T.D. 8045

Treasury Decisions

DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Part 1

50 FR 33519

Income Tax; Taxable Years Beginning After December 31, 1953; Below-Market Loans

T.D. 8045

DATE: August 20, 1985

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the Federal tax treatment of both the lender and the borrower in certain below-market interest rate loan transactions. Changes to the applicable law were made by the Tax Reform Act of 1984. The regulations exempt taxpayers who are parties to certain below-market interest rate loan transactions from the new rules which generally apply to below-market interest rate loans. See the text of the notice of proposed rulemaking in the Proposed Rules section of this issue of the Federal Register for rules which would affect taxpayers who enter into certain below-market loans and provide them with guidance needed to comply with the law.

DATES: The regulations apply to below-market term loans made after June 6, 1984, and below-market demand loans outstanding after June 6, 1984, and are effective June 6, 1984.

ADDRESSES:
FOR FURTHER INFORMATION CONTACT:Sharon L. Hall of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224 (Attention: CC:LR:T), 202-566-3828, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary Income Tax Regulations (26 CFR Part 1) under section 7872 of the Internal Revenue Code of 1954.

In General

Prior to the enactment of section 7872, some taxpayers used interest-free loans or loans with an interest rate below the current market rate (in each case, "below-market loans") which purported to circumvent well-established rules of taxation. Thus, in family or similar situations below-market loans have been used which purported to have the effect of avoiding taxation under the grantor trust rules and deflecting income to others. Corporations have made below-market loans to shareholders with the effect of avoiding taxation of income at the corporate level which is the economic equivalent of receiving a deduction for dividends paid to those shareholders. Employers have made below-market loans to employees with the effect of providing compensation which has not been subject to employment taxes. Interest-free loans have also been used to convert non-deductible expenses into the equivalent of deductible expenses.

Section 7872 addresses these and similar practices, generally, by treating certain below-market loans described in one of the categories specified in section 7872(c) as economically equivalent to loans bearing interest at the applicable Federal rate coupled with a payment by the lender to the borrower sufficient to fund the payment of interest by the borrower. Thus, the lender is treated as making: (i) A loan to the borrower in exchange for a note requiring the payment of interest at the applicable Federal rate, and (ii) a transfer of funds to the borrower in an amount generally equal to the amount of interest imputed under section 7872. In the case of term gift loans, however, the amount of money treated as transferred by the lender to the borrower which is subject to gift tax, and the amount of the imputed interest payment by the borrower to the lender are unequal because they are calculated differently under the statute.

Exemption From Section 7872

These temporary regulations provide for the exemption of certain below-market loans from the rules of section 7872. Section 7872(g)(1)(C) provides regulatory authority for exempting from the application of section 7872 any class of transactions if the application of section 7872 would not have a significant effect on any Federal tax liability of the lender or the borrower. Accordingly, these temporary regulations provide that certain below-market loans which are not structured as such for tax avoidance purposes are exempted from the provisions of section 7872. If, however, such a loan is structured as one of the exempted loans for tax avoidance purposes, the Service may recharacterize the transaction according to its economic substance and apply section 7872 in accordance with its terms.

Notice of Proposed Rulemaking

The notice of proposed rulemaking, which is published in the Proposed Rules section of this issue of the Federal Register, provides taxpayers who enter into certain below-market loans with the guidance needed to comply with section 7872. Accordingly, those proposals would provide rules for determining:

(1) The type of transactions characterized as loans;

(2) The types of below-market loans subject to section 7872;

(3) The timing and amount of transfers in connection with gift demand and term loans;

(4) The special application of section 7872 to loans made directly between natural persons;

(5) The rule of *de minimis* amount of loans; and

(6) Other special rules.

As a result, these temporary regulations reserve all sections of the regulations other than § 1.7872-5T until the proposed regulations are published as either temporary or final regulations.

Inapplicability of Executive Order 12291

The Treasury Department has determined that these temporary regulations are not subject to review under Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required.

Regulatory Flexibility Act

A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitue regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Drafting Information

The principal author of these regulations is Howard A. Balikov of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing these regulations on matters of both substance and style.

List of Subjects in 26 CFR 1.7872-1 to 1.7872-14

Income taxes, Gift taxes, Below-market loans.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Income Tax Regulations

PART 1 -- [AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Section 1.7872-5T also issued under 26 U.S.C. 7872.

Par. 2. New §§ 1.7872-1 through 1.7872-4 are added and reserved in the appropriate place.

Par. 3. New §§ 1.7872-6 through 1.7872-14 are added and reserved in the appropriate place.

Par. 4. New § 1.7872-5T is added in the appropriate place. The new section reads as follows:

§ 1.7872-5T Exempted loans (temporary).

(a) *In general* -- (1) *General rule.* Except as provided in paragraph (a)(2) of this section, notwithstanding any other provision of section 7872 and the regulations thereunder, section 7872 does not apply to the loans listed in paragraph (b) of this section because the interest arrangements do not have a significant effect on the Federal tax liability of the borrower or the lender.

(2) *No exemption for tax avoidance loans.* If a taxpayer structures a transaction to be a loan described in paragraph (b) of this section and one of the principal purposes of so structuring the transaction is the avoidance of Federal tax, then the transaction will be recharacterized as a tax avoidance loan as defined in section 7872 (c)(1)(D).

