



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

Attention:

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated January 11, 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.

LEGEND:

Agency	=
City	=
State	=
Partnership	=
Redevelopment Plan	=
Project Area	=
County	=
Year 1	=
Year 2	=

Year 3	=
Year 4	=
Year 5	=
Year 6	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
x	=
a	=
b	=
c	=
d	=
e	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
Series A Bonds	=
Series B Bonds	=

ISSUES:

1. Whether a city and redevelopment agency's agreement to reimburse a partnership for the costs of developing real property constitutes an obligation within the meaning of I.R.C. § 103, causing interest payments received under the agreement to be tax-exempt.
2. In the event the agreement constitutes a valid obligation, whether such obligation is an industrial development bond or private activity bond.
3. Whether payments the partnership is required to make to the city and the agency under the agreement are deductible business expenses.

CONCLUSION:

1. While the agreement appears to satisfy the basic criteria for an obligation within the meaning of section 103, this is merely the first step in determining whether interest on such obligation is tax-exempt. Issues relating to the tax-exempt status of a municipal financing arrangement must be coordinated with Exempt Organizations. Further, there is insufficient information to determine whether payments received under the agreement actually represent interest payments, irrespective of their nature as tax-exempt.
2. The agreement provides for the development of private property in addition to property generally defined as nonprivate infrastructure. The city and the agency also receive payments under the agreement from users of the developed infrastructure property as a source of payment for the principal and interest on the obligation. If it is concluded that this is an obligation subject to the rules of section 103 and 141 through 150, the provisions of the agreement warrant additional examination to determine whether the obligation is an industrial development bond.
3. Before allowing a deduction for amounts for which the partnership is obligated under the agreement, it must establish that such amounts were either paid or incurred and were ordinary and necessary business expenses. Section 265 is inapplicable as it has not been established to what extent, if any, payments received constitute tax-exempt interest. Further, section 265(a)(1) only prohibits the deduction of an item otherwise allowable as a deduction, which is attributable to tax-exempt interest only if such item is deductible under section 212.

FACTS:

The facts, as stated below, are based solely on the information submitted and the representations in your memorandum.

City is a municipal corporation formed under the laws of State. Agency is a public body corporate and politic duly organized and existing pursuant to the community redevelopment law of State. Agency is authorized to acquire real and personal property, including through the exercise of eminent domain, to incur indebtedness to finance redevelopment in project areas, to pledge tax increments for the payment of principal and interest on such indebtedness, and to permit owner participation in the redevelopment of planned project areas.

Partnership is a State limited partnership in the business of real estate development. In Year 1, Partnership was the legal and equitable owner of

residentially zoned property located within City. The property Partnership owned encompassed an area known as Project Area.

In Year 1, City approved the Redevelopment Plan. Pursuant to the Redevelopment Plan, City also approved a specific plan for the development of Project Area. Development of Project Area called for the eventual construction of more than x residential homes, park lands and school sites, as well as related infrastructure items. In Year 2, City and Agency contracted with Partnership for the purpose of effectuating the development of Project Area. The terms of the agreement between City and Agency and the Partnership are set forth in an Owner Participation Agreement (the "OPA") dated Date 1. The OPA was subsequently amended on Date 2, Date 3 and again on Date 4. The Date 4 amendment ("Amendment 3") purportedly incorporates all prior amendments to the OPA. The rights and obligations of the parties, as we understand them, under the OPA and Amendment 3 are set forth below.

The OPA

Pursuant to the OPA, Partnership agrees to undertake the development of Project Area in accordance with City's Redevelopment Plan. The development of Project Area refers to the overall development of Project Area including the construction and development of infrastructure items as well as the acquisition of land and construction necessary for the residential and other private uses set forth in City's plan.

The OPA provides that Partnership is to incur the costs associated with completing the overall development plan of Project Area, including the construction of infrastructure items. In turn, Agency agrees to reimburse the partnership for all development costs after approval of such costs. Development costs, as defined by the OPA, include all costs and obligations incurred by Partnership in connection with construction of infrastructure items, including overhead costs, land acquisition costs, costs of legal and financial services, and project management fees. Project management fees under the OPA equal m% of the sums paid by Partnership to any contractor performing infrastructure development in Project Area pursuant to competitive bid.

