Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Glenn DeLoriea, Program Manager, Examination Specialization & Technical Guidance (Small Business/Self-Employed)
Attn: Grace Robertson

from: Paul Handleman, Senior Technician Reviewer, Branch 5, Office of the Associate Chief Counsel (Passthroughs and Special Industries), CC:PSI:5

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subject: Section 45D, New Markets Tax Credit - Request for Advice Regarding Qualified Low-Income Community Investments

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

These issues involve the treatment of loans made to a qualified active low-income community business (QALICB) as a qualified low-income community investment (QLICI) under § 45D(d)(1)(A) of the Internal Revenue Code when the community development entity (CDE) intends to eventually forgive or otherwise not collect on the debt after the end of the 7-year credit period.

1. For purposes of making a QLICI under § 45D(d)(1)(A), what constitutes true debt? How should the debt be documented?

2. If it is determined during the 7-year credit period that a CDE intends to forgive or otherwise not collect on a loan treated as a QLICI, should the loan amount be considered a QLICI for purposes of the substantially-all requirement under § 45D(b)(1)(B) and § 1.45D-1(c)(5)(i) of the Income Tax Regulations?

3. If it is determined during the 7-year credit period that a CDE intends to forgive or otherwise not collect on a loan treated by the CDE as a QLICI, is the loan amount considered a gift to the QALICB to the extent the loan is to be forgiven or not collected? If the loan amount is considered a gift and the QALICB is a charitable nonprofit organization, does the gift qualify as a charitable contribution under § 170?

4. If it is determined during the 7-year credit period that a CDE intends to forgive or otherwise not collect on a loan treated as a QLICI, is the QALICB subject to § 61(a)(12), § 108 or § 1017 regarding the forgiveness of debt?

CONCLUSIONS

1. Based on the limited facts presented in your request, we would have difficulty concluding that a loan with a pre-arranged forgiveness feature constituted bona fide debt for federal tax purposes.

2. If a loan with a pre-arranged forgiveness feature does not constitute bona fide debt for federal tax purposes, the loan amount should not be considered a QLICI for purposes of the substantially-all requirement under § 45D(b)(1)(B) and § 1.45D-1(c)(5)(i).

3. Assuming that a loan is not true debt, the determination of whether forgiveness of the loan constitutes a gift must be made on consideration of all factors surrounding a particular case. The Field should examine the specific facts and make such determination. Further, if the loan is not true debt and the QALICB is a charitable organization described in § 170(c), whether and to what extent a payment may be treated as a charitable contribution for purposes of § 170 depends on the facts and circumstances of a particular case.

4. Assuming that a loan is true debt, the QALICB generally would be subject to §§ 61(a) (12), 108, and 1017. If the QALICB is an organization described in § 170(c), whether there may be a charitable contribution deduction under § 170 under these circumstances is an issue that we cannot address without further facts.

FACTS

The facts presented in this case are limited and we received no representative loan documents or other documentation to review in the original submission.

Per an e-mail from the LMSB Program Analyst for New Markets Tax Credit, an investor does not expect its initial equity investment to be returned after the end of the 7-year credit period. The CDE would be the party forgiving the loan.

LAW AND ANALYSIS

Section 45D(a)(1) provides a new markets tax credit on certain credit allowance dates described in § 45D(a)(3) with respect to a qualified equity investment (QEI) in a CDE described in § 45D(c).

Section 45D(b)(1)(B) provides that an equity investment in a CDE is a QEI if, among other requirements, substantially all of the cash is used by the CDE to make QLICIs.

Under § 1.45D-1(c)(5)(i), the substantially-all requirement must be satisfied for each annual period in the 7-year credit period using either the direct-tracing calculation under § 1.45D-1(c)(5)(ii), or the safe harbor calculation under § 1.45D-1(c)(5)(iii). For purposes of § 1.45D-1(c)(5)(i), the 7-year credit period means the period of 7 years beginning on the date the QEI is initially made.

Under § 45D(d)(1)(A), a QLICI includes any capital or equity investment in, or loan to, any QALICB (as defined in § 45D(d)(2)).

Under § 45D(d)(2), a QALICB is any corporation (including a nonprofit corporation) or partnership if for such year, among other requirements, (i) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within any low-income community, (ii) a substantial portion of the use of the tangible property of the entity (whether owned or leased) is within any low-income community, and (iii) a substantial portion of the services performed for the entity by its employees are performed in any low-income community.

Issue 1:

You have requested our assistance in determining whether a loan made to a QALICB as a QLICI under § 45D(d)(1)(A) constitutes debt for federal income tax purposes when the CDE intends to eventually forgive or otherwise not collect on the debt after the end of the 7-year credit period.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. Among the factors that may be considered in making such a determination are: (1) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (2) whether holders possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instrument are subordinate to rights of general creditors; (4) whether the instruments give the holders the right to participate in the management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between holders of the instruments and stockholders of the issuer; (7) the label placed upon the instrument by the parties; and, (8) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes. The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity.

Based on the limited facts presented in your request, we would have difficulty concluding that a loan with a pre-arranged forgiveness feature constituted bona fide debt for federal tax purposes.

Issue 2:

To qualify as a QLICI under § 45D(d)(1)(A), a CDE must make a capital or equity investment in, or loan to, to a QALICB. If a loan with a pre-arranged forgiveness feature does not constitute bona fide debt for federal tax purposes, then loan does not qualify as a QLICI under § 45D(d)(1)(A). Therefore, the loan amount will not be considered a QLICI for purposes of the substantially-all requirement under § 45D(b)(1)(B) and § 1.45D-1(c)(5)(i).

Issue 3:

The following analysis is based on the assumption that a loan treated by a CDE as a QLICI is not true debt.

