in the amount of $e, bearing interest of w percent to be paid on or before Year 30. The note was secured by a mortgage. The projected annual payment was $f. P made some payments on the note.

Second, P executed a nonrecourse promissory note to R totaling $g, bearing interest of x percent. The funds were derived from private foundation funds. Both principal and interest were due on or before Year 30. The note was secured by a second mortgage. P made no payments on the note.

Third, P executed a nonrecourse promissory note to S in the amount of $h, bearing interest of x percent. Both principal and interest were due on or before Year 30. The note was secured by a third mortgage. A portion of the loan, $i, was from the T (federal funds). P made no payments on the note.

P placed the apartment building in service on Date 2 and began claiming the low-income housing credit. The three mortgages were included in eligible basis. Because of various items of disallowed costs, however, the eligible basis of the property was reduced to $j. P=s applicable percentage for the low-income housing credit was nine percent.

In Year 5, P experienced financial difficulties. As a result, on Date 3, P executed a nonrecourse promissory note to the S in the amount of $k, bearing interest of x percent. Annual payments on the note were equal to y percent of the net cash flow for the preceding year, as determined by the preceding year's annual audited financial statements. The remaining balance was due on or before Year 34. The proceeds of the loan were used to extinguish the note to Q. The note was secured by a mortgage (which was junior to the two existing mortgages.) P made no payments on the note.

In each of Year 6 and Year 7, P claimed a low-income housing credit in the amount of $l. In determining the amount of credit, P included the three original notes in calculating the eligible basis.

LAW AND ANALYSIS

A low-income housing credit is allowed against the tax imposed for the taxable year for an investment in a qualified low-income housing building. I.R.C. '' 42(a), 38(a)(2), (b)(5). For any taxable year in a ten-year credit period, the amount of the low-income housing credit is equal to the applicable percentage of the qualified basis of each qualified low-income building. I.R.C. '' 42(a), (g)(1). The qualified basis of any qualified low-income building for any taxable year is an amount equal to the applicable fraction of the eligible basis. I.R.C. ' 42(c)(1)(A). In general, the eligible basis of a new building is its adjusted basis as of the close of the first taxable year of the credit period. I.R.C. ' 42(d)(1). If, however, during a taxable year in the compliance period a federal grant is made with respect to a low-income building or the operation thereof, the eligible basis of the building for the taxable years is reduced to the extent of the federal grant. I.R.C. ' 42(d)(5). The compliance period is the period of 15 taxable years beginning with the first taxable year of the credit period with respect thereto. I.R.C. ' 42(i)(1).

The adjusted basis is the cost of the underlying property. I.R.C. '' 42(d), 1012. ACost@ is the amount paid for the property in cash or other property. Treas. Reg. ' 1.1012-1(a). Nonrecourse debt may constitute part of a taxpayer=s basis in property as long as the fair market value of the property securing the debt reasonably approximates the principal amount of the debt. Commissioner v. Tufts, 461 U.S. 300 (1983); Crane v. Commissioner, 331 U.S. 1 (1947); Estate of Baron v. Commissioner, 798 F.2d 65, 68 (2d Cir. 1986), aff=g 83 T.C. 542 (1984); Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048-49 (9th Cir. 1976), aff=g 64 T.C. 752 (1975); Odend=hal v. Commissioner, 80 T.C. 588, 604-05 (1983), affd. on this issue and remanded, 748 F.2d 908 (4th Cir. 1984); Corbin West Ltd. Partnership v. Commissioner, T.C. Memo. 1999-7. To the extent the debt exceeds the fair market value, no investment exists as payments of the purchase price in accordance with the design of the parties will yield no equity to the purchaser. Estate of Franklin, supra.

Conversely, a taxpayer may not include in his basis a liability that, for any economic reason, does not constitute a genuine debt. Estate of Upham v. Commissioner, 923 F.2d 1328, 1335 (8th Cir. 1991), aff=g T.C. Memo. 1989-253; Estate of Baron, 798 F.2d at 68-69; Chamberlain v. Commissioner, T.C. Memo. 1987-20. When debt used to purchase an asset is unlikely to be paid by the taxpayer, the debt does not represent a bona fide capital investment by the taxpayer and will be excluded from the basis of the asset. Estate of Upham, 923 F.2d at 1335; Durkin v. Commissioner, 872 F.2d 1271, 1276 (7th Cir. 1989), aff=g 87 T.C. 1329 (1986); Estate of Baron v. Commissioner, 83 T.C. 542, 550-53 (1984), aff=d, 798 F.2d 65 (2d Cir. 1986). A debt may be considered as unlikely to be paid by the taxpayer when the principal is to be paid solely out of exploitation proceeds; the loan is nonrecourse, shielding the taxpayer from personal liability; and the purchase price of the asset unreasonably exceeds its fair market value. Durkin, 872 F.2d at 1276; Estate of Baron, 83 T.C. at 550-53. The rationale for excluding such debt from basis is that the taxpayer is not entitled to enjoy benefits for which there has been no economic incentive or expectation of repayment. Estate of Baron, 798 F.2d at 68-69; Estate of Franklin, 544 F.2d at 1048-49.

Under the present facts, there is no indication that the fair market value of the building does not reasonably approximate the principal amount of the debt. In addition, the three promissory notes are each with independent third party lenders and reflect a legally binding debtor-creditor relationship. Finally, because P held real property, there may be value apart from the income stream that could support the payment of the notes so that the value of the underlying collateral is not so uncertain or elusive as to be considered too contingent to justify inclusion of the notes in basis. Based on the above, the three notes are properly considered as part of the cost basis of the building.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Federal Subsidy

For a new building placed in service in 1987, the building is treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof. I.R.C. ' 42(i)(2)(A). A Abelow market Federal loan@ is any loan funded in whole or part with Federal funds if the interest rate payable on such loan is less than the applicable Federal rate in effect under section 1274(d)(1) as of the date on which the loan was made. I.R.C. ' 42(i)(2)(D).

For projects allocated credits in calendar years after 1989, however, a building will not be considered federally subsidized if a loan would be a below market Federal loan solely because of federal assistance under section 106, 107, or 108 of the Housing and Community Development Act of 1974. Thus, if the portion of the loan from S, or $i, relates to section 106, 107, or 108 of the Housing and Community Development Act of 1974, the project could still qualify for the nine percent credit. I.R.C. '' 42(b)(1), (2); (i)(2)(D).

At-risk Rules

There are at-risk rules for the low-income housing tax credit in the case of nonrecourse financing. I.R.C. ' 42(k). Specifically, they provide recharacterization rules in the context of qualified non-profit loans (as defined under section 42(k)(2)) which fall more than one percentage point below the applicable Federal rate as of the time such financing was incurred. I.R.C. ' 42(k)(3). In certain situations, the related qualified basis (to which the financing relates) of the project is deemed to equal the present value of this financing based on the applicable Federal rate. I.R.C. ' 42(k)(3).

There is a potential application of the at-risk rules of section 42(k), which would apply a present value calculation to the eligible credit base. In particular, there may be an application of the at-risk rules beginning in Year 5, when the refinancing of the property increased the amount of nonrecourse financing at an interest rate below the applicable Federal rate. Given the complexity of the at-risk rules, we recognize that additional assistance may be needed to determine the correct tax treatment under this provision. Accordingly, the National Office is willing to provide further advice on this issue as necessary.

Please call if you have any further questions.

By: ______________________________
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