As set forth in the OPA, infrastructure items include, but are not limited to, flood control and drainage; sewer collection, treatment and disposal; public streets and traffic control; school facilities; water supply facilities; police and fire protection facilities; parks and recreation facilities; and landscaping. The agreement states that infrastructure items refer generally to non-residential, non-commercial and non-

industrial land used for non-residential, non-commercial and non-industrial purposes.

Upon completion of the infrastructure items and acceptance by Agency or City, the OPA requires Partnership to transfer title to the infrastructure items to Agency or City clear of all encumbrances. Partnership is to retain ownership of improved property not related to infrastructure items for resale to residential and commercial builders.

Under the OPA, development costs are to be paid from tax revenues, agency revenues and revenues derived therefrom. Tax revenues are defined as the tax increment revenues generated within Project Area. Agency revenues are defined as redevelopment participation fees, builder's fees and similar fees to be paid pursuant to owner participation agreements by and between participating owners and Agency. The phrase "tax revenues, agency revenues and revenues derived therefrom" includes tax revenues and agency revenues as defined above. It further includes money advanced by third parties and secured directly or indirectly by tax revenues and/or agency revenues, including, but not limited to, the proceeds of tax allocation bonds, notes or other forms of indebtedness, interest earnings derived from tax revenues and/or agency revenues and other moneys available to Agency.

With respect to the timing of reimbursement payments, development costs relating to land acquisition are to be paid at the time title to the related infrastructure item is transferred to and accepted by Agency. Other development costs are to be paid upon approval. Development costs are only to be paid, however, to the extent of tax revenues, agency revenues and revenues derived therefrom on hand. Development costs, approved but not paid at the times specified in the OPA, are to be paid when and to the extent that such revenues are available to Agency.

Pursuant to the original OPA, development costs bear interest at the rate of n% per annum from the later of the date approved by Agency or paid by Partnership until the date of repayment. The OPA provides that repayments are to be credited first to the repayment of the principal amount of all development costs and the excess, if any, to accumulated interest.

Revised Agreement as of Amendment 3

Citing changed circumstances and the existence of unresolved disputes, the parties amended the OPA for a third time on Date 4. While many of the provisions contained in Amendment 3 are apparently the product of the prior amendments, we refer primarily to Amendment 3, as it purportedly incorporates all prior amendments and is the latest known version of the agreement.

First, Amendment 3 explicitly names City as a party to the agreement where the OPA merely named Partnership and Agency. Further, under Amendment 3, all unpaid Development Costs bear interest at the rate of 0%, rather than the n% stated in the original OPA. In addition, reimbursement payments to the partnership are first credited to the repayment of accumulated interest as opposed to crediting such payments to the principal amount of unpaid development costs as provided in the original agreement.

The definition of agency revenues is expanded to include "Assessments and Sewer Fees" payable to Partnership under the Sewer Agreement entered Date 5. The definition of sewer fees includes a \$a fee per residential unit located in Project Area.

Amendment 3 also provides that, upon the request of Partnership, City and/or Agency shall require that all developers and landowners having an interest in the property within Project Area (other than Partnership), and who are benefitted by the implementation of the infrastructure items, reimburse Partnership for the development costs relating to the implementation of the plan. The reimbursement shall be in an amount equal to the economic benefit received by the benefitted party with respect to such infrastructure item. Amounts received by City will be paid to Agency and shall be deemed agency revenues to be utilized by Agency in the payment of development costs.

Amendment 3 modifies the definition of development costs under the agreement to include an amount equal to p% of all development costs, including those that relate directly or indirectly to the implementation of infrastructure items, as allowance for the overhead expenses incurred by Partnership. In addition, the agreement provides that the taxpayer will receive q% of all development costs, excluding the allowance for overhead expenses, as an allowance for management reimbursement. As with the original OPA, however, there is no statement as to the total expected development costs for Project Area.

