Prop. Reg. Section 1.7872-4

Types of below-market loans

(a) In general. Section 7872 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 section 7872 as significant tax effect loans (i.e., loans whose interest arrangements have a significant effect on any Federal tax liability of the lender or the borrower.)

(b) Gift loans.

(1) In general. The term "gift loan" means any below-market loan in which the foregoing of interest is in the nature of a gift within the meaning of Chapter 12 of the Internal Revenue Code (whether or not the lender is a natural person).

(2) Cross reference. See §1.7872-8 for special rules limiting the application of section 7872 to gift loans. See paragraph (g) of this section for rules with respect to below-market loans which are indirectly gift loans.

(c) Compensation-related loans.

(1) In general. A compensation-related loan is a below-market loan that is made in connection with the performance of services, directly or indirectly, between-

(i) An employer and an employee,

(ii) An independent contractor and a person for whom such independent contractor provides services, or

(iii) A partnership and a partner if the loan is made in consideration for services performed by the partner acting other than in his capacity as a member of the partnership.

The imputed transfer (amount of money treated as transferred) by the lender to the borrower is compensation. For purposes of this section, the term "in connection with the performance of services" has the same meaning as the term has for purposes of section 83. A loan from a qualified pension, profit-sharing, or stock bonus plan to a participant of the plan is not, directly or indirectly, a compensation-related loan.

(2) Loan in part in exchange for services. Except as provided in paragraph (d)(2) of this section (relating to a loan from a corporation to an employee who is also a shareholder of the corporation), a loan which is made in part in exchange for services and in part for other reasons is treated as a compensation-related loan for purposes of section 7872(c)(3) only if more than 25 percent of the amount loaned is attributable to the performance of services. If 25 percent or less of the amount loaned is attributable to the performance of

services, the loan is not subject to section 7872 by reason of being a compensation-related loan. The loan may, however, be subject to section 7872 by reason of being a below-market loan characterized other than as a compensation-related loan (e.g., corporation-shareholder loan or tax avoidance loan). If-

(i) A loan is characterized as a "compensation-related" loan under this paragraph (c),

(ii) Less than 100 percent of the amount loaned is attributable to the performance of services, and

(iii) The portion of the amount loaned that is not attributable to the performance of services is not subject to section 7872,

then the amounts of imputed transfer (as defined in § 1.7872-1(a)(2)) and imputed transfer (as defined in § 1.7872-1(a)) are determined only with respect to that part of the loan which is attributable to services. All of the facts and circumstances surrounding the loan agreement and the relationship between the lender and the borrower are taken into account in determining the portion of the loan made in exchange for services.

(3) Third-party lender as agent. A below-market loan by an unrelated third-party lender to an employee is treated as attributable to the performance of services if, taking into account all the facts and circumstances, the transaction is in substance a loan by the employer made with the aid of a third-party lender acting as an agent of the employer. Among the facts and circumstances which indicate whether such a loan has been made is whether the employer bears the risk of default at and immediately after the time the loan is made. The principles of this paragraph (c)(3) also apply with respect to a below-market loan by an unrelated third-party lender to an independent contractor.

(4) Special rule for continuing care facilities. Any loan to a continuing care facility will not be treated, in whole or in part, as a compensation-related loan.

(5) Cross-references. For a special rule in the case of a below-market loan that could be characterized as both a compensation-related loan and a corporation-shareholder loan, see paragraph (d)(2) of this section. See paragraph (g) of this section for rules with respect to below-market loans which are indirectly compensation-related loans.

(d) Corporation-shareholder loans.

(1) In general. 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 section 301 or in the case of an S corporation, section 1368) if the corporation is the lender, or a contribution to capital if the shareholder is the lender.

(2) Special rule. A below-market loan-

(i) From a publicly held corporation to an employee of the corporation who is also a shareholder owning directly or indirectly more than 0.5 percent of the total voting power of all classes of stock entitled to vote or more than 0.5 percent of the total value of shares of all other classes of stock or 0.5 percent of the total value of shares of all classes of stock (including voting stock) of the corporation; or

(ii) 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 5 percent of the total voting power of all classes of stock entitled to vote or more than 5 percent of the total number of shares of all other classes of stock or 5 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 performance of services. For purposes of determining the percentage of direct and indirect stock ownership, the constructive ownership rules of section 267(c) apply.

(3) Cross-reference. See paragraph (g) of this section for rules with respect to below-market loans which are indirectly corporation-shareholder loans.

(e) Tax avoidance loans. A tax avoidance loan is any below-market loan one of the principal purposes for the interest arrangements of which is the avoidance of Federal tax with respect to either the borrower or the lender, or both. For purposes of this rule, tax avoidance is a principal purpose of the interest arrangements if a principal factor in the decision to structure the transaction as a below-market loan (rather than, for example, as a market interest rate loan and a payment by the lender to the borrower) is to reduce the Federal tax liability of the borrower or the lender or both. The purpose for entering into the transaction (for example, to a make a gift or to pay compensation) is irrelevant in determining whether a principal purpose of the interest arrangements of the loan is the avoidance of Federal tax.

(f) Certain below-market loans with significant effect on tax liability ("significant-effect" loans). [Reserved].

(g) Indirect loans.

(1) In general. 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 section 301 or in the case of an S corporation, section 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 section 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.

Section 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 the borrower. Thus, for example, if a father makes an interest-free loan to his daughter's corporation, the loan is restructured as a below-market loan from father to daughter (deemed gift loan) and a second below-market loan from daughter to corporation (deemed corporation-shareholder loan). Similarly, 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.

(2) Special rule for intermediaries. 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 section 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.