Imputed Interest

Introduction

In 1940, the U.S. Supreme Court issued a landmark decision in the case of *Helvering v. Horst* (61 S.Ct. 144, 11/25/1940). Horst owned various bearer bonds. "*In 1934 he detached unmatured coupons of face value of $25,182.50 and transferred them by manual delivery to his son as a gift. The coupons matured later on in the same year, and the son collected the face amount, $25,182.50, as his own property. There was a similar transaction in 1935. The petitioner kept his books on a cash basis. He did not include any part of the moneys collected on the coupons in his income tax returns for these two years. The son included them in his returns. The Commissioner added the moneys collected on the coupons to the petitioner's taxable income and determined a tax deficiency for each year.*"

The Supreme Court held in favor of the IRS, holding that "The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it."

This case is but one of several, all decided around the same time regarding the assignment of income. The Supreme Court in *Lucas v Earl* (281, US 111, 03/17/1930) introduced the analogy of the fruit and the tree with regard to assignment of income which analogy has been used in many tax cases since. The case [Lucas v Earl, supra] "*turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.*"

Essentially, the owner of the tree is taxable on the fruit from that tree, regardless of who they allow to eat the fruit.

NOTE: The issuance of bearer bonds (also called "coupon bonds" has been prohibited since the Tax Equity And Fiscal Responsibility Act Of 1982 (TEFRA), PL 97-248, 09/03/1982. And the ability to physically shift income

without changing ownership of the underlying instrument no longer practically exists.

NOTE: it is this same assignment of income doctrine that led to the enactment of the "kiddie tax" statute (IRC §1(g)) in 1986.

Assignment of income is a complex concept; and it is the foundational basis for the concept of the taxation of below market interest loans. Imputed interest, also called "unstated interest" or "below market interest" is a concept designed to require the recognition of interest income of at least a minimum amount to the lender, severing the interest (fruit) from the money loaned (tree).

The owner of the money owns the income that money can produce and cannot escape taxation on that income by its assignment to another. Charging zero interest effectively assigns the interest (fruit) that *could have been earned*, to the borrower; resulting in taxation of the lender, as the owner of the tree.

The economic theory behind this would not seem to prevent the government from levying a tax on unearned interest on money simply held in cash and uninvested (essentially allowing the fruit to rot on the tree unpicked), although to date they have not tried.

NOTE: the assignment of interest income can give rise to a gift tax liability of the donor even when income tax on the interest is imposed on that same donor. A gift for income tax purposes is defined differently than a gift for gift tax purposes; and both taxes may apply to the same transaction.

History:

IRC §483 has been in the Code since 1964, taxing unstated interest in a contract for sale. This session does not cover this kind of below market interest transaction, although both the concept and the computational process is similar to what we will cover.

This session covers IRC §7872, "treatment of loans with below-market interest rates". Code section 7872 was added by Section 172 of the Deficit Reduction Act of 1984, PL 98-369, 07/18/1984.

"Investment income is generally taxed to the owner of the income producing property, even if the owner of the property makes a gift of the right to receive the income prior to its receipt. The rationale for

this rule is that the owner of the property realizes the income upon the exercise of control over its disposition. Further, an assignment of the right to receive income is a taxable gift by the assignor to the assignee which occurs at the time of the assignment. In such case, the amount of the gift is the value of the right received by the donee."

...

"Under prior law, an interest-free or below-market interest rate loan (each of which is referred to herein as a "below-market loan") without consideration resulted in a gift from the lender to the borrower for Federal tax purposes."

...

"Under prior law, the Federal income tax consequences of these below-market loans were not clear. Prior to enactment of the provision, the courts had addressed only the gift tax consequences of the transactions."

...

"Under prior law, loans between family members (and other similar loans) were being used to avoid the assignment of income rules and the grantor trust rules. A below-market loan to a family member, for example, generally involves a gratuitous transfer of the right to use the proceeds of the borrowing until repayment is demanded (in the case of a demand loan) or until the end of the term of the loan (in the case of a term loan). If the lender had assigned the income from the proceeds to the borrower instead of lending the proceeds to the borrower, the assignment of income doctrine would have taxed the lender (and not the borrower) on the income."

...

"In addition, loans from corporations to shareholders were being used to avoid rules requiring the taxation of corporate income at the corporate level. A below-market loan from a corporation to a shareholder is the economic equivalent of a loan by the corporation to the shareholder requiring the payment of interest at a market rate, and a distribution by the corporation to the shareholder with respect to its stock equal to the amount of interest required to be paid under the terms of the loan"

...