In addition, Amendment 3 provides for certain payments to be made by Partnership to City and Agency upon the occurrence of a stated event. Specifically, on the earlier of: 1) the date on which proceeds of the Year 3 bond issue are paid to Partnership pursuant to a facilitation agreement¹ or 2) the date following the date on which Partnership has been fully paid from tax revenues an amount equal to \$b, together with interest at the rate of m%. Partnership is required to pay annually to City and Agency an amount equal to r% of residual tax revenues for the duration of the plan and s% thereafter. Moreover, s% of sewer fees payable to Partnership as agency revenues are to be paid to City and the Agency. Amendment 3 states that

¹ From the information provided, it appears that the Year 3 bonds referenced in Amendment 3 were not issued until Year 4.

Partnership's payment obligation to City and Agency is in mitigation of disputes between the parties and negative impacts to City and Agency resulting from the development of the project area.

For purposes of determining Partnership's payment obligation, residual tax revenues are defined as all tax revenues payable to the taxpayer under the agreement, less certain costs. Residual tax revenues also include funds advanced by third parties and secured by residual tax revenues including the proceeds of tax allocation bonds. They do not include tax revenues required for the payment of debt service on the Series A Bonds or tax revenues required for the payment of debt service on the Year 3 bonds when issued. If an event occurs that reduces the amount of available tax revenues, there is a corresponding adjustment to Partnership's payment obligation to City and Agency.

At the time the parties entered Amendment 3, the outstanding unpaid development costs owed to Partnership were over \$c, including interest. Total approved development costs, excluding interest, are \$d. Only interest on the unpaid development costs has been paid. You also indicate that the parties do not expect the unpaid principal related to development costs to be paid. The provisions of Amendment No. 3 were purportedly validated by the County Court.

Tax Allocation Indebtedness

In addition, Amendment 3 provides that Agency may issue additional debt to refund a portion of its obligation to Partnership. Specifically, at the request of Partnership, Agency shall use good faith efforts to issue and sell tax allocation bonds, as parity bonds or junior lien securities. Such bonds shall be issued for the purpose of refinancing Agency's obligations to pay development costs, provided that Partnership enters into a subordination agreement for the payment of tax revenues to pay principal and interest on such bonds.

In Year 5, the Agency issued its Series A Bonds. The Series A Bonds were issued to refund a portion of Agency's obligation to Partnership. \$e of proceeds were to be placed in a refunding escrow and remain there until from time to time expended for the purpose of refunding the obligation to Partnership. On or about Date 6, the Agency issued its Series B Bonds also for the purpose of refunding a portion of the obligation to Partnership. The Series A Bonds were advance refunded in Year 6.

This case arose from an income tax examination of Partnership. Your memorandum indicates that the taxpayer is receiving payments under the OPA and Amendment 3 (collectively referred to as the "agreement") and excluding such payments from income on the theory that they represent tax-exempt interest under

section 103. You indicate that there is no current examination of Agency or City with respect to the transactions described above.

LAW AND ANALYSIS

Issue 1: Whether the agreement constitutes an obligation pursuant to section 103

Pursuant to section 103(a), gross income does not include interest on any State or local bond. Section 103(c) provides that the term "State and local bond" means an obligation of a State or political subdivision thereof. Obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such unit. Section 1.103-1(b). The current inquiry is not whether City or Agency had authority to incur an obligation within the meaning of section 103, but whether the agreement constitutes such an obligation.

For purposes of section 103(c), the term obligation is not limited to a particular form of obligation, such as a conventional bond or promissory note. The exemption is equally applicable to an obligation evidenced by an ordinary written agreement of purchase and sale, in which the political subdivision agrees to pay interest. Kings County Development Co. v. Commissioner, 93 F.2d 33, 35 (9th Cir. 1937), cert. denied, 304 U.S. 559 (1938); Rev. Rul. 60-179, 60-1 C.B. 37. In addition to issuing bonds as evidence of indebtedness, qualified governmental units may incur debt, the interest on which is tax-exempt, by means of installment sales contracts, finance leases or transactions similar to mortgage loans. Tax Reform Act of 1986, Pub. L. No. 99-514, 99th Cong., H.R. 3838 (1986).

