

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CC:DOM:FS:CORP

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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MEMORANDUM FOR



FROM: STEVEN J. HANKIN
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FIELD SERVICE DIVISION CC:DOM:FS

SUBJECT: Below-Market Loans Subject to I.R.C. § 7872 (Indirect Loans
Between a Corporation and its Shareholders)

This Field Service Advice responds to your memorandum dated September 24, 1998. 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:

X =
A =
B =
C =
D =
E =
F =
Corp =

PS1 =
PS2 =
PS3 =
PS4 =

\$a =
\$b =
\$c =
\$d =
\$e =
\$f =
\$g =
\$h =
\$i =
\$j =
\$k =

a% =
b% =
c% =
d% =
e% =
f% =
g% =
h% =
i% =
j% =
k% =
l% =
m% =
n% =

Date 1 =
Date 2 =

ISSUES:

Whether X realized forgone interest income under I.R.C. § 7872 in the amounts of \$a and \$b for its tax years ending on Date 1 and Date 2, respectively. Specifically:

- (1) whether the loan from X to Corp can be characterized as an indirect loan between a corporation and its shareholders under I.R.C. § 7872(c)(1)(C);
- (2) whether the loans from X to each of PS1, PS2, PS3 and PS4 (the “borrowing partnerships”) can be characterized as indirect loans from X to its shareholders under I.R.C. § 7872(c)(1)(C); and
- (3) whether I.R.C. § 7872(c)(1)(C) applies to the loans from X to each of B and C.

CONCLUSIONS:

The interest-free loans from X to: (1) Corp, (2) each of the borrowing partnerships, and (3) each of B and C, may all be classified as corporation-shareholder loans under I.R.C. § 7872(c)(1)(C).

FACTS:

For the taxable years ending Date 1 and Date 2, the following shareholders owned the stock of X in the following amounts:

B	C	D	E
f%	l%	k%	e%

B, C and D are the children of A. E is the estate of the deceased spouse of A.

A and B are also compensated full-time officers of X, while C and D are compensated part-time employees of X.

X made interest-free demand loans dated Date 1 to: (1) Corp, (2) each PS1, PS2, PS3 and PS4 (the “borrowing partnerships”), (3) and each of B and C. The amounts of all of the loans, the stock ownership of Corp and the capital and profits interest of the borrowing partnerships are as follows:

	A	B	C	D	E	Others	Amount Borrowed

Corp	k%	d%	i%	a%	d%		\$d
PS1			m%			m% ¹	\$c
PS2		b%	b%	b%		n% ²	\$e
PS3	g%	j%	j%	g%			\$f
PS4	h%	h%	h%	h%			\$g, \$h
B							\$i, \$j
C							\$k

LAW AND ANALYSIS

Law:

I.R.C. § 7872(a)(1) provides that, for purposes of this title, in the case of any below-market loan to which this section applies and which is a demand loan, the forgone interest shall be treated as (A) transferred from the lender to the borrower, and (B) retransferred by the borrower to the lender as interest.

I.R.C. § 7872(c)(1)(C) provides, with exceptions not relevant here, that this section shall apply to any below-market loan directly or indirectly between a corporation and any shareholder of such corporation.

I.R.C. § 7872(e)(1)(A) provides that, for purposes of this section, the term "below-market loan" means any loan if, in the case of a demand loan, interest is payable on the loan at rates less than the applicable Federal rate.

I.R.C. § 7872(e)(2) provides that the term "forgone interest" means, with respect to any period during which the loan is outstanding, the excess of --

(A) the amount of interest which would have been payable on the loan for the period if interest accrued on the loan at the applicable Federal rate and were payable annually on the day referred to in I.R.C. § 7872(a)(2) [generally the last day of the calendar year], over

¹ F, the son of C

² Seven children of B, C and D.

(B) any interest payable on the loan properly allocable to such period.

I.R.C. § 7872(f)(2)(B) provides that, in the case of a demand loan, the applicable Federal rate shall be the Federal short-term rate in effect under I.R.C. § 1274(d) for the period for which the amount of the amount of the forgone interest is being determined, compounded semiannually.

I.R.C. § 7872(f)(5) provides that the term "demand loan" means any loan which is payable in full at any time on the demand of the lender.