"The Congress intended that, in general, in the case of a loan subject to this provision, the amount of the deemed payment from the lender to the borrower is to be determined solely under this provision. Thus, in the case of a below-market loan from a parent to a child, the amount of the gift is to be determined under section 7872, and not under the decision in the *Dickman* case, supra, even if the applicable Federal rate is less than a fair market interest rate."

[JCX 41-84 explanation of the Deficit Reduction Act of 1984, citations omitted].

Below Market Loans

IRC §7872 is intended to apply to term or demand notes that are gift loans, compensation related loans, corporation-shareholder loans, and tax-avoidance loans. "It is intended that the term 'loan' be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans." [Conference Committee 98-861]

For purposes of IRC §7872, a below market loan is any loan where either:

- "In the case of a demand loan, interest is payable on the loan at a rate less than the applicable federal rate, or
- In the case of a term loan, the amount loaned exceeds the present value of all payments due under the loan" [IRC §7872(e)(1)]

Gift Loans

"A gift loan is any below-market loan where the foregone interest is in the nature of a gift. In general, there is a gift if property (including foregone interest) is transferred for less than full and adequate consideration under circumstances where the transfer is a gift for gift tax purposes." [Conference Report 98-861]

Compensation Loans

"A compensation-related loan is any below-market loan made in connection with the performance of services directly or indirectly between (1) an employer and an Employee, or (2) an independent contractor and a person for whom such independent contractor provides services." [*Ibid*]

"The conferees wish to clarify that an arrangement will be treated as a compensation-related loan only if, in substance, there is a debtor-creditor relationship between the employee and the employer at the time the loan is made." [*Ibid*]

Compensation occurs when an employer provides an employee or a contractor with a below market loan. The foregone interest portion is computed annually and included in Form W-2 or 1099MISC.

Corporation-Shareholder Loans

"A corporation-shareholder loan is any below market loan made directly or indirectly between a corporation and any shareholder of such corporation." [*Ibid*]

"In the case of a below-market demand loan from a corporation to a shareholder, the corporation is treated as transferring to the shareholder, and the shareholder is treated as paying to the corporation, an amount equal to the foregone interest. The deemed transfer from the corporation to the shareholder is treated as a distribution, which generally is taxed as a dividend to the shareholder. Secs. 61(a)(7), 301(c)(1); H. Conf. Rept. 98-861, supra at 1013, 1984-3 C.B. at 267. The shareholder generally may deduct the deemed interest payment to the corporation. H. Conf. Rept. 98-861, supra at 1013, 1984-3 C.B. at 266. The shareholder's income from the deemed dividend and the shareholder's deduction for the deemed payment of interest may offset each other within the meaning of the temporary regulation. The corporation, on the other hand, is subject to tax on the foregone interest but is not entitled to a deduction for the deemed distribution it made to the shareholder. Therefore, it has no deduction to offset the interest income from the loan." [KTA-Tator Inc, 108 TC 100 (03/11/1997), emphasis added]

NOTE: the corresponding deduction for the interest deemed paid has been restricted by IRC §163 since 1986.

When the parties are reversed, so that the lender is the shareholder and the corporation is the borrower, the deemed transfer of funds from lender to borrower is booked as a contribution to capital of the corporation.

If the loan to the corporation qualifies as a gift loan, the gift would not qualify for the gift exemption from income tax and would be taxable to the corporation.

Tax-Avoidance Loans

"A below-market loan is a tax-avoidance loan if one of the principal purposes of the interest arrangement is the avoidance of any Federal tax by either the borrower or the lender. Tax-avoidance is a principal purpose of the interest arrangement if it is a principal factor in the decision to structure the transaction as a below-market loan." [Conference Report 98-861]

Foregone Interest

"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 the interest accrued on the loan at the applicable federal rate and were payable annually on the [last day of the calendar year], over
B. Any interest payable on the loan properly allocable to such period." [IRC §7872(e)(2)]

A "gift loan" is any below market loan where the forgoing of interest is in the nature of a gift.

Applicable Federal Rate

The applicable Federal Rate is published monthly by IRS in the form of a Revenue Ruling. The most current (at the time of writing) is June 2018; published as Rev Rul 2018-16, 2018 23 IRB 05/17/2018. The NATP website contains monthly AFR tables back to January 1994.

The AFR computed under IRC §1274(d) is the rate to use for below market loans under IRC §7872. It represents the proper market rate that is to be used to measure the existence and amount of a below market loan.

NOTE: Demand loans use the "short-term" AFR rates.

The June 2018 AFR table is reproduced below:

Rev. Rul. 2018-16 TABLE 1

Applicable Federal Rates (AFR) for June 2018

	Period for Compounding			
	Annual	Semiannual	Quarterly	Monthly
	Short-term (less than 3 yrs & demand)			
AFR	2.34%	2.33%	2.32%	2.32%
	Mid-term (3 yrs to 9 yrs)			
AFR	2.86%	2.84%	2.83%	2.82%
	Long-term (longer than 9 yrs)			
AFR	3.05%	3.03%	3.02%	3.01%

Present Value

Present value answers the question: "How much must I invest at the stated interest rate, over the period to equal the end amount I want to achieve?" Put another way: "How much is that stream of income worth **today** at the stated interest rate, with the stated payment stream over the stated period?"

"The time value of money is one of the most basic concepts used in financial theory, especially when determining the value of a stream of cash flows. There are numerous calculators available online to help with making this calculation." [https://bizfluent.com/how-5994738-calculate-present-value-loan.html]

"Here's the equation:

$$DCF = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \ldots + \frac{CF_n}{(1+r)^n}$$

Let's break that down.

DCF is the sum of all future discounted cash flows that the investment is expected to produce. This is the fair value that we're solving for.

CF is the total cash flow for a given year. CF1 is for the first year, CF2 is for the second year, and so on.

R is the discount rate in decimal form. The discount rate is basically the target rate of return that you want on the investment." [https://www.lynalden.com/discounted-cash-flow-analysis/#101]

Everyone who was not a math major in college breathe a sigh of relief, we're not going to apply this formula ourselves.

The sum of the discounted cash flows represents the present value of a stream of payments. MS Excel® has a present value function built into it that is used in this session. In MS Excel® the formula to enter is: **=PV (rate, periods, periodic payment, future value, type (0 = end of period, 1 = beginning of period))**. By building a small spreadsheet with each of the required variables in a separate cell, changing, modifying and using this function over and again becomes easy. Becoming familiar with this function will go a long way to understanding imputed interest as well as a wide variety of financial concepts.

EXAMPLE: Consider a term loan with an initial loan amount of $50,000, a stated interest rate of 1% and monthly payments of $854.69 over 60 months.

By definition, the present value of this payment stream ***AT 1%*** is $50,000, that's the original loan amount lent at 1%. The future value of the stream of payments will be zero, since the loan fully amortizes over 60 months.

	A	B	C
1	Present Value Computation		
2			Annotation
3	Rate	0.000833333	.01 / 12
4	Period	60	
5	Payment	854.69	
6	Future Value	0	
7	Type	0	0 = end of period; 1 = beginning of period
8	Present Value	($50,000)	=ROUND(PV(B3, B4, B5, B6, B7), 0)

However, if the market interest rate was 2.82% (the mid-term AFR for monthly payments in June) the present value of the series of 60 payments of $854.59 becomes 47,778, a difference of $2,222. This $2,222 is the

amount of interest that is foregone by a lender who lends the funds at 1% as opposed to 2.82% on a term loan that is not a gift loan.

Present Value Computation		
		Annotation
Rate	0.00235	0.282 / 12
Period	60	
Payment	854.69	
Future Value	0	
Type	0	0 = end of period; 1 = beginning of period
Present Value	($47,778)	

Notice that the future value is remains zero (-0-). This is because the terms of payment and period of the loan is at 1% and the loan will fully amortize after the 60th payment.

NOTE: At zero percent interest (0.00%) the monthly payment on a 60 month $50,000 loan would drop to $833.33, making the present value at the required AFR $46,584, so the foregone interest would be $3,416. As often as not, below market gift loans within a family will be at 0% interest.

Present Value Computation		
		Annotation
Rate	0.00235	0.282 / 12
Period	60	
Payment	833.33	
Future Value	0	
Type	0	0 = end of period; 1 = beginning of period
Present Value	($46,584)	

Imputed Interest

IRC §7872(a) treats the amount of foregone interest as if it had been transferred (as a gift) on the last day of the calendar year from the lender to the borrower, and then transferred back to the lender as interest. Effectively, the lender gifts the funds needed to pay the interest for the year to the borrower, and the borrower uses these gifted funds to pay the interest due to the lender.