Consistent with the principle that exclusions from income must be construed narrowly, the exclusion under section 103(a) does not apply to every obligation. Hernandez v. Commissioner, T.C. Memo 1998-46; United States v. Centennial Savings Bank, 499 U.S. 573 (1991). The primary purpose of the exclusion is to permit State and local governments to obtain capital at a low rate of interest. King v. Commissioner, 77 T.C. 1113, 1118 (1981). Accordingly, it is well established that interest on an obligation is not excludable unless the obligation is issued by the State or political subdivision pursuant to the exercise of its borrowing power, as opposed to some other sovereign power. Newman v. Commissioner, 68 T.C. 433 (1977) (interest earned on a state employees' retirement account is not tax-exempt because the account balance was neither loaned to the state nor available for use in governmental operations); Consolidated Edison Co. of N.Y., Inc. v. United States, 10 F.3d 68 (2d Cir. 1993). A necessary element for the exclusion is the availability of borrowed funds for governmental operations or public use. Fox v. United States, 397 F.2d 119 (8th Cir. 1968).

In order to entitle the holder of an obligation to the exclusion under section 103(a), the State or political subdivision must also pay interest pursuant to the terms of a written obligation. M.C. Parrish & Co. v. Commissioner, 147 F.2d 284 (5th Cir. 1945). There must be a written instrument evidencing both the obligation and a specific interest rate. Newlin Machinery Corp. v. Commissioner, 28 T.C. 837 (1957).

In addition to the above criteria, if a debt obligation of a state or local governmental unit is not validly issued under state law, interest on such debt obligation is not tax-exempt. Rev. Rul 87-116, 1987-2 C.B. 44. In making a determination of Federal tax liability, state law controls to the extent the tax statute, by express language or necessary implication, makes its own operation dependent upon state law. Sampson v. Commissioner, 81 T.C. 614 (1983).

While the agreement at issue may differ from more conventional municipal financings, its form does not preclude the application of section 103 provided the elements necessary for an obligation are present. Present here is the existence of a written agreement evidencing City and Agency's obligation to pay interest. The facts also suggest that this obligation was incurred pursuant to the exercise of Agency's borrowing power. While neither City nor Agency actually received funds pursuant to a borrowing, the performance of services by Partnership on behalf of City and Agency, namely the construction of sewers, roads, schools, and other items, with the corresponding promise of repayment, accomplishes the same result as would a conventional borrowing undertaken for the same purposes. In that Partnership agrees to defer payment on the cost of the infrastructure items, the transaction is also analogous to an installment sale agreement, a transaction which the Tax Court has recognized as an acceptable form for a section 103 obligation. See Newlin Machinery Corp. v. Commissioner, 28 T.C. 837 (1957).

Further, there is no indication that this agreement is not valid under state law. As stated, Agency was formed under State's redevelopment laws for the purpose of effectuating redevelopment within City. Generally, agencies formed through this process are given broad powers to implement redevelopment plans, including the authority to acquire real and personal property in project areas and to incur indebtedness to finance redevelopment in project areas. Based on our review of State law, the most common method of obtaining funds for this type of redevelopment is through the issuance of tax allocation bonds.

Permissible indebtedness is not, however, confined to principal and interest on bonds but includes all redevelopment agency obligations whether pursuant to an executory contract or performed contract.

Thus, it does not appear that the form of this transaction is in violation of State law. In addition, the parties also

reportedly received a judgment from the County Court upholding the validity of the agreement under State law.

From the information provided, it appears that the form of this agreement satisfies the basic criteria for the existence of an obligation within the meaning of section 103. Such a finding, however, is merely the initial step in determining whether interest on the obligation is tax-exempt. Once the existence of an obligation is established, compliance with the rules governing tax-exempt bonds must also be determined.

As discussed with your office, the Examination Guidelines for Municipal Financing Arrangements (the "Guidelines"), Ann. 95-61, 1995-33, provide that the Assistant Commissioner (Employee Plans/Exempt Organizations) is responsible for enforcement relating to municipal financing arrangements. The Guidelines require case development of a financing transaction to be conducted at the issuer level. Bondholders are generally not contacted until the Service has completed an examination of the bond issue and determined that the issue fails to comply with the Code and Regulations.

