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DEPARTMENT OF THE TREASURY
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MEMORANDUM FOR GREGORY A. NYGREN, GROUP MANAGER 1436
NORTH CENTRAL DISTRICT

FROM: Assistant Chief Counsel (Income Tax & Accounting)
Jody Brewster by George Baker

SUBJECT: City of Grand Forks, ND, Interest Subsidy Program

This Technical Assistance responds to your memorandum dated March 31, 1998. You requested our views on the tax treatment of the City of Grand Forks, ND, Interest Subsidy 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.

LEGEND:

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ISSUES:

- (1) What are the federal income tax consequences to a business taxpayer on whose behalf interest subsidy payments are made by the City to a lender?
- (2) What information reporting requirements, if any, does the City have with respect to the interest subsidy payments?

CONCLUSIONS:

- (1) We conclude that interest subsidy payments are to be treated for federal income tax purposes as being paid first by the City to the business and then paid by the business to the lender. Such payments are includible in the gross income of the business and are deductible as interest paid by the business under the method of accounting regularly used by the business. On the facts set forth below, the lender's monthly debiting of a pre-determined amount from the Buydown Account is the proper

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time for inclusion and deduction of that amount by both cash basis and accrual basis taxpayers.

(2) The City must file information returns as to those business taxpayers for which the annual interest subsidy payments total \$ 600 or more and which are not corporations.

FACTS:

The City of Grand Forks, ND (City), located in a Presidentially declared disaster area, established through its Office of Urban Development an Interest Subsidy Program (Program). The purpose of the Program is to provide assistance to businesses that incurred increased debt levels after sustaining damage from an April 1997 flood. The Program, through the use of interest subsidy payments on certain pre-existing loans, is intended to help the businesses return to a pre-flood debt service level.

The maximum subsidy available to a business under the Program is \$16,000 for a loan of \$100,000 or more. For loans less than \$100,000, the maximum subsidy available will be reduced proportionately. The subsidy will buy down the interest on a loan of \$100,000 by a maximum of 4.25 percentage points and will not buy down the interest below 4.00 percent.¹

To be eligible for an interest subsidy, a business must have SBA loan approval, have loans outstanding as of March 11, 1998, to which the subsidy will be applied, and be located within the city limits of Grand Forks. The business applies for the subsidy through the original lender (the "lender") of the loan, which will forward the application to the City.

If a business obtains an interest subsidy, then the City, the business, and the lender will enter into an Interest Buydown Agreement and an Escrow Agreement.² A single advance in the amount of the interest buydown will be deposited by the City into a restricted interest-bearing account opened with the lender (the "Buydown Account").³

¹ This description is taken from the "City of Grand Forks Interest Subsidy Program Description and Pre-Application."

² These two agreements are similar. B of the Grand Forks Office of Urban Development explained that the first agreement is primarily for the business and the second one is primarily for the original lender. The remaining facts are taken from these agreements.

³ It is not clear whether the amount deposited is sufficient, in itself, to meet the total scheduled subsidy payments, or whether the amount deposited represents only

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The lender will be authorized to debit the account monthly for a pre-determined amount in order to subsidize the interest on the loan. Although the account will be in the business's name, only the lender will have access to the account and to any interest that it earns. After the final subsidy payment, any money left in the account will be disbursed to the City.

The interest subsidy agreement will not affect the amount the lender is owed under the original loan. The lender is entitled to payment of the principal and to amortization of the debt as originally agreed upon, and the business will remain obligated to pay the full amount of principal and interest.

If the business makes a prepayment of principal on the original loan, then the amount of the remaining interest subsidy payments will be reduced proportionately. If the business defaults on the original loan, then the interest subsidy arrangement will be terminated and the lender will return to the city any money remaining in the Buydown Account.

LAW AND ANALYSIS:

Discussion of Question (1)

Section 61(a) of the Code states that, except as otherwise provided, gross income means all income from whatever source derived.

Section 451(a) provides generally that an item of gross income shall be included in gross income in the taxable year in which received by the taxpayer, unless under the taxpayer's method of accounting, the amount is to be properly accounted for in a different period. Section 446(c)(1) and (c)(2) provide generally that both the cash method and the accrual method are permissible methods of accounting.

Cash basis taxpayers generally take items into gross income in the taxable year in which they are actually or constructively received. Income Tax Regulations, §§ 1.451-1(a); 1.446-1(c)(i). Under § 1.451-2(a), income is constructively received during the taxable year in which it is credited to a taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or could have drawn upon it during the taxable year if notice of intention to withdraw had been given. Income is not constructively received, however, if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Alternatively, under the

the present value of that total. In the latter circumstance, the total scheduled subsidy payments can be made only if interest earned on the original deposit is included in the subsidy payments. B of the Grand Forks Office of Urban Development stated that interest earned on the account might indeed be included in subsidy payments.

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economic benefit doctrine, a cash basis taxpayer is currently taxable on the economic benefit received when money or property is irrevocably and unconditionally set aside for the individual in an escrow or trust. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952); Pulsifer v. Commissioner, 64 T.C. 245 (1975); Anastasio v. Commissioner, 67 T.C. 814 (1977).

Accrual basis taxpayers generally take items into gross income when all the events have occurred that fix the taxpayer's right to receive the income and the amount of the income can be determined with reasonable accuracy. Sections 1.451-1(a); 1.446-1(c)(ii)(A).

Section 163(a) generally permits business taxpayers to deduct all interest paid or accrued within the taxable year on trade or business indebtedness.

Section 461(a) provides generally that deductions are taken in the taxable year which is proper under the taxpayer's method of accounting. In general, deductions for cash basis taxpayers are proper in the year of payment. Section 1.461-1(a)(1). Accrual basis taxpayers generally take deductions in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Section 461(h)(1), (h)(2), and (h)(4); § 1.461-1(a)(2). In the case of interest expense, economic performance occurs as the interest cost economically accrues. Section 1.461-4(e).

A business taxpayer participating in the Program neither actually receives the interest subsidy payments made by the City on its behalf, nor actually pays the amounts subsidized to the lender. Nevertheless, the interest subsidy payments properly are treated for federal tax purposes as being paid first to the business (and included in the business's gross income) and then paid by the business to the lender (and deducted by the business).

Looking first to the income side, we note that a business taxpayer participating in the Program remains obligated to pay the full amount of principal and interest on its loan. However, to the extent of the interest subsidy payments, the City is paying the taxpayer's obligation. Payments made by the City on behalf of the taxpayer constitute gross income to the business. Section 61(a); Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). See also Rev. Rul. 76-75, 1976-1 C.B. 14 (interest subsidy payments made by government agency to mortgagees on behalf of mortgagor owners of lower-income rental housing constitute gross income to owners); Graff v. Commissioner, 74 T.C. 743, 758 - 760 (1980), aff'd, 673 F.2d 784 (5th Cir. 1982) (sustaining government's claim that payments described in Rev. Rul. 76-75 were includible in mortgagor-owner's gross income; lack of actual physical receipt of funds by taxpayer immaterial).

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On the deduction side, a business taxpayer participating in the Program is entitled to a § 163(a) deduction for the interest paid by the City to the lender on the taxpayer's behalf, to the extent the interest subsidy payments were included in the owner's gross income. Rev. Rul. 76-75; Graff.⁴ Additionally, of course, the business taxpayer is entitled, subject to its method of accounting, to deduct the interest it pays directly to the lender.

The taxpayer's method of accounting will determine the proper time for inclusion and deduction of the interest subsidy payments. We conclude, based on the analysis below, that the lender's monthly debiting of a pre-determined amount from the account held by the lender -- rather than the time at which the deposit to that account was made by the City -- is the proper time for inclusion by both cash basis and accrual basis taxpayers. That same action by the lender -- the monthly debiting of the Buydown Account -- also constitutes the proper time for both cash basis and accrual basis taxpayers to claim a § 163(a) interest deduction.

