Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:POSTF-152711-01
PJSewell

date: June 4, 2002

to: LMSB Examination
Team Manager, Group 1254
Attn: Joe Costelow, Revenue Agent

from: Associate Area Counsel (LMSB)

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subject: **Request for LMSB Division Counsel Assistance - Accrual and Deduction of Interest Expense**

[redacted]
EIN: [redacted]
Last Known Address: [redacted]

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect of privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

* * *

This is a supplement to our advice to you dated May 21, 2002 based on modifications proposed by the National Office. Please note the following changes:

p.6, paragraph beginning with "Cohen" - Deleted citation "accord Rev. Rul. 70-367, 1970-2 C.B. 37."

p.6, paragraph beginning with "When the debtor" - Deleted the following citation and accompanying parenthetical text at end of paragraph: "See, e.g., Odend'hall, 748 F.2d at 912 (stating "[i]f, as a matter of fact, the fair market value of the property is less than that financed by a nonrecourse loan, the authorities hold that the principal of the nonrecourse

loan which exceeds fair market value does not represent a real investment in the property by a taxpayer and he may not include the nonrecourse amount in his basis for depreciation.")."

We have attached a revised copy of our earlier advice with the changes as indicated above.

If you have any questions on this matter, please call me at (303) 844-2214 ext. 224.

DAVID J. MUNGO
Associate Area Counsel (LMSB)

By:_____
PAMELA J. SEWELL
Attorney (LMSB)

Attachment:
as stated

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[redacted]
EIN: [redacted]
Last Known Address: [redacted]

This memorandum supersedes our advice to you dated May 21, 2002 based on the two modifications discussed in the attached memorandum. The conclusions and the majority of the advice remain unchanged. This memorandum should not be cited as precedent.

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ISSUE

Whether the interest that [redacted] accrued and capitalized but never paid was properly deducted for the tax years [redacted] through [redacted].

CONCLUSION

Yes, the Service should treat the taxpayer's interest as properly accrued and deducted because it is unable to

establish that the amount of nonrecourse indebtedness exceeded the fair market value of the property at the time of the loan restructuring.

FACTS

[redacted] (hereinafter the "Partnership") is a Delaware limited partnership using the accrual method of accounting and the calendar year as its tax year. The Partnership was formed in [redacted] as a [redacted] In that year, the Partnership purchased a [redacted] commercial block consisting of [redacted] (hereinafter the "Property").[1] The total purchase price was $[redacted].

[redacted] financed the Property's construction and held the mortgage prior to the acquisition of the Property by the Partnership in [redacted] At the time of the Partnership's acquisition of the Property, [redacted] financed the acquisition by a loan of $[redacted]. There was no relationship between any of the partners in the Partnership and [redacted]. Also, [redacted] (hereinafter "[redacted]") lent the Partnership $[redacted] which was secured by a Deed of Trust dated [redacted].

At the time of the [redacted] purchase, the Property was also encumbered by an $[redacted] liability in favor of [redacted]. Upon taking title to the Property, the Partnership accepted no liability for the repayment of this [redacted] loan.

By [redacted], substantial interest had accrued on the [redacted] note and the loan was restructured. Under the [redacted] loan restructuring agreement, [redacted] made the following new nonrecourse loans: one loan for $[redacted], one loan for $[redacted],

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[1] [redacted] was the initial purchaser of the Property on [redacted]. [redacted] assigned the Property to the Partnership on [redacted].

and a loan for Additional Facility in the amount of $[redacted].[2] The loan restructuring provided that the proceeds from the [redacted] and [redacted] Loans were used to pay down the amount previously owed under the original [redacted] note which reduced the balance owed on this loan to $[redacted]). The [redacted] note was modified to effectuate the [redacted] loan restructuring agreement.

The interest rate on the [redacted], [redacted] and Existing Loans was [redacted] percent per annum, compounded annually, for the period from [redacted] until [redacted] and [redacted] percent per annum, compounded annually, from [redacted] until Maturity on [redacted]. The interest rate on the [redacted] Loan was [redacted] percent per annum above the Prime Rate. The interest rate on the [redacted] loan was [redacted] percent per year, compounded monthly.

Interest on the loans was to be paid out of cash flow. Briefly, cash flow was defined as revenue plus disbursements of "Additional Facility" proceeds[3] less costs as annually budgeted. Interest on the [redacted] [redacted], and [redacted] was payable from [redacted] percent of the aggregate cash flow. Interest on the [redacted] loan was payable out of [redacted] percent of aggregate cash flow. Unpaid interest was capitalized to principal.

As of [redacted] the appraised value of the real property, excluding personal property, was $[redacted]. [redacted] performed the appraisal.