As this case arose from an examination of Partnership and not through a bond examination, there has been no prior coordination with Exempt Organizations. Due to the potential existence of an obligation described in section 103, we have contacted the Tax Exempt Bond Coordinator in your region for the purpose of having an agent specializing in this area assigned to the case. However, prior to declaring interest on the obligation not excludable from income under section 103, the Service must comply with current examination procedures. This includes notifying the issuer of the preliminary determination that interest on the obligation is not exempt and providing the issuer with the opportunity to request technical advice with respect to such determination. Current procedures also provide the issuer with the opportunity to appeal an adverse determination. Notice 98-58, 1998-49 I.R.B. 13.

While it is necessary to coordinate with Exempt Organizations the issue of whether interest on a municipal financing arrangement is tax-exempt, the initial inquiry in the current case should be whether the payments received by Partnership actually represent interest, irrespective of their nature as tax-exempt or not. The Partnership's treatment of all payments received under the agreement as interest is not controlling. It is axiomatic that the economic substance of a transaction, rather than its form, governs for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935). In determining whether a payment constitutes interest, economic realities, not form, control the determination. Knetsch v. United States, 364 U.S. 361, 366 (1960).

At the time Amendment 3 was executed, unpaid Development Costs were more than \$c, including interest. Amendment 3 provides that all payments to

Partnership are applied first to the repayment of interest. Partnership treats all amounts received as excludable from income. The payments, ostensibly for the reimbursement of costs, are defined in such a manner as to include all costs incurred by and fees paid to Partnership, including managerial and sewer fees as described above. No allocation is made to unpaid principal as provided in the original OPA until all accrued interest is paid. Moreover, there is no "maturity date" for this obligation in that, conceivably, the principal remains unpaid indefinitely. Tax Allocation bonds may be issued to refund a portion of the unpaid principal, but only at Partnership's request. Further, your memorandum indicates that no portion of the development costs, other than interest, has been paid and the parties do not expect such costs to be repaid.

From our analysis of the information, we express concerns about the economic reality of this transaction. The documents evidence Partnership's obligation to provide services to Agency and/or City. Whether this arrangement is viewed as a loan to Agency, which enabled Agency to engage Partnership to complete the project, or, alternatively, as a service contract with Partnership agreeing to accept deferred payment, the facts demonstrate that Partnership provided the services of developing and managing Project Area. Partnership's agreement to undertake such services and indefinitely defer payment would appear to be economically unsound but for the high interest rate accruing on unpaid development costs and the tax-exempt treatment of the payments received. Consequently, the classification of all payments, including management fees, as reimbursement for costs; the indefinite deferral of principal repayment; and the significant increase in the interest rate on unpaid development costs from n% to 0% suggest an attempt by Partnership to recast payments that would otherwise be taxable service income into tax-exempt interest payments.

The contention that all amounts received under the agreement represent interest lacks credibility, particularly in light of the fact that there is no expectation of repayment of principal. Simply accepting Partnership's treatment of all amounts received as tax-exempt interest would result in Partnership's avoiding recognition of income received for the performance of services. Taxpayers must substantiate the extent to which a payment constitutes interest. See Brenauer v. Commissioner, T.C. Memo. 1983-418 (taxpayer failed to substantiate that amounts received were tax-exempt interest). On the facts presented, there is a legitimate question as to whether the amounts received represent the payment of interest. Further, as there is insufficient information to determine compliance with the rules governing tax-exempt bonds, we are unable to formulate an opinion as to what extent, if any, the payments received represent interest on a tax-exempt obligation.

Issue 2: Is the Obligation Either An Industrial Development or Private Activity Bond.

In addition to the above issues, you have also requested advice as to whether the obligation may constitute a private activity bond. Before turning to this issue, we stress that determinations involving the provisions of sections 103 and 141 through 150 require coordination with Exempt Organizations as well as compliance with the applicable examination procedures set forth in Announcement 95-61, 1995-33 and Notice 98-58, 1998-49 I.R.B. 13. A determination regarding this issue prior to coordination is premature. However, we will provide a general discussion of this issue as it relates to the current facts to assist in the further development of this case.

