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memorandum

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from: Christopher F. Kane
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subject: Deduction of facility fees

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

LEGEND

Taxpayer	=
Limited Partner	=
Facility Fee	=
$x	=
Year1	=
Year2	=
$y	=

ISSUES

For purposes of § 461 of the Internal Revenue Code, is the taxpayer's liability for a facility fee treated as an interest liability, or a liability for the provision of services, and if not for services, a liability as described in § 1.461-4(g)(1)-(6) or (7) of the Income Tax Regulations.

CONCLUSIONS

For purposes of § 461, the payment of the facility fee is an other liability under § 1.461-4(g)(7), and economic performance takes place when payment is made to the entity to whom the liability is owed.

FACTS

Taxpayer's overall method of accounting is the accrual method. Taxpayer was formed as a limited liability partnership for the purpose of constructing and operating a residential housing project.

In order for Taxpayer to receive a lower interest rate on a bond, Limited Partner agreed to guarantee the bond for Taxpayer. The Partnership Agreement states that in each fiscal year that the bonds are outstanding, Taxpayer must pay a Facility Fee to Limited Partner so that Limited Partner will continue to guarantee the bond.

The Facility Fee is defined in the Agreement as an annual fee equal to the product of 30 basis points and the weighted average of the outstanding principal balance of the bonds during the fiscal year in which such fee relates.

Thus, the amount of the Facility Fee varies depending on the amount of the bond outstanding.

Taxpayer deducted $x on its Year1 partnership return. In Year 2, Taxpayer deducted $y. Taxpayer has deferred payment of the Facility Fee to Limited Partner in Year 1 and Year 2.

LAW AND ANALYSIS

Section 162(a) provides a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year under the method of accounting used in computing taxable income.

Section 461(h) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

Section 1.461-1(a)(2) of the Income Tax Regulations provides, in part, that under an accrual method of accounting, a liability is incurred and generally is taken into account in the taxable year in which all events have occurred that fix the fact of the liability, the

amount of the liability is reasonably determinable and economic performance has occurred with respect to the liability.

Section 1.461-4(d)(2)(i) provides that if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property are provided.

Section 1.461-4(e) provides that in the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the relevant provisions of the Code.

Section 1.461-4(g) identifies 6 types of liabilities, in addition to liabilities arising out of workers' compensation or out of any tort, for which payment constitutes economic performance. They are: 1) liabilities arising out of a breach of contract; 2) liabilities arising from a violation of law; 3) rebates and refunds; 4) awards, prizes and jackpots; 5) amounts paid for insurance, warranty and service contracts; and 6) taxes other than creditable foreign taxes.

Section 1.461-4(g)(7) provides that in the case of a taxpayer's liability for which specific economic performance rules are not provided elsewhere in the section or in any other regulation, revenue ruling or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed.

In the instant case, facility fees are not specifically enumerated in the list of payment liabilities. Consequently, if they are payment liabilities under § 1.461-4(g), they must fall under § 1.461-4(g)(7).

Are the facility fees paid by Taxpayer an interest liability?

For federal income tax purposes, the generally accepted definition of interest is "compensation for the use or forbearance of money." Deputy v. Dupont, 308 U.S. 488. (1940). Section 163 of the Internal Revenue Code ("the Code") permits, as a deduction, all interest paid or accrued within a taxable year on indebtedness. Indebtedness is "an existing, unconditional, and legally enforceable obligation for the payment of a principal sum." Howlett v. Commissioner, 56 T.C. 951, 960 (1971); see also Midkiff v. Commissioner, 96 T.C. 724 at 734-735 (1991), affd. sub nom. Noguchi v. Commissioner, 992 F.2d 226 (9th Cir. 1993).

The guarantee fee in the present case can not be treated as interest unless the guarantee creates indebtedness. In this case, there are no facts indicating that Limited Partner has made a loan on which interest can be charged. It appears that the guarantee was extended for the initial negotiation of the debt. Limited Partner guaranteed the debt so that Taxpayer could obtain better loan terms, i.e. a lower interest rate.

The facts in this case do not support a conclusion that Limited Partner assumed a primary obligation on the guaranteed debt. Therefore, the fee paid to Limited Partner by Taxpayer should not be treated as interest.

Are the facility fees paid by Taxpayer deductible under § 1.461-4(d)(2)(i) or § 1.461-4(g)(7)?
In Centel Communications Co. v. Commissioner, 920 F.2d 1335 (7th Cir. 1990), aff'g 92 T.C. 612 (1989), the Seventh Circuit held that guarantees constitute contributions to capital and that guarantees do not constitute services under § 83(h).