As of [redacted], the obligation to [redacted] totaled $[redacted] for the [redacted], [redacted] and [redacted], consisting of principal in the amount of $[redacted] and accrued interest in the amount of $[redacted]. From [redacted] through [redacted], $[redacted] of interest accrued on the [redacted], [redacted] and [redacted]. The obligation to [redacted] totaled $[redacted] consisting of principal in the amount of $[redacted] and accrued interest in the amount of $[redacted]. From [redacted] through [redacted] $[redacted] of interest accrued on the [redacted] loan.

On [redacted], the debt was again restructured. In

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[2] The numbering on the loans is in accord with the Loan Agreement.

[3] A $[redacted] from [redacted] and [redacted].

one of the acknowledgments to this second restructuring agreement, the borrower stated that it had no equity in the property. [redacted] discharged the accrued but unpaid interest and restructured the original principal of the [redacted] [redacted] and [redacted]. Only $[redacted] of the accrued interest and original principal on the obligation to [redacted] was forgiven. After the second restructuring, the total aggregate indebtedness to [redacted] was $[redacted] and the total aggregate indebtedness to [redacted] was $[redacted]. As consideration for restructuring the loans, all of the Partnership's indebtedness was reclassified as recourse.

LEGAL DISCUSSION

I.R.C. § 163 allows a deduction for all interest paid or accrued within the taxable year on indebtedness. In order to be deductible, interest must be paid on genuine indebtedness. Knetsch v. United States, 364 U.S. 361 (1960).

Section 7701(a)(25) provides that the term "paid or accrued" shall be construed according to the method of accounting upon the basis of which taxable income is computed.

The standard for determining whether an accrual basis taxpayer has incurred a deductible expense for federal income tax purposes is governed by the "all events" test. See United States v. General Dynamics Corp., 481 U.S. 239, 242 (1987); Treas. Reg. § 1.461-1(a)(2). Treas. Reg. § 1.461-1(a)(2)(i) provides that under the accrual method of accounting, a liability is taken into account in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be ascertained with reasonable accuracy, and economic performance has occurred with respect to the liability.

Economic performance with respect to interest occurs as the interest cost economically accrues in accordance with the principles of relevant provisions of the Code. Treas. Reg. § 461-4(e). The legislative history explains that this means, in general, computation of interest at a constant rate with compounding. See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 265.

1. Whether the Interest Accrual was Contingent

In order to find that there is a contingency such that all the events creating the liability have not occurred in the taxable year, there must be a contingency as to the fact of the liability itself. Restore, Inc. v. Commissioner, T.C. Memo. 1997-571 (citing United States v. Hughes Properties, Inc., 476 U.S. 593, 601-03 (1986)(payment not contingent where the fact of the liability was fixed by State law); Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 406 (5th Cir. 1969)). A contingency related only to the timing of the required payment will not prevent a taxpayer from satisfying the all events test. Hughes Properties, 476 U.S. at 604.

Interest may not currently be deducted if payment is so contingent that the event that triggers the payment may never occur:

> [A] deduction for interest may be taken on an accrual basis only in the year in which the taxpayer's liability to pay becomes fixed or is already existing; not in the year when the taxpayer decides that it is convenient or good business to pay or accrue the interest. An obligation is not sufficiently definite for accrual until all events occur which fix and determine the liability. . . . A liability that is uncertain, indefinite, or contingent may not be accrued and deducted until the year when it becomes certain, definite, and no longer contingent.

Guardian Investment Corp. v. Phinney, 253 F.2d 326, 330 (5th Cir. 1958)(citations omitted). Similarly, the court in Pierce Estates, Inc. v. Commissioner, 195 F.2d 475 (3d Cir. 1952), stated that:

> If the liability to pay the item of expense is wholly contingent upon the happening of a subsequent event, the item cannot be regarded as incurred or deductible as accrued until the year in which by the occurrence of the event the contingent liability becomes an absolute one.

Id. at 477.

In this case, the interest rate on the loans was clearly specified and fixed in the [redacted] loan restructuring agreement. While interest on the loans was to be paid out of aggregate

cash flow,[4] a contingency related only to the timing of the required payment will not prevent a taxpayer from satisfying the all events test. See, e.g., Hughes Properties, 476 U.S. at 604. Thus, the accrual of interest was not contingent because it was clearly specified and "ascertained with reasonable accuracy." Treas. Reg. § 1.461-1(a)(2)(i).

2. Whether the Debt was Genuine

As a general rule, an accrual basis taxpayer may deduct interest on a liability as it accrues, notwithstanding the unlikelihood of payment:

> The rule which emerges from the decision of this Court is that deductions for accrued interest are proper where it cannot be categorically said at the time these deductions were claimed that the interest would not be paid, even though the course of conduct of the parties indicated that the likelihood of payment of any part of the disallowed portion was extremely doubtful.