Section 103(b) provides that the exemption provided by subsection (a) shall not apply to any private activity bond which is not a qualified bond within the meaning of section 141. Section 141 was added to the Code by the Tax Reform Act of 1986 and generally applies only to bonds issued after October 13, 1987 (other than bonds issued to refund bonds issued on or before such date). For obligations issued prior to the Tax Reform Act of 1986, the provisions of section 103 of the Internal Revenue Code of 1954, as amended, are applicable. As the original OPA was entered in Year 2, we examine this issue under the provisions of the 1954 Code.²

Section 103(b) of the 1954 Code provides that, except as otherwise provided in section 103(b), any industrial development bond shall be treated as an obligation that is not an obligation described in section 103(a).

Section 103(b)(2) provides that the term "industrial development bond" means any obligation

² Although the original OPA was executed in Year 2, the subsequent amendments raise the issue as to whether the obligation was "reissued" on a later date. A reissuance would result in a new obligation on the date of the deemed reissuance and, thus, the application of the law in effect on that date. For all bonds other than qualified tender bonds, a reissuance occurs if there is a change to the terms of the bond which would cause a disposition of the bond under section 1001. Notice 88-130, 1988-2 C.B. 543. It appears that the significant revisions to the OPA, including the change in the interest rate, were merely incorporated into Amendment 3 from the two prior amendments, both of which also predate the 1986 Act. Thus, even in the event that a modification to this obligation resulted in a reissuance, it is arguable such reissuance occurred prior to the effective date of section 141 and an analysis under the 1954 Code is appropriate. If additional facts evidence a reissuance occurring in Year 4, an analysis under section 141 will be necessary.

(A) that is issued as a part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person, and

(B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part

(i) secured by any interest in property used or to be used in a trade or business or in payment in respect of such property, or

(ii) to be derived from payments in respect to property, or borrowed money, used or to be used in a trade or business.

Section 103(b)(3) defines an exempt person as (A) a governmental unit, or (B) an organization described in section 501(c)(3) and exempt from tax under section 501(a).

Both the private trade or business test and the private security interest test must be met before an obligation will be considered an industrial development bond. These tests are addressed below.

Private Trade or Business Test

Treas. Reg. § 1.103-7(b)(3) provides that the trade or business test relates to the use of proceeds of a bond issue. The test is met if all or a major portion (more than 25 percent) of the proceeds of a bond issue is used in a trade or business carried on by a nonexempt person. For example, if all or a major portion of the proceeds of a bond issue is to be loaned to one or more private business users, or is to be used to acquire, construct, or reconstruct facilities to be leased or sold to such private business users, and such proceeds or facilities are to be used in trades or businesses carried on by them, such proceeds are to be used in a trade or business carried on by persons who are not exempt persons and the debt obligations satisfy the trade or business test. Treas. Reg. § 1.103-7(b)(3)(i); Rev. Rul. 80-251, 1980-2 C.B. 40. However, when publicly-owned facilities which are intended for general public use, such as toll roads or bridges, are constructed with the proceeds of a bond issue and used by non-exempt persons in their trades or businesses on the same basis as other members of the public, such use does not constitute a use in the trade or business of a non-exempt person for purposes of the trade or business test. Under section 1.103-7(b)(3)(ii), the indirect, as well as the direct, use of proceeds is to be taken into account in determining whether a debt obligation meets the trade or business test.

The agreement at issue provides that Partnership was to undertake development of the entire Project Area including not only the development of infrastructure items, but also the acquisition of land and construction necessary for the residential and other private uses specified in City's plan. Reimbursement to Partnership was to be only for the cost of the infrastructure items. Partnership was required to transfer ownership of the infrastructure items to City and Agency upon completion. The agreement provides that Partnership was to retain ownership of improved property not related to infrastructure items for resale to residential and commercial builders.