Prop. Reg. § 1.7872-4(d)(1) provides that a below-market loan is a corporation-shareholder loan if the loan is made directly or indirectly between a corporation and any shareholder of the corporation. The amount of money treated as transferred by the lender to the borrower is a distribution of money (characterized according to I.R.C. § 301) if the corporation is the lender, or a contribution to capital if the shareholder is the lender.

Prop. Reg. § 1.7872-4(c)(5) provides a special rule in Prop. Reg. § 1.7872-4(d)(2) in the case of a below-market loan that could be characterized as both a compensation-related loan and a corporation-shareholder loan.

Prop. Reg. § 1.7872-4(d)(2)(ii) provides that a below-market loan from a corporation that is not a publicly held corporation to an employee of the corporation who is also a shareholder owning directly or indirectly more than five percent of the total voting power of all classes of stock entitled to vote or more than five percent of the total number of shares of all other classes of stock or five percent of the total value of shares of all classes of stock (including voting stock) of the corporation will be presumed to be a corporation-shareholder loan, in the absence of clear and convincing evidence that the loan is made solely in connection with the performances of services.

Prop. Reg. § 1.7872-4(g)(1) provides that if a below-market loan is made between two persons and, based on all the facts and circumstances, the effect of the loan is to make a gift, or a capital contribution, or a distribution of money (under I.R.C. § 301 or, in the case of an "S" corporation, I.R.C. § 1368), or to pay compensation to a third person ("indirect participant"), or is otherwise attributable to the relationship of the lender or borrower to the indirect participant, the loan is restructured as two or more successive below-market loans ("deemed loans") for purposes of I.R.C. § 7872, as follows:

(i) A deemed below-market loan made by the named lender to the indirect participant; and,

(ii) A deemed below-market loan made by the indirect participant to the borrower.

I.R.C. § 7872 is applied separately to each deemed loan, and each deemed loan is treated as having the same provisions as the original loan between the lender and borrower. Thus, for example, if a corporation makes an interest-free loan to another commonly controlled corporation, the loan is restructured as a below-market loan from the lending corporation to the common parent corporation and a second below-market loan from the parent corporation to the borrowing corporation.

Prop. Reg. § 1.7872-4(g)(2) provides that if a lender and a borrower use another person, such as an individual, a trust, a partnership, or a corporation, as an intermediary or middleman in a loan transaction and a purpose for such use is to avoid the application of I.R.C. § 7872(c)(1)(A), (B), or (C), the intermediary will be ignored and the loan will be treated as made directly between the lender and the borrower. Thus, for example, if a father and a son arrange their below-market loan transaction by having the father make a below-market loan to the father's partnership, followed by a second below-market loan (with substantially identical terms and conditions as the first loan) made by the partnership to the son, the two below-market loans will be restructured as one below-market loan from the father to the son.

Analysis:

Background

As noted above, X loaned money to Corp, the borrowing partnerships, and B and C at a zero percent interest rate. Therefore, the Service is alleging that the loans between X and each of the borrowers were below-market demand loans within the meaning of I.R.C. § 7872(e)(1)(A). Therefore, X should be deemed to have received forgone interest income within the meaning of I.R.C. § 7872(e)(2).

Section 7872 treats a below-market loan as if the lender transferred an amount equal to the forgone interest to the borrower and the borrower immediately transferred such amount to the lender as interest income. The term "loan" is interpreted broadly to implement the anti-abuse intent of the statute. Prop. Reg. § 1.7872-2(a)(1). Section 7872, however, applies only to certain categories of below-market loans. These categories are gift loans, compensation-related loans, corporation-shareholder loans, tax avoidance loans, and certain other loans classified in the regulations under I.R.C. § 7872 as significant tax effect loans.

According to the Committee Reports for I.R.C. § 7872, Congress believed that the failure to tax below-market loans according to their substance provided taxpayers with

opportunities to avoid a number of tax rules. Specifically, corporation-shareholder loans were being used to avoid taxing corporate income at the corporate level. S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess. 474, 478 (1984).