(b) *List of exemptions.* Except as provided in paragraph (a) of this section, the following transactions are exempt from section 7872:

(1) Loans which are made available by the lender to the general public on the same terms and conditions and which are consistent with the lender's customary business practice;

(2) Accounts or withdrawable shares with a bank (as defined in section 581), or an institution to which section 591 applies, or a credit union, made in the ordinary course of its business;

(3) Acquisitions of publicly traded debt obligations for an amount equal to the public trading price at the time of acquisition;

(4) Loans made by a life insurance company (as defined in section 816 (a)), in the ordinary course of its business, to an insured, under a loan right contained in a life insurance policy and in which the cash surrender values are used as collateral for the loans;

(5) Loans subsidized by the Federal, State (including the District of Columbia), or Municipal government (or any agency or instrumentality thereof), and which are made available under a program of general application to the public;

(6) Employee-relocation loans that meet the requirements of paragraph (c)(1) of this section;

(7) Obligations the interest on which is excluded from gross income under section 103;

(8) Obligations of the United States government;

(9) Loans to a charitable organization described in section 170(c), but only if at no time during the taxable year will the aggregate outstanding amount of loans by the lender to all such organizations exceed $10,000;

(10) Loans made to or from a foreign person that meet the requirements of paragraph (c)(2) of this section;

(11) Loans made by a private foundation or other organization described in section 170(c), the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B);

(12) Loans made prior to July 1, 1986, to the extent excepted from the application of section 482 for the 6-month (or longer) period referred to in § 1.482-2(a)(3);

(13) For periods prior to July 1, 1986, all money, securities, and property received by a futures commission merchant or by a clearing organization (i) to margin, guarantee or secure contracts for future delivery on or subject to the rules of a qualified board or exchange (as defined in section 1256 (g)(7)), or (ii) to purchase, margin, guarantee or secure options contracts traded on or subject to the rules of a qualified board or exchange, and all money accruing to account holders as the result of such futures and options contracts;

(14) Loans the interest arrangements of which the taxpayer is able to show have no significant effect on any Federal tax liability of the lender or the borrower, as described in paragraph (c)(3) of this section; and

(15) Loans, described in revenue rulings or revenue procedures issued under section 7872(g)(1)(C), if the Commissioner finds that the factors justifying an exemption for such loans are sufficiently similar to the factors justifying the exemptions contained in this section.

(c) *Special rules* -- (1) *Employee-relocation loans* -- (i) *Mortgage loans.* In the case of a compensation-related loan to an employee, where such loan is secured by a mortgage on the new principal residence (within the meaning of section 217 and the regulations thereunder) of the employee, acquired in connection with the transfer of that employee to a new principal place of work (which meets the requirements in section 217(c) and the regulations thereunder), the loan will be exempt from section 7872 if the following conditions are satisfied:

(A) The loan is a demand loan or is a term loan the benefits of the interest arrangements of which are not transferable by the employee and are conditioned on the future performance of substantial services by the employee;

(B) The employee certifies to the employer that the employee reasonably expects to be entitled to and will itemize deductions for each year the loan is outstanding; and

(C) The loan agreement requires that the loan proceeds be used only to purchase the new principal residence of the employee.

(ii) *Bridge loans.* In the case of a compensation-related loan to an employee which is not described in paragraph (c)(1)(i) of this section, and which is used to purchase a new principal residence (within the meaning of section 217 and the regulations thereunder) of the employee acquired in connection with the transfer of that employee to a new principal place of work (which meets the requirements in section 217(c) and the regulations thereunder), the loan will be exempt from section 7872 if the following conditions are satisfied:

(A) The conditions contained in paragraphs (c)(1)(i) (A), (B), and (C) of this section;

(B) The loan agreement provides that the loan is payable in full within 15 days after the date of the sale of the employee's immediately former principal residence;

(C) The aggregate principal amount of all outstanding loans described in this paragraph (c)(1)(ii) to an employee is no greater than the employer's reasonable estimate of the amount of the equity of the employee and the employee's spouse in the employee's immediately former principal residence, and

(D) The employee's immediately former principal residence is not converted to business or investment use.

(2) *Below-market loans involving foreign persons* -- (i) Section 7872 shall not apply to a below-market loan (other than a compensation-related loan or a corporation-shareholder loan where the borrower is a shareholder that is not a C corporation as defined in section 1361(a)(2)) if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

(ii) Section 7872 shall not apply to a below-market loan where both the lender and the borrower are foreign persons unless the interest income imputed to the lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

(iii) For purposes of this section, the term "foreign person" means any person that is not a U.S. person.

(3) *Loans without significant tax effect.* Whether a loan will be considered to be a loan the interest arrangements of which have a significant effect on any Federal tax liability of the lender or the borrower will be determined according to all of the facts and circumstances. Among the factors to be considered are --

(i) Whether items of income and deduction generated by the loan offset each other;

(ii) the amount of such items;

(iii) the cost to the taxpayer of complying with the provisions of section 7872 if such section were applied; and

(iv) any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal rate and a payment by the lender to the borrower.

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue this Treasury decision with notice and public procedure under section (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

Approved: August 12, 1985.

Ronald A. Pearlman,

Assistant Secretary of the Treasury.
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