The conditions under which a business may forfeit the monthly subsidy payments (in whole or in part) are critical in determining that the business is not taxed when the City makes the deposit into the account. Had the City promised to make the agreed-upon interest subsidy payments in all circumstances, borrowing businesses would have realized income when the City deposited the money in the Buydown Account: the economic benefit doctrine would have been satisfied for cash basis taxpayers (because the borrower's right to future cash payments would be nonforfeitable and the payments were funded), and the all events test would have been satisfied for accrual basis taxpayers.

Under the terms of the Escrow Agreement, however, the lender's right to debit the Buydown Account is contingent not only on the passage of time but also on performance by the borrower. Once the borrower has performed, the lender's debiting of the Buydown Account puts a cash basis taxpayer in constructive receipt of the amount debited, as at that point the amount is credited to his account and is not subject to substantial limitations or restrictions. § 1.451-2(a). On the deduction side, the lender's debiting constitutes deemed payment for the cash basis taxpayer under Rev. Rul. 76-75 and Graff. For the accrual basis taxpayer, the monthly debiting satisfies the

⁴ This conclusion is also consistent with § 1.1273-2(g)(4) (concerning certain payments made incident to a lending transaction), which provides:

If, as part of a lending transaction, a party other than the borrower (the third party) makes a payment to the lender, that payment is treated in appropriate circumstances as made from the third party to the borrower followed by a payment in the same amount from the borrower to the lender

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all events test for both income and deduction purposes and the passage of time causes the interest cost economically to accrue for purposes of the economic performance test.

To the extent that the interest subsidy payments are treated as being paid first by the City to the business taxpayer and then paid by the business to the lender, the lender should treat the subsidy payments in the same way that it would treat payments of those amounts by the business in the absence of the interest subsidy arrangement. In other words, the interest subsidy arrangement does not affect the tax consequences to the lender of receiving payment under the original loan.

Discussion of Question (2)

Section 6049(a) requires every person who makes payments of interest (as defined in § 6049(b)) aggregating \$10 or more to any person during a calendar year to file an information return. Section 6049(b)(1)(C) defines "interest" as including amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares.

Interest is compensation for the use or forbearance of money. Deputy v. Du Pont, 308 U.S. 488, 498 (1940); Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 145 (1974); U.S. v. Midland-Ross Corp., 381 U.S. 54, 57 (1965). In this transaction, the lender is compensated for the use of its money by the borrower through interest payments made, or deemed made, by the borrower. The City is compensated for the use of its money by the lender upon the City's deposit of a lump sum into the Buydown Account. The grant money deemed received by the borrower from the City, on the other hand, is not paid by the City for the use by the City of the borrower's money.⁵ Consequently, the City has no reporting obligations under § 6049(a) relating either to its deposit of a lump sum into the Buydown Account or to the monthly interest subsidy payments that, upon being debited by the lender, are deemed received by the borrower.

Section 6041(a) generally requires all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of fixed or determinable gains, profits, and income of \$600 or more in any taxable year to file an information return with respect to such payments. Section 1.6041-3(e) (effective before January 1, 1999), and § 1.6041-3(q)(1) (effective after December 31, 1998), provide

⁵ By contrast, as noted under the discussion of Question (1), the money deemed paid by the borrower to the lender is generally deductible as trade or business interest under § 163(a).

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generally that payors are not required to file information returns for payments made to corporations.⁶

The interest subsidy payments are fixed and determinable income to the borrowers. Accordingly, the City is subject to the reporting requirements of § 6041 and is required to file a Form 1099-MISC if the borrower is not a corporation and the monthly payments total \$600 or more in a year. By contrast, if the business borrower is a corporation, the City need not file an information return as to that borrower, even if the interest subsidy payments for the year total \$600 or more.

If you find that the facts differ from those recited here, we will be happy to offer further assistance.

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. 98-1, 1998-1 I.R.B. 7, and Rev. Proc. 98-2, 1998-1 I.R.B. 74, respectively.

⁶ After 1998, § 1.6049-4(c)(1)(ii)(A), incorporated by reference in § 1.6041-3(q)(1), provides rules payors may use to determine that a payee is a corporation (absent actual knowledge to the contrary).