According to your memorandum, the approved development costs for Project Area totaled \$d, excluding interest. While the agreement states that development costs relate primarily to the development of non-residential, non-commercial and non-industrial property, it is not clear if the property developed as infrastructure was actually intended for use by the general public. The facts suggest that a substantial portion of the project area was to be developed for private purposes, specifically the development and sale of residential property. Many of the items defined as infrastructure, such as flood control and drainage, streets, and landscaping, may also relate to the cost of developing areas of the project designated for private use.

Further, while infrastructure items are to be transferred to City or Agency, Partnership appears to derive a direct economic benefit from such items. For example, the agreement provides for a sewer fee payable to Partnership as defined above. In addition, Amendment 3 provides for payments to Partnership, through City and Agency, from private parties benefitting from the development of the infrastructure items. This arrangement suggests that the infrastructure items may be used in the trade or business of the partnership.

We also express concern with the broad definition of development costs under the agreement, which includes not only the allowance for overhead expenses, but the payment of the project management fee. While the amount of these payments relative to total development costs is unclear, such payments appear to constitute use of proceeds in a private business. See Priv. Ltr. Rul. 87-04-049 (October 28, 1986) (Bond proceeds loaned to private developer to satisfy obligation incurred in course of constructing property used primarily by the general public constitutes use in a trade or business). While not cited as precedent, the facts of the ruling, somewhat analogous to the instant matter, provide an example of a transaction where the Service found private business use.

From the provided information, we are unable to make the factual determination of the extent to which proceeds of the obligation were used in a trade or business. The facts addressed above, however, do raise concerns that warrant additional examination. Specifically, a determination must be made as to whether the property developed through this arrangement is in fact use by the general

public, or whether Partnership or other private parties use such property for private purposes. We also suggest verifying the manner in which amounts were allocated to development costs. Additional information regarding the purpose and manner of calculating payments to the partnership for use of infrastructure items by private parties is also necessary. Finally, whether title to the infrastructure items was transferred to City or Agency as provided by the agreement must also be determined.

The trade or business test is met if more than 25 percent of the funds obligated by the Agency were used directly or indirectly in Partnership's trade or business. The facts presented cause concern as to whether Partnership has rights or privileges to the developed property not available to the general public. As stated, a tax-exempt bond specialist will be available to assist with the development of these issues.

Security Interest Test

The security interest test is met if the payment of the principal or interest on the obligation (under the terms of such obligation or any underlying arrangement) is, in whole or in major part (i) secured by any interest in property used or to be used in a trade or business or in payment in respect of such property, or (ii) to be derived from payments in respect to property, or borrowed money, used or to be used in a trade or business.

Treas. Reg. § 1.103-7(b)(4) provides that the security interest test relates to the nature of the security for, and the source of, the payment of either the principal or interest on a bond issue. The nature of the security for, and the source of, the payment may be determined from the terms of the bond indenture or on the basis of any underlying arrangement. An underlying arrangement to provide security for, or the source of, the payment of the principal or interest on an obligation may result from separate agreements between the parties or may be determined on the basis of all the facts and circumstances surrounding the issuance.

The Agency and City pledged tax revenues and agency revenues for the purpose of repaying development costs on the obligation. Tax Revenues are defined as the tax increment revenues generated within Project Area. Prior to enactment of section 141, the Service took the position that the mere use of tax increment financing did not result in the satisfaction of the security interest test. Rev. Rul. 73-481, 1973-2 C.B. 23.

Payment on the instant obligation is secured not only by tax revenues, but agency revenues as well. Agency revenues are defined as redevelopment participation fees, builder's fees and similar fees to be paid pursuant to owner participation agreements by and between participating owners and Agency. Amendment 3 also provides for reimbursement payments to Partnership from parties benefitting from the implementation of an infrastructure item. Such amounts are apparently paid to City or Agency and are classified as agency revenues to be utilized by Agency in the payment of development costs to Partnership.

The payment of participation fees, builder's fees and similar fees to City and Agency which are made available for the payment of development costs evidence an arrangement providing security for or payment of the principal and interest on the obligation. From the available information, we are unable to ascertain the extent to which these private payments provided the security for or the payment of the principal and interest on the obligation. Accordingly, additional development is necessary to determine if the security interest test is met.

