Prop. Reg. 1.7872-3
Definition of below-market loans

(a) In general. Section 7872 does not impute interest on loans which require the payment of interest at the applicable Federal rate. This section defines the applicable Federal rate and provides rules for determining whether an interest-bearing loan provides sufficient stated interest to avoid classification as a below-market loan. The term "below-market loan" means any loan if-

(1) In the case of a demand loan, interest is payable at a rate less than the applicable Federal rate; or

(2) In the case of a term loan, the amount loaned exceeds the present value of all payments due under the loan, determined as of the day the loan is made, using a discount rate equal to the applicable Federal rate in effect on the day the loan is made.

Sections 1.7872-13 and 1.7872-14 contain the computations necessary for determining the amount of imputed interest on a below-market loan which is subject to section 7872.

(b) Applicable Federal rate.

(1) In general. The applicable Federal rate is an annual stated rate of interest based on semiannual compounding. In addition, the Commissioner may prescribe equivalent rates based on compounding periods other than semiannual compounding (for example, annual compounding, quarterly compounding, and monthly compounding), to facilitate application of this section to loans other than those involving semiannual payments or compounding. Thus, loans providing for annual payments or annual compounding of interest over the entire life of the loan will use the applicable Federal rates based on annual compounding; loans providing for quarterly payments or quarterly compounding over the entire life of the loan will use the applicable Federal rates based on quarterly compounding; and loans providing for monthly payments or monthly compounding over the entire life of the loan will use the applicable Federal rates based on monthly compounding. The shorter of the compounding period or the payment interval determines which rate is appropriate. Loans providing for payments or compounding of interest at other intervals (e.g., daily, weekly, bi-monthly) may use the applicable Federal rates published by the Commissioner based on the shortest compounding period that is longer than the shorter of the compounding period or the payment interval provided for over the entire life of the loan. Thus, loans providing for daily or weekly payments or compounding of interest may use the applicable Federal rates based on monthly compounding; loans providing for bi-monthly payments or compounding of interest will use the applicable Federal rates based on quarterly compounding; etc. Alternatively, taxpayers may compute and use interest rates other than those published by the Commissioner for other interest payment or compounding periods if such rates are equivalent to the applicable Federal rates. Any reference to the applicable Federal rate in
the regulations under section 7872 includes the equivalent rates based on different compounding or payment periods.

(2) Determination of applicable Federal rate.
   (i) In general. The applicable Federal rate for loans described in paragraphs (b)(3),
       (4), and (5) of this section is defined by reference to Federal statutory rates and
       alternate Federal rates.

   (ii) Definition of Federal statutory rate. The Federal statutory rates are the short-,
       mid-, and long-term rates in effect under section 1274(d) and their equivalent
       rates based on different compounding assumptions. These rates are published by
       the Commissioner for each semiannual period January 1 through June 30 and July
       1 through December 31.

   (iii) Definition of alternate Federal rate. The alternate Federal rates are the short-,
       mid-, and long-term rates established by the Commissioner on a monthly basis,
       and their equivalent rates based on different compounding assumptions. These
       rates are published by the Commissioner on a monthly basis.

   (iv) Definition of semiannual period. For purposes of section 7872 and the
       regulations thereunder, the first semiannual period means the period in any
       calendar year beginning on January 1 and ending on June 30, and the second
       semiannual period means the period in any calendar year beginning on July 1 and
       ending on December 31.

(3) Demand loans.
   (i) In general. In the case of a demand loan, the applicable Federal rate for a
       semiannual period (January 1 through June 30 or July 1 through December 31), is
       the lower of:

       (A) The Federal statutory short-term rate in effect for the semiannual
           period; or

       (B) The special rate for demand loans described in paragraph (b)(3)(ii) of
           this section.

   (ii) Special rate for demand loans. The special rate for demand loans is-

       (A) For the semiannual period in which the loan is made, the alternate
           Federal short-term rate which is in effect on the day the loan is made; and

       (B) For each subsequent semiannual period in which the loan is
           outstanding, the alternate Federal short-term rate which is in effect for the
           first month of that semiannual period (i.e., January or July).

For a special safe harbor rule for certain variable interest rate demand loans, see
paragraph (c)(2) of this section.

(4) Term loans. In the case of a term loan, including a gift term loan or a term loan that is
    treated as a demand loan as provided in §1.7872-10(a)(5), the applicable Federal rate is
    the lower of:
(i) The Federal statutory rate for loans of that term in effect on the day the loan is made; or

(ii) The alternate Federal rate for loans of that term in effect on the day the loan is made.