The lender must recognize taxable interest income.

Whether the borrower can deduct this interest follows the normal interest sourcing rules of IRC §163; following the use of the borrowed proceeds. There are no other tax consequences to the borrower. In addition, the

lender has made a gift of that amount to the borrower that must be considered for gift tax purposes.

Two Calculation Methods

The law provides for two different calculation methods, one for each of two types of loans; computation method stems from the type of loan and is not optional.

Gift Loans and Non-Gift Demand Loans: The first method is for gift loans and demand loans with below market interest rate. Gift loans and non-gift demand loans do not use the present value formula discussed above.

Each year, the lender computes the amount of interest that would have been due on the loan at the AFR, subtract interest at the rate actually charged, and the difference is foregone interest. Interest at AFR and interest under the contract are determined by multiplying the balance due by the stated rates.

NOTE: The AFR is determined when the loan is written and *does not change* from year to year.

***EXAMPLE**: Continuing with the zero interest 60-month loan with $833.33 monthly ($10,000 annual) payments, assuming that the loan was made on January 1 of year 1, in year one, the interest on the 50,000 loan at 2.82% would have been $1,410. So, the lender is deemed to have made a gift (for gift tax purposes) of $1,410. For year 2, the balance is $40,000 the imputed interest would be $1,128, etc. Calculating amounts in this manner will not equal the amount of foregone interest computed using present value formulas discussed above.*

***EXAMPLE**: Randolph loans $200,000 to his son, Winston to start a business. The loan is interest free, as a gift. Based on an AFR rate of 3.01% (monthly long-term rate), the interest for the year should be $6,020; and Randolph is deemed to gift $6,020 to Winston. Assuming that Randolph makes no other gift to Winston during the year, its amount is under the $15,000 annual gift tax exclusion, it is a nontaxable gift requiring no gift tax reporting. If Randolph makes other gifts to Winston during the year totaling more than $15,000 a gift tax return would be required and potentially gift tax could be due.*

Winston is deemed to have paid the $6,020 received as a gift back to Randolph as interest on the loan. Randolph will have $6,020 of interest income.

Winston will likely be able to deduct the $6,020 interest payment since the loan was made to start a business. If Winston borrowed the money for personal reasons, the deemed interest payment would be a nondeductible personal expense.

Term Loans that are not Gift Loans: The second computation method is for term loans that are not a gift loan, the full imputed interest amount computed *using the present value formula* (above) for the life of the loan is deemed transferred on the date the loan is made. [IRC §7872(b)]

EXAMPLE*: In June 2018, Corporation XYZ extends a loan to A, a shareholder. The loan is for $100,000 to be repaid at $598.49 monthly for 15 years, with interest computed at 1% annually.*

This is a term loan; it is not a gift loan. The long term monthly AFR is 3.01%. The present value of the series of payments at 1% will be, by definition, $100,000 (see above). However, at 3.01% the present value of this stream of payments is $86,604. The foregone interest over this 15 year period is $13,396.

XYZ is deemed to receive the full $13,396 as interest income in the year the loan is granted.

Courts have held that where the corporation/lender is a C corporation, the foregone interest is also a dividend distribution to the shareholder [KTA-Tator Inc, supra]

Exceptions

The law provides several exceptions to the imputed interest rules.

- IRC §7872(c)(2) exempts loans between individuals where the aggregate unpaid balance of the loans does not exceed **$10,000**.
- IRC §7872(c)(3) provides the same aggregate de minimis exclusion to compensation related and corporate-shareholder loans, at $10,000.
- When a gift loan is made between individuals and the **balance is $100,000 or less**, the amount of imputed interest deemed transferred to the borrower is limited to the borrower's net investment income (as specified in IRC §163(d)(4)) for the year [IRC §7872(d)(1)(A)]. But…

- When the net investment income of the borrower is less than 1,000 for the year, imputed interest is deemed to be zero [IRC §7872(d)(1)(E)(ii)]

These exemptions do not apply to a below market loan in which one of the principal purposes of the loan was tax avoidance.

