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Prop. Reg. Section 1.7872-7

Timing and amount of transfers in connection with below-market term loans

(a) In general. This section governs the Federal income tax consequences of below-market term loans, other than gift term loans or term loans treated as demand loans under the provisions of § 1.7872-10(a)(5), to which section 7872 applies. It also governs the Federal gift tax consequences of below-market gift term loans. See § 1.7872-11(f) for special rules which govern loans repayable in foreign currency and which apply notwithstanding any contrary rules set forth in this section.

(1) Timing and amount of transfer from lender to borrower. In the case of term loans to which this section applies, the amount of the imputed transfer by the lender to the borrower-

(i) Is treated as transferred at the time the loan is made and is treated for tax purposes in a manner consistent with the taxpayer's method of accounting; and

(ii) Is equal to the excess of-

(A) The amount loaned (as defined in paragraph (a)(4) of this section); over

(B) The present value (as determined in paragraph (a)(5) of this section and § 1.7872-14) of all payments which are required to be made under the terms of the loan agreement, whether express or implied.

(2) Gift term loans. In the case of a gift term loan, the rules of paragraph (a)(1) of this section apply for gift tax purposes only. For rules governing the income tax consequences of gift term loans, see § 1.7872-6.

(3) Treatment of amount equal to imputed transfer as original issue discount.

(i) In general. Any below-market loan to which paragraph (a)(1) of this section applies shall be treated as having original issue discount in an amount equal to the amount of the imputed transfer determined under paragraph (a)(1) of this section. This imputed original issue discount is in addition to any other original issue discount on the loan (determined without regard to section 7872(b) or this paragraph). For purposes of applying section 1272 to a loan described in this paragraph, the issue price shall be treated as equal to the stated principal reduced by the amount of the imputed transfer and the yield to maturity is the applicable Federal rate.

(ii) Example. The provisions of this paragraph (a)(3) may be illustrated by the following example.

Example.

(i) On June 10, 1984, L lends \$45,000 to B, a corporation in which L is a shareholder, for five years in exchange for a \$50,000 note bearing interest at a below-market rate. Assume that the present value of all payments that B must make to L is \$42,000. This loan is a corporation-shareholder term loan under section 7872(c)(1)(C). Accordingly, the amount of the imputed transfer by L to B is determined under the provisions of section 7872(b).

(ii) On June 10, 1984, L is treated as transferring \$3,000 (the excess of \$45,000 (amount loaned) over \$42,000 (present value of all payments)), in accordance with section 7872(b)(1). This imputed transfer is treated as a contribution to B's capital by L. An amount equal to the imputed transfer is treated as original issue discount. This original issue discount is in addition to the \$5,000 (\$50,000, the stated redemption price, less \$45,000, the issue price) of original issue discount otherwise determined under section 1273. As a result, the loan is treated as having a total of \$8,000 of original issue discount.

(4) Amount loaned. The term "amount loaned" means the amount received by the borrower (determined without regard to section 7872). See §1.7872-2(a)(3) for the treatment of the transfer of the loan proceeds to the borrower in installments or subject to draw-down restrictions.

(5) Present value. The present value of all payments which are required to be made under the provisions of the loan agreement is computed as of the date the loan is made (or, if later, as of the day the loan first becomes subject to the provisions of section 7872). The discount rate for the present value computation is the applicable Federal rate as defined in §1.7872-3(b) in effect on the day on which the loan is made. For rules governing the computation of present value, see §1.7872-14. See also Example (3) in §1.7872-8(b)(5).

(6) Basis. In the case of a term loan the lender's basis in the note received in exchange for lending money is equal to the present value of all payments which are required to be made under the terms of the loan agreement, whether express or implied, with adjustments as provided for in section 1272(d)(2).

(b) Special rule for the de minimis provisions.

(1) In general. If as a result of the application of the de minimis provisions of section 7872(c)(2) or (3), a loan becomes subject to section 7872 and this section on a day after the day on which the loan is made, the provisions of this section generally apply to the loan as if the loan were made on that later day. The applicable Federal rate applied to this loan (including for purposes of computing the present value of the loan), however, is the applicable Federal rate (as defined in §1.7872-3(b)) in effect on the day on which the loan is first made. The present value computation described in paragraph (a)(1)(ii)(B) of this section is made as of the day on which section 7872 and this section first apply to the loan. For purposes of making this computation, the term of the loan is equal to the period beginning on the day that section 7872 first applies to the loan and ending on the day on which the loan is to be repaid according to the loan agreement. Any payments payable according to the loan agreement before the day on which section 7872 and this section first apply to the loans are disregarded.

(2) Continuing application of section 7872. Once section 7872 and this section apply to a term loan, they continue to apply to the loan regardless of whether the de minimis

provisions of section 7872(c)(2) or (3) apply at some later date. In the case of a gift term loan, this paragraph applies only for gift tax purposes and does not apply for income tax purposes.