(5) Loans conditioned on future services. In the case of a term loan that is treated as a demand loan as provided in § 1.7872-10(a)(5), on the date the condition to perform substantial services is removed or lapses, the demand loan is treated as terminated and a new term loan is created. The applicable Federal rate for the new term loan is the lower of the following:

(i) The applicable Federal rate in effect on the day the original loan was made; or

(ii) The applicable Federal rate in effect on the day the condition lapses or is removed.

(6) Periods before January 1, 1985. For term loans made and demand loans outstanding after June 6, 1984, and before January 1, 1985, the applicable Federal rate under section 7872(f)(2) is as follows:

(i) 10.25 percent, compounded annually;

(ii) 10.00 percent, compounded semiannually;

(iii) 9.88 percent, compounded quarterly; and

(iv) 9.80 percent, compounded monthly.

(c) Loans having sufficient stated interest.

(1) In general. Section 7872 does not apply to any loan which has sufficient stated interest. A loan has sufficient stated interest if it provides for interest on the outstanding loan balance at a rate no lower than the applicable Federal rate based on a compounding period appropriate for that loan. See paragraph (b)(1) of this section for a description of appropriate compounding periods. See §1.7872-11(a) for rules relating to waiver of interest.

(2) Safe harbor for demand loans. If the interest rate on a demand loan is changed, either under the terms of the original loan agreement, or subsequently, the loan will be treated as a new loan for purposes of determining the applicable Federal rate for that loan. Thus, the loan will have sufficient stated interest for the remainder of the semiannual period following such change of interest rate if the new interest rate is not less than the lower of the Federal statutory short-term rate in effect for the semiannual period or the alternate Federal short-term rate in effect on the day the new interest rate takes effect.

(3) Examples. The provisions of this paragraph (c) may be illustrated by the following examples.

Example (1). On December 1, 1984, A makes a $100,000 5-year gift term loan to B, requiring 10 interest payments of $5,000 each, payable on May 31 and November 30 of each year the loan is outstanding. Since the loan requires semiannual interest payments,
the appropriate compounding assumption is semiannual compounding. For term loans made during 1984, the applicable Federal rate based on semiannual compounding is 10 percent. The loan is not a below-market loan because it provides for interest at a rate of 10 percent, payable semiannually.

Example (2). Assume the same facts as in Example (1), except that the loan requires 5 annual interest payments of $10,000 each, payable on November 30 of each year the loan is outstanding. Since the loan requires annual interest payments, the appropriate compounding assumption is annual compounding. The loan is a below-market loan because, although interest is stated at a rate of 10 percent, a rate that reflects semiannual compounding is not appropriate for a loan with annual payments.

Example (3). Assume the same facts as in Example (2), except that the loan requires 5 annual payments of $10,250 each, payable on November 30 of each year that the loan is outstanding. Since the loan requires annual interest payments, the appropriate compounding assumption is annual compounding. For term loans made during 1984, the applicable Federal rate based on annual compounding is 10.25 percent. The loan is not a below-market loan because it provides for interest at a rate of 10.25 percent, compounded annually.

Example (4). Assume the same facts as in Example (1), except that the loan requires 60 monthly interest payments of $816.67 each, payable on the last calendar day of each month that the loan is outstanding. Since the loan requires monthly interest payments, the appropriate compounding assumption is monthly compounding. The loan is not a below-market loan because it requires monthly payments of interest based on a rate of 9.80 percent, the applicable Federal rate of interest based on monthly compounding.

Example (5). (i) A makes a demand loan to her son, B, on April 1, 1985. The loan requires quarterly interest payments due at the end of each calendar quarter at a rate of 10 percent. Assume that on April 1, 1985, the Federal statutory short-term rate in effect is 12 percent, compounded quarterly, and that the alternate Federal short-term rate in effect for the month of April is 10 percent, compounded quarterly. The loan is not a below-market loan for the period April 1, 1985, through June 30, 1985.

(ii) Assume that on July 1, 1985, the Federal statutory short-term rate in effect is 11 percent, compounded quarterly, and the alternate Federal short-term rate in effect for the month of July is 10.20 percent, compounded quarterly. The loan no longer has sufficient stated interest. If A raises the interest rate to at least 10.20 percent, the loan will have sufficient stated interest and will not be a below-market loan for the period of July 1 through December 31, 1985.

(iii) Assume that on July 1, 1985, A increases the interest rate on the loan to 10.20 percent, a rate equal to the alternate Federal short-term rate in effect for July. Further assume that the alternate Federal short-term rate subsequently decreases so that such rate in effect for the month of August decreases to 10 percent. On August 1, 1985, A lowers the interest rate on this loan to 10 percent and does not change that rate for the remainder of the semiannual period. The loan has sufficient stated interest and will not be a below-market loan for the semiannual period beginning on July 1, 1985, even if the alternate
Federal rate is greater than 10 percent for any or all of the four remaining months in the semiannual period ending on December 31, 1985.

(d) Short periods. The rules for determining whether a loan has sufficient stated interest also apply to short periods (e.g., a period that is shorter than the interval between interest payments or interest compounding under the loan which may occur at the beginning or end of the loan). For special computational rules and examples relating to a short periods, see §1.7872-12.

(e) Variable rates of interest.

(1) In general. If a loan requires payments of interest calculated at a rate of interest based in whole or in part on an objective index or combination of indices of market interest rates (e.g., a prime rate, the applicable Federal rate, the average yield on government securities as reflected in the weekly Treasury bill rate, the Treasury constant maturity series, or LIBOR (London interbank offered rate)), the loan will be treated as having sufficient stated interest if-

(i) In the case of a term loan, the rate fixed by the index or indices is no lower than the applicable Federal rate, as determined under paragraph (b)(4) of this section (as modified by paragraph (e)(2) of this section), on the date the loan in made; or

(ii) In the case of a demand loan, the interest rate fixed by the index or indices is no lower than the applicable Federal rate, as determined under paragraph (b)(3) of this section, for each semiannual period that the loan is outstanding. See paragraph (e)(2)(i) of this section for rules relating to variable interest rate demand loans the interest rates of which are tied to the applicable Federal rate.

(2) Special rules.

(i) Demand loans tied to the applicable Federal rate. A variable rate demand loan will be treated as having sufficient stated interest if, by the terms of the loan agreement, the interest rate cannot be less than the lower of the Federal statutory short-term rate or the alternate Federal short-term rate in effect at the beginning (or, if the agreement so provides, at the end) of the payment or compounding period (whichever is shorter).

(ii) Applicable Federal rate for variable interest rate term loans. For purposes of determining the applicable Federal rate, if a term loan requires payments or compounding of interest based on a variable rate (within the meaning of paragraph (e)(1) of this section), the term of the loan shall be treated as being equal to the longest period of time that exists between the dates that, under the loan agreement, the interest rate charged on the loan is required to be recomputed (whether or not the recomputation results in a rate different from the immediately preceding rate). Thus, for example, in the case of a 10 year term loan that charges interest at a variable rate equal to a rate 2 points above the prime rate, and that requires that the interest rate be adjusted every 18 months to reflect any changes in the prime rate, the applicable Federal rate is determined by treating the loan as having a term of 18 months rather than a term of 10 years. Accordingly, the applicable Federal short-term rate rather than the applicable Federal long-term rate shall apply.
(3) The provision of paragraph (e)(1) of this section may be illustrated by the following examples:

Example (1). On April 1, 1985, A loans $200,000 to B, repayable on demand. The note calls for interest to be paid semiannually on September 30 and March 31 of each year at a rate equal to the alternate Federal short-term rate (based on semiannual compounding) for the month in which the payment is made. The loan has sufficient stated interest.

Example (2). Assume the same facts as in Example (1) except that the note calls for interest at a rate equal to the lower of the alternate Federal short-term rate or the statutory Federal short-term rate (in each case, based on semiannual compounding) for the month in which the payment is made. The loan has sufficient stated interest.

Example (3). Assume the same facts as in Example (1) except that interest is computed and compounded at the end of each month at a rate equal to the lower of the alternate Federal short-term rate or the statutory Federal short-term rate (in each case, based on monthly compounding) in effect for that month. Accrued interest is payable semiannually on September 30 and March 31 of each year. The loan has sufficient stated interest.

Example (4). Assume the same facts as in Example (1) except that interest is payable at the prime rate of a major lending institution at the time each payment is made. The prime rate is not an index which by its terms cannot be less than the lower of the statutory Federal short-term rate or the alternate Federal short-term rate. Therefore, the loan will be tested for sufficient stated interest in each semiannual period under the rules of paragraph (b)(3) of this section.

(f) Contingent interest. [Reserved]