For example, by structuring a transaction as an interest-free loan, a corporation could avoid including in income interest that otherwise would be paid by its shareholder. *Id.* As a result, a corporation would be in the same economic position as if it were able to deduct amounts distributed as dividends to its shareholder. *Id.* However, if the transaction were structured as a distribution and loan, the shareholder would have dividend income and an offsetting interest deduction and the corporation would have interest income. *Id.*

To eliminate this abuse, a below-market loan is recharacterized as an arm's-length transaction in which the lender (1) made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory rate and (2) made a gift, distributed a dividend, made a contribution to capital, paid compensation, or made another payment to the borrower which, in turn, is used by the borrower to pay the interest. Conf. Comm. Rep., H.R. Rep. No. 861, 98th Cong., 2d Sess., 1011, 1015 (1984) [1984-3 C.B. (Vol. 2) 265, 269]. Specifically, in the case of a corporation-shareholder loan, the corporation-lender is treated as paying a dividend which is includible in the income of the shareholder-borrower. S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess. 479 (1984). The shareholder-borrower is treated as using this payment to pay interest to the corporation-lender at the applicable Federal rate. The corporation is treated as receiving this imputed interest income at the corporate level. Also see Prop. Reg. § 1.7872-4(d)(1).

The Loan from X to Corp

A loan between commonly owned corporations that is in substance an indirect below-market loan under I.R.C. § 7872(c)(1) should be recast as two or more deemed loans to reflect the substance of the transaction. For example, a loan that in form is made between commonly owned corporations is in substance characterized one or more indirect loans between the lending corporation, the common shareholders, and the borrowing corporation (I.R.C. § 7872 applies to any below-market loan directly or indirectly between a corporation and its shareholder). Such a transaction should be recast as two deemed loans: the first deemed loan being between the lending corporation and its shareholders (i.e., the lending corporation is deemed to have loaned the money to its shareholders) and the second deemed loan being between those shareholders and the borrowing corporation (i.e., those shareholders are in turn deemed to have loaned the money received from the lending corporation to the borrowing corporation). See Prop. Reg. § 1.7872-4(g)(ii).

Based on our interpretation of I.R.C. § 7872(c)(1)(C) (and consistent with the proposed regulations under I.R.C. § 7872), the loan from X to Corp should be treated as an indirect corporation-shareholder loan under I.R.C. § 7872(c)(1)(C) and recast as two deemed loans. The first deemed loan is between X and its shareholders, and the second deemed loan is between those shareholders and the respective borrowing corporation. Only the first deemed loan involving petitioner X as the lender is before the Tax Court.

To illustrate the operation of the indirect loan provisions under I.R.C. § 7872 and the proposed regulations, we will use similar facts to this case, but we will assume that: (1) individual C owns all of the stock of both X (the “lending corporation”) and Y (the “borrowing corporation”), (2) in form X loans \$100 interest-free to Y, and (3) the applicable Federal rate is 10%. Based on these assumed facts, I.R.C. § 7872 would recharacterize the loan from X to Y as two deemed loans. The first deemed loan would be in the amount of \$100 from X to C. The second deemed loan would also be in the amount of \$100, but from C to Y.

With respect to the first deemed loan, X would be treated as having made a loan of \$100 at 10% to C, plus a distribution with respect to its stock to C of \$10. Thus, C would receive \$10 of dividend income to the extent that X has earnings and profits at least equal to the amount of such distribution. C would be treated as having paid \$10 as interest to X. Thus, X would have \$10 of interest income.

With respect to the second deemed loan, C should be treated as having made a loan of \$100 at 10% to Y, and as having contributed \$10 to the capital of Y. Y should be treated as having paid \$10 of interest to C.

The Loans from X to the Borrowing Partnerships

As noted above, X also made interest-free demand loans to the borrowing partnerships. However, these partnerships are intermediaries being used by X and its shareholders to avoid the application of I.R.C. § 7872(c)(1)(C). That is, if X had made these loans directly to its shareholders, X would have been subject to I.R.C. § 7872(c)(1)(C). If X sought to avoid the application of that provision by making the loans to the borrowing partnerships instead of to its shareholders, the borrowing partnerships may be ignored and the loans may be considered as made by X to its shareholders.

The Loans from X to B and C

In this case, B and C are employees as well as shareholders of X. Therefore, the loans from X to each of B and C could be classified as either compensation-related loans or corporation-shareholder loans. Absent evidence that the loans were made

solely in connection with the performance of services, it is the position of the Service that where there is an overlap between the two types of loans, such a loan is classified as a corporation-shareholder loan. Prop. Reg. § 1.7872-4(c)(5) and Prop. Reg. § 1.7872-4(d)(2)(ii). The record does not indicate that such loans were made by X to each of B and C in any other capacity than as shareholders. Therefore, the loans from X to each of B and C are classified as corporation-shareholder loans under I.R.C. § 7872(c)(1)(C). X receives imputed interest income on these loans under I.R.C. § 7872.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:





