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Rules on Below-Market and Interest-Free Loans

By: Elliot Pisem

When new concepts are added to our tax system, they sometimes take a while to penetrate the consciousness of taxpayers, advisors, and return preparers. On occasion, applicable provisions added by recent legislation or administrative action may simply be overlooked. However, after they have been part of the law for a time, we all (including the Internal Revenue Service) come to expect that they will be treated with the same respect accorded to perhaps more familiar rules. This month we focus on a recent case in which a taxpayer "fell behind the learning curve" and failed during 1992 and 1993 to apply changes that had been made almost a decade earlier by the Tax Reform Act of 1984 to the treatment of below-market and interest-free loans. *KTA-Tator, Inc. v. Commissioner*, 108 T.C. No. 8 (March 11, 1997). The case is a useful reminder both of the existence of the rules and of how easy they can be to overlook.

Prior to enactment of the 1984 Act, the tax treatment of interest-free and below-market loans was in many respects uncertain. Although the Supreme Court held shortly before passage of the Act that such loans could give rise to a gift taxable under the gift tax,[1] it was far from certain that they gave rise to income tax consequences; for example, the Tax Court had consistently ruled that below-market demand loans from a corporation to one of its shareholders did not give rise to imputed dividend income to the shareholder in the amount of the foregone interest.[2]

The 1984 Act took the view that many below-market loans should be treated for tax purposes as though the borrower had in fact paid interest to the lender at the so-called "applicable Federal rate" and the lender had simultaneously made a payment in some other capacity to the borrower in order to enable the borrower to pay that interest. For example, if the lender of a below-market loan were an employer and the borrower were the lender's employee, the lender would be treated as having paid compensation to the borrower, which the borrower remitted to the lender in order to pay (imputed) interest on the loan. The results are even more dramatic in the context of a below-market loan from a corporation to one of its shareholders. In such a case, the lender would be treated as having made a distribution (generally a taxable dividend) to the borrower, which the borrower paid back to the corporation as (imputed) interest. Since the receipt of interest income is of course taxable, while the making of distributions is not generally deductible to a corporation, the net effect on the corporation of the imputation of interest is an increase in its taxable income; at the same time, the borrowing shareholder may be required to take imputed dividend income into account, while being denied an offsetting interest deduction under the substantial limitations on the deductibility of interest adopted two years after the 1984 Act by the Tax Reform Act of 1986.

The rules added by the 1984 Act apply for income tax and gift tax purposes generally to four categories of loans -- below-market loans where the foregoing of interest is in the nature of a gift, those between an employer and an employee (including an independent contractor), those between a corporation and any shareholder, and those having as a principal purpose the avoidance of any Federal tax.[3] The precise mechanics of the interest imputation and the applicability of the inevitable exceptions, exceptions to the exceptions, special rules, and definitions vary depending on which category of loan is involved, whether the loan is a demand loan or a term loan, and whether the tax involved is the income tax or the gift tax.

KTA-Tator, Inc. (the "Corporation") was engaged in the businesses of consulting, engineering, inspection, and lab analysis. All of the stock of the Corporation was owned by Kenneth B. Tator and his wife. Commencing in 1991, the Corporation made over 100 separate loans to the Tators to fund two construction projects in which the Tators were individually involved. There were no written repayment terms for these loans. When each project was completed, the Tators began to repay the loans attributable to it over a 20-year amortization schedule at 8% interest; however, prior to completion, the Tators did not pay any interest on the loans and the Corporation did not report any interest income on them. The Internal Revenue Service determined that the Corporation should have reported imputed interest income and asserted a deficiency which was upheld by the Tax Court.

The Corporation appears to have made two arguments against application of the statutory rules for below-market loans, both of which have much the flavor of theories created after the fact and both of which were rejected by the Court. First, the Service has proposed Regulations which would provide that, for purposes of the below-market loan rules, an "integrated series of transactions which is the equivalent of a loan is treated as a loan."[4] The Corporation contended that this meant that no below-market loan arose until the integrated series of transactions had been completed, *i.e.*, until the Corporation had lent all of the funds needed to complete both construction projects. The Court made short shrift of this attempt to turn what was intended to be an anti-abuse rule, reaching transactions having the effect, if not the form, of a loan, into a weapon to avoid the imputation of interest on a transaction that never pretended to be anything other than a loan. Indeed, other provisions of the proposed Regulations, as well as the legislative history of the 1984 Act, clearly led to the conclusion that the Corporation had made loans to the Tators.

The Corporation also argued that the loans to the Tators came within an exception for 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."[5] The Corporation interpreted this exception as permitting a comparison of the effect on the Tators of <u>not</u> being allowed an interest deduction with the effect on the Corporation of <u>not</u> being required to report interest income. Since the Tators incurred the interest expense in a business context and would thus have been permitted to deduct any interest paid, the Corporation argued that the failure to charge interest had no net tax effect.

The Court felt, however, that the Corporation's comparison was inapposite. Rather, what was relevant was a comparison of what the Corporation's <u>own</u> tax liability would have been if interest had been charged on the loans (and the interest had then been immediately redistributed to the Tators) -- so that the Corporation would have interest income with no offsetting deduction -- with what the Corporation's liability would have been if the interest-free nature of the loans to the Tators had been respected for tax purposes. Unsurprisingly, in view of the fact that the Internal Revenue Service in fact asserted a deficiency against the Corporation based solely on the application of the below-market loan rules, the Court found that there was a significant effect on the Corporation's tax liability and that the exception did not apply.[6]

One of the most surprising things about this case is that it was litigated at all. The total asserted deficiency was under $13,000 and the Corporation seemed not to have had terribly good arguments against paying the tax. In any event, perhaps others who would have fallen into the same trap can be grateful for the reminder that has been given about the need to be very cautious in structuring below-market loans from corporations to their shareholders.

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1 *Dickman v. Commissioner*, 465 U.S. 330 (1984).

2 *E.g.*, *Dean v. Commissioner*, 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4.

3 Internal Revenue Code section 7872(c)(1)(A)-(D), (f)(3).

4 Proposed Treasury Regulation section 1.7872-2(a)(1). This Regulation, which was proposed in 1985, has still not been promulgated in either final or temporary form.

5 Treasury Regulation section 1.7872-5T(b)(14); *see* Internal Revenue Code section 7872(h)(1)(C).

6 An intriguing question is just when the exception on which the Corporation tried to rely <u>is</u> intended to apply. If it is unavailable except in cases in which in makes no significant bottom-line difference to anyone's tax liability, why bother enacting it at all?