In Centel, Fisk Telephone Systems ("Fisk") obtained a series of loans to carry on its essential operations. The shareholders of Fisk personally guaranteed these loans. A few years later, Fisk showed a profit and, in recognition of the risks assumed by the shareholders, Fisk granted them warrants authorizing each to purchase 50,000 additional shares of Fisk stock at $1 per share. The shareholders exercised their warrants. In the reorganization, the shareholders traded in those shares for Centel Communications Company ("Centel") stock. In this trade, the shareholders received $1,860,000 more than they had paid for their Fisk stock. At the same time, Centel agreed to release the shareholders from their obligations under the guarantees.

Centel claimed a deduction in the amount of $1,860,000 pursuant to § 83(h), which allows a deduction for the transfer of property made "in connection with the performance of services." The Service argued that the warrants were not transferred "in connection with the performance of services." Instead, the warrants were constructive dividends to the shareholders.

The Tax Court found that the shareholders, by offering guarantees to their company, assumed additional financial risk in their role as stockholders. In giving the guarantees, the stockholders were making additional contributions to capital to protect their substantial stock investment in Fisk, Centel's predecessor. They were not employees or independent contracts laboring or performing "services" for Fisk by guaranteeing Fisk's loans. Consequently, the warrants granted to the shareholders were not issued "in connection with" the performance of services. The legislative history of § 83 and relevant cases reveal that the term "services" usually connotes an act performed by an employer or independent contractor for the employer, rather than aid lent to the company by a stockholder. The Seventh Circuit agreed with the Tax Court, finding that the legislative history of § 83 supported the employee/shareholder distinction.

Applying the logic of the Centel decision to the instant case, it is clear that Limited Partner is neither an employee nor an independent contractor of Taxpayer. By guaranteeing the loan and ensuring that Taxpayer receives the lower interest rate, Limited Partner is acting to protect its substantial investment in Taxpayer. The reasoning employed by the court in Centel would indicate that this is not a service for purposes of § 83.

The taxpayer cites to Dieker v. Commissioner, T.C. Memo 2005-225, as support that the liability in question is a service liability under § 1.461-4(d)(2). In Dieker, the Tax Court held that the liability to the surety arose because of the surety's performance under the performance bond and indemnity agreement. National Contractors, Inc. ("National") was an S corporation that operated a construction business. In 1997, National contracted with a school district to build a performing arts center. As part of the contract, National was required to obtain a performance bond. In the event that National failed to complete the construction work for the project, Fidelity & Deposit Co. of Maryland ("F&D") agreed to act as surety to the school district and was obligated to complete the project. In addition, National and another corporation agreed to indemnify F&D for any costs incurred under the performance bond.

In 1998, the school district terminated its contract with National and F&D contracted with another construction company to complete the project in accordance with the District's specifications. F&D then sued National under the performance bond and the indemnity agreement.

The court stated that the liability arose because of F&D's performance under the performance bond and the indemnity agreement. When National breached the contract with the school district, F&D became obligated to perform under its performance bond, which in turn caused National to become obligated to indemnify F&D. National's inability to meets its obligation to the school district was the condition precedent to F&D's performance. Consequently, economic performance was satisfied as F&D performed under the performance bond.

This case is inapplicable to the instant case. In the instant case, Limited Partner is guaranteeing payment of the bond. Thus, the condition precedent needed to force the Limited Partner's performance would be Taxpayer not making payments to the bondholder. The liability in Dieker was not the payments that National was making to F&D for the performance bond prior to National's breaching. The liability was National's agreement to indemnify F&D and to make F&D whole under the performance agreement after National breached the contract with the school district. If National had not breached the contract, the payments made by National to F&D for the performance bond would be liabilities for which economic performance would be satisfied as payment was made to the entity to which the liability was owed.

Pursuant to the terms of the Agreement, Taxpayer was to pay facility fees annually. Taxpayer has deferred payments of the accrued facility fees. Because neither the statutory nor regulatory rules provide for an earlier time when economic performance occurs with respect to Taxpayer's liability for facility fees, economic performance occurs under § 1.461-4(g)(7) as Taxpayer makes payments to Limited Partner or its designated affiliate. By that time, all the events have occurred which establish the fact of the liability and the amount of the liability could be determined with reasonable accuracy. See § 1.461-1(a)(2). Thus, on the facts of this case Taxpayer incurs and may take into

account, the liability for the facility fees in the taxable year in which Taxpayer pays the facility fees.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Erika Reigle at 202-622-4950 if you have any further questions.