Cohen v. Commissioner, 21 T.C. 855, 857 (1954), acq. 1954-2 C.B. 4. Thus, if the accrual of an item results in a genuine obligation on the part of the debtor to pay the creditor, the fact that actual payment of the obligation itself may be deferred does not preclude deduction of the item. See United States v. Anderson, 269 U.S. 422 (1926).

Nevertheless, if the debt on which the interest accrual is based is not genuine, then there can be no deduction under I.R.C. § 163. In order to justify an interest deduction, a taxpayer must actually pay for the use or forbearance of money.

When the debtor has the choice of abandoning the property that secures the debt rather than making payment, courts have allowed an interest deduction only in those situations where the debtor has an economic incentive to satisfy the obligation. Odend'hall v. Commissioner, 748 F.2d 908, 913 (4th

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[4] Interest on the loans was to be paid out of cash flow--interest on the [redacted] and [redacted] Loans was payable from [redacted] percent of the aggregate cash flow and interest on the [redacted] Loan was payable out of the remaining [redacted] percent.

Cir. 1984), cert. denied, 471 U.S. 1143 (1985); Estate of Franklin v. Commissioner, 544 F.2d 1045, 1047 (9th Cir. 1976). See also Ames v. Commissioner, T.C. Memo. 1990-87, aff'd, 937 F.2d 616 (10th Cir. 1991), and aff'd sub. nom., Hildebrand v. Commissioner, 967 F.2d 350 (9th Cir. 1992). Thus, it follows that where the amount of a nonrecourse obligation bears no reasonable relationship to the value of the property securing payment of the debt, the debt will not ordinarily be recognized for tax purposes as in such circumstances it is unlikely the obligation will be paid.

The Tax Court and the Second, Fourth, Ninth, Tenth, and Eleventh Circuits have held that nonrecourse indebtedness should not be treated as genuine indebtedness if, at the time of acquisition, the principal amount of the debt greatly exceeds the fair market value of the property securing the debt.[5] See, e.g., Estate of Franklin, 544 F.2d at 1047. Thus, the proper inquiry is between the amount of indebtedness and the value of the underlying collateral. Lebowitz v. Commissioner, 917 F.2d 1314, 1318 (2d Cir. 1990). The events subsequent to the time of purchase that affect the value of the security are irrelevant; rather the valuation test is applicable as of the time of purchase. Id.

At the time of acquisition in [redacted], [redacted] lent the Partnership $[redacted] and [redacted] lent the Partnership $[redacted]. The total purchase price was $[redacted].

After the [redacted] restructuring, the Partnership's total nonrecourse indebtedness to [redacted] on the [redacted], [redacted] and [redacted] was $[redacted]. The nonrecourse indebtedness to [redacted] remained unchanged after the [redacted] restructuring.

On [redacted], the debt was again restructured and all of the Partnership's remaining indebtedness was reclassified as recourse. [redacted] discharged accrued but unpaid interest

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[5] The Third Circuit modified this approach. In Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988), the Third Circuit held that a taxpayer who has acquired property subject to nonrecourse indebtedness was entitled to deduction for interest and depreciation attributable to nonrecourse indebtedness to the extent of the property's fair market value where the nonrecourse indebtedness was far larger than the property's fair market value at the time of acquisition. Id. at 276-77.

totaling $[redacted] on the [redacted], [redacted] and [redacted] [redacted] discharged accrued interest and unpaid principal totaling $[redacted]. The total remaining aggregate indebtedness to [redacted] was $[redacted] and to [redacted] was $[redacted] after the second restructuring.

Neither the taxpayer nor [redacted] have any records of the appraised value of the real property prior to [redacted] [redacted]. Furthermore, the Service is unable to establish the value of the property in relation to the amount of the nonrecourse indebtedness for [redacted]. As of [redacted] the appraised value of the real property, excluding personal property was $[redacted]; however, the [redacted] appraisal should not be considered in determining whether the value of the property equaled the face amount of the nonrecourse note in [redacted]. See Lebowitz, 917 F.2d at 1318. Thus, unless the Service obtains a valuation for [redacted] which establishes that the amount of nonrecourse indebtedness exceeded the fair market value at the time of the loan restructuring, the Service should treat the taxpayer's accrual and capitalization of interest as proper.

If you have any questions on this matter, please call me at (303) 844-2214 ext(b)(6)[redacted]

DAVID J. MUNGO
Associate Area Counsel (LMSB)

By:_____
PAMELA J. SEWELL
Attorney (LMSB)