Section 61(a) and the regulations thereunder define gross income to mean all income from whatever source derived except as otherwise provided by law. See also § 1.61-1(a). Under § 61, Congress intended to tax all gains or undeniable accessions to wealth, clearly realized, over which the taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

Section 61(a)(12) states that gross income includes income from the discharge of indebtedness. Section 1.61-12(a), in part, provides that the discharge of indebtedness may result in the realization of income. For example, if an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt. See § 1.61-12(a).

Section 102(a) provides that gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. Neither the Code nor legislative history accompanying § 102 defines the term "gift."

A leading authority on the meaning of the term "gift" for § 102 purposes is Commissioner v. Duberstein, 363 U.S. 278 (1960), 1960-2 C.B. 428. In Duberstein, the Supreme Court ruled that a gift proceeds from a "detached and disinterested generosity...out of affection, respect, admiration, charity or like impulses." Id. at 285. In this regard, the most critical consideration is the transferor's intent. Id. If a payment proceeds primarily from "the constraining force of any moral or legal duty" or from "the incentive of anticipated benefit" of an economic nature, it is not a gift. Id. However, the mere absence of a legal or moral obligation to make the payment is not sufficient to render it a gift. Id. The Court further stated that whether a specific transfer is a gift for income tax purposes is one that must be reached on consideration of all factors. Id. at

288; see United States v. Kaiser, 363 U.S. 299 (1960) (whether receipts by taxpayer are gifts excepted from income tax is primarily a question of fact).

A transfer to a for-profit business usually does not receive gift treatment under § 102. For example, in Publishers New Press, Inc. v. Commissioner, 42 T.C. 396 (1964), a for-profit newspaper company solicited contributions to keep its business in operation. The court applied the Duberstein intent test and determined that the contributions in issue were not gifts because the funds were furnished "by the contributors to obtain something the contributors desired...namely, the continued publication of the newspaper." Id. at 400. The court found that "the private contributions here were made in consideration of the performance of the petitioner's normal business function of publishing a newspaper." Id. at 401.

In general, a payment made by a charity to an individual that responds to the individual's needs and does not proceed from any moral or legal duty is motivated by detached and disinterested generosity. In Situation 2 of Rev. Rul. 2003-12, 2003-1 C.B. 283, the grants made by the charitable organization are designed to help distressed individuals with unreimbursed medical, temporary housing, or transportation expenses they incur as a result of a flood. Rev. Rul. 2003-12 concludes that payments made by a § 501(c)(3) charitable organization are made out of detached and disinterested generosity rather than to fulfill any moral or legal duty and, thus, are excluded from the gross income of the recipients under § 102.

The determination of whether the forgiven amount is a "gift" is one that must be reached on consideration of all relevant facts and circumstances surrounding each case. There is no fixed and precise standard. The most critical consideration would be the intention of a transferor, i.e., the intention of a CDE, for forgiving the loan. See Cook v. U.S., 897 F. Supp. 1403 (M.D. Fla., 1995) (discharge of indebtedness in overpaid United States Navy disability retirement payments was not a gift because the discharge may be caused by a moral or legal duty of the United States).

Section 170 generally allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in § 170(c)) payment of which is made within the taxable year. To be deductible as a charitable contribution under § 170, a transfer must be a gift to or for the use of an organization described in § 170(c). A gift for purposes of § 170 is a voluntary transfer of money or property without receipt or expectation of receipt of adequate consideration made with charitable intent. See United States v. American Bar Endowment, 477 U.S. 105, 117-18 (1986); see also § 1.170A-1(h).

Whether and to what extent a deduction is allowable under § 170 depends on the facts of a particular case. For example, no deduction is allowed if a taxpayer receives or expects to receive economic benefits commensurate with the amount of the transfer. Subject to certain exceptions, § 170(f)(3) provides that no deduction is allowed for a contribution of less than the taxpayer's entire interest in property.

A contribution must meet certain substantiation requirements in order to be allowable as a deduction under § 170. Section 170(a)(1), (f)(8), (f)(11); § 1.170A-13(c) and (f). If not substantiated properly, the deduction may be disallowed. See, e.g., Addis v. CIR, 374 F. 3d. 881 (9th Cir. 2004); Hewitt v. CIR, 109 T.C. 258 (1997).

Contributions of property may raise valuation issues. If a transfer meets the requirements of § 170 and a deduction is thereby allowable, the amount of the deduction may not exceed the fair market value of the contributed property on the date of contribution (reduced by the fair market value of any consideration received by the taxpayer), further reduced as provided in § 170(e). See § 1.170A-1(c)(1).

These are only some examples of issues that may arise under § 170. There are many other issues that may be raised under § 170, and many other requirements that must be met in order for a deduction to be allowable under § 170. We would need more facts in order to analyze whether, to what extent, and under what circumstances there could be a charitable contribution deduction under § 170 in cases involving a CDE that:1) forgives a loan, or 2) makes a loan that is not treated as a true debt.

Issue 4:

As explained above, § 61(a) defines gross income to mean all income from whatever source derived except as otherwise provided by law. Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness.

Section 108(a) provides that gross income does not include any amount which would be includible in gross income by reason of the discharge of indebtedness of the taxpayer if (i) the discharge occurs in a title 11 case, (ii) the discharge occurs when the taxpayer is insolvent, (iii) the indebtedness discharged is qualified farm indebtedness, or (iv) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Section 1017 provides that if an amount is excluded from gross income under § 108, and any portion of such amount is to be applied to reduce basis, then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

Assuming that a loan is true debt, the QALICB may be subject to §§ 61(a) (12), 108, and 1017.

Please call me at (202) 622-3040 if you have any further questions.