***EXAMPLE**: Randolph loans his son, Winston, $9,000 charging no interest. Randolph and Winston are both individuals and the amount of the loan is less than $10,000. Randolph and Winston are not subject to the imputed interest rules.*

***EXAMPLE**: Randolph loans his son, Winston, $90,000 charging no interest. Winston has $1,575 net investment income for the year. The imputed interest based on an AFR of 2.64% is $2,376. Since the amount of the loan is under $100,000 the amount of imputed interest is limited to Winston's net investment income of $1,575.*

However, if Winston's net investment income was $750, since the loan amount is $100,000 or less, there is no imputed interest because Winston's net investment income is below the $1,000 de minimis amount.

***EXAMPLE**: In June 2018, Corporation XYZ extends a loan to A, a shareholder. The loan is for $9,000 to be repaid at $253.87 monthly for 36 months, with interest computed at 1% annually.*

This is a term loan; it is not a gift loan. The short term monthly AFR is 2.32%. The present value of the series of payments at 1% will be, by definition, $9,000 (see above). At 2.32% the present value would be $8,820 for $180 imputed.

However, because the balance on the loan is below the $10,000 de minimis amount of IRC §7872(c)(3) no imputed interest computation needs to be made, and no foregone interest is reported by either XYZ or shareholder A.

Reporting

Imputed interest is reported by the lender on Form 1040, Schedule B just like any other interest income. If the interest is deductible, it is reported as any other deductible interest. Between individuals, often the tax ID of the lender is needed.

However, Prop Reg 1.7872-11(g) specifies reporting requirements that do apply to below market interest loans, as follows:

(1) Lender. A lender must attach a statement to the lender's income tax return for any taxable year in which the lender either has interest imputed under section 7872 or claims a deduction for an amount deemed to be transferred to a borrower under section 7872. The statement must—

(i) Explain that it relates to an amount includible in income or deductible by reason of section 7872,

(ii) Provide the name, address, and taxpayer identification number of each borrower,

(iii) Specify the amount of imputed interest income and the amount and character of any item deductible by reason of section 7872 attributable to each borrower,

(iv) Specify the mathematical assumptions used *(e.g.,* 360 day calendar year, the exact method or the approximate method for computing interest for a short period (see § 1.7872-13)) for computing the amounts imputed under section 7872, and

(v) Include any other information required by the return or the instructions thereto.

(2) Borrower. A borrower must attach a statement to the borrower's income tax return for any taxable year in which the borrower either has income from an imputed transfer under section 7872 or claims a deduction for an amount of interest expense imputed under section 7872. The statement must—

(i) Explain that it relates to an amount includible in income or deductible by reason of section 7872,

(ii) Provide the name, address, and taxpayer identification number of each lender,

(iii) Specify the amount of imputed interest expense and the amount and character of any income imputed under section 7872 attributable to each lender,

(iv) Specify the mathematical assumptions used *(e.g.*, 360 day calendar year, the exact method or the approximate method for computing interest for a short period (see, § 1.7872-13)), for computing the amounts imputed under section 7872, and

(v) Include any other information required by the return or the instructions thereto.

(3) Special rule for gift loans. In the case of a gift loan directly between natural persons, the lender must recognize the entire amount of interest income imputed under section 7872 (determined without regard to section 7872(d)(1)) unless the borrower notifies the lender, in a signed statement, of the amount of the borrower's net

investment income properly allocable to the loan according to the provisions of section 7872(d)(1) and §1.7872-8(c)(6).

(4) Information and reporting. All amounts imputed under section 7872 (e.g., interest, compensation, gift) are characterized in accordance with the substance of the transaction and, except as otherwise provided in the regulations under section 7872, are treated as so characterized for all purposes of the Code. Accordingly, all applicable information and reporting requirements *(e.g.,* reporting on Form W-2 and Form 1099) must be satisfied.

When only individuals are involved, and the foregone interest is not in the nature of compensation, Form 1099-INT will generally not be required for these imputed interest loans.

Regs 1.6049-5(b)(1) which governs the reporting of interest payments on Form 1099-INT states: "The term *interest* or *original issue discount* (OID) does not include—

(1) Interest on any obligation issued by a natural person as defined in §1.6049-4(f)(2), irrespective of whether such interest is collected on behalf of the holder of the obligation by a middleman."

However, if the lender is a corporation, or the foregone interest is intended as compensation, or is between the corporation and a shareholder, appropriate reporting (W-2, 1099-MISC, 1099-DIV) is required.