Issue 3: Treatment of Payments to City and Agency

Section 162(a) permits a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Taxpayers have the burden of proving a claimed expense was paid or incurred and that it was both reasonable and related to the taxpayer's trade or business in order to be deductible. Noyce v. Commissioner, 97 T.C. 670 (1991).

Section 265(a)(1) provides, in relevant part, that no deduction shall be allowed for any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by subtitle A, or any amount otherwise allowable under section 212 (relating to expenses for production of income for individuals) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by subtitle A.

Section 265 generally denies taxpayers the double benefit of tax-exempt income and a deduction for expenses incurred in generating such income. United States v. Skelly Oil Co., 394 U.S. 678 (1969). From the foregoing, however, it is evident that section 265(1) of the Code prohibits the deduction of an item otherwise allowable as a deduction, which is attributable to tax-exempt interest only if such item is deductible under section 212. Rev. Rul. 61-86, 1961-1 C.B. 41. Section 212 refers to nontrade or nonbusiness expenses incurred by individuals for the production of income and allowable as itemized deductions. Treas. Reg. § 1.212-1(a)(1).

As discussed, Amendment 3 requires Partnership to pay to City and Agency r% of residual tax revenues during the duration of the plan, and s% thereafter. In addition to excluding from income the payments received under the agreement, Partnership claims as a deduction the amount it is obligated to pay to City and Agency under the agreement. The payment obligation is purportedly in settlement of disputes that existed between the parties. The deductibility of expenses or payments incurred to settle claims or litigation depends upon the origin of the claim that culminated in the settlement. United States v. Gilmore, 372 U.S. 39 (1963); Lieb v. Commissioner, T.C. Memo. 1974-272, aff'd without opinion, 535 F.2d 1246 (3d Cir. 1976) (Where a creditor agreed, in settlement of litigation with the debtor, to reduce the amount owed to it, the amount of the reduction was deductible as an expense incurred to protect an existing asset or as a settlement cost).

The amount that Partnership is obligated to pay to City and Agency arguably represents a payment in settlement of a dispute which may qualify as a deductible expense. Nonetheless, taxpayers have the burden of showing the right to a claimed deduction, INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992), and there is insufficient information to determine if the partnership's payment obligation represents a deductible business expense.

Further, section 265(a)(1) is currently inapplicable as it has not been established whether the amounts received under the agreement represent interest, let alone tax-exempt interest. If a subsequent determination is made that the partnership received tax-exempt interest under the agreement, the provisions of section 265(a)(1) only prohibit the deduction of an expense which is allocable to such interest if such item is deductible under section 212.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As discussed, the issue of whether interest on the current obligation is tax-exempt must be coordinated with Exempt Organizations. Nevertheless, we recognize that the imminent expiration of the statute of limitations for Year 6 may necessitate the issuance of a notice of deficiency before a tax-exempt bond specialist has the opportunity to fully review the facts of this transaction. In such event, you propose

[REDACTED]. Further, to avoid conflict with the Service's examination procedures regarding municipal financing arrangements, any notice of deficiency shall not assert that interest on the Agency's obligation is includable in income.

The need to issue a notice of deficiency for Year 6 should not preclude additional development of the case with the assistance of Exempt Organizations. Presumably, the current arrangement is ongoing and will affect subsequent years as well. Based on the information provided, the amount of potential tax at issue is also substantial. Moreover, the omission from income of amounts received under the agreement may constitute a substantial omission within the meaning of section 6501(e). This would result in a six year statute of limitations for any year in which there was a substantial omission. Consequently, tax years prior to the year under examination may still be open for assessment purposes.³

Further, the ultimate determination as to whether the agreement at issue constitutes a tax-exempt obligation may impact more than the current taxpayer. For instance, a determination regarding the tax-exempt nature of the instant obligation may affect whether interest on the Series A and Series B Bonds, or any other bonds issued to refund the obligation to Partnership, is excludable from the income of bondholders.

³ Reliance on a six year statute of limitations for Year 6 is not advisable due to the existence of adjustments unrelated to the income issue. If the Service did not prevail on the issue that there was a 25% omission, it would preclude the assessment of tax resulting from the unrelated adjustments.

Please call if you have any further questions.

By:

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