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Department of the Treasury
Washington, DC 20224

Person To Contact:
,

Telephone Number:

Refer Reply To:
CC:ITA:B02
PLR-111610-04

Date:
September 29, 2004

LEGEND

Taxpayer =
Foundation =
Amount A =

Dear :

This is in response to your letter dated February 2, 2004, requesting rulings on behalf of Taxpayer that: (1) a potential loan to Foundation will be classified as "property held for investment" under § 163 of the Internal Revenue Code; (2) any interest earned on the loan will be "investment income" under § 163; and (3) any interest paid on a line of credit used to make the loan will be "investment interest" under § 163.

FACTS

In 2001, Taxpayer founded Foundation. An advanced ruling was obtained from the Internal Revenue Service to preliminarily classify the Foundation exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). Taxpayer has agreed to loan Foundation Amount A to fund certain costs related to Foundation's tax exempt purpose. Taxpayer has formally committed to a loan agreement (line of credit) with a commercial bank to obtain funds to loan Amount A to Foundation. Taxpayer will be responsible for the payment of interest on any amount obtained though the line of credit. Further, any borrowed funds from the line of credit will be loaned only to Foundation. The amounts loaned to Foundation by Taxpayer from the line of credit will be interest-free and payable upon demand. The loan agreement with Foundation was not entered into at arms-length, in the ordinary course of business, or for adequate consideration.

ISSUES

(1) Whether the term "property held for investment" under § 163(d)(5)(A)(i) includes interest-free loans to tax exempt Foundation which are deemed to yield gross income as a result of interest imputed under § 7872.

(2) Whether any imputed interest income deemed received by Taxpayer on the potential loan to Foundation is investment income under §163(d)(4)(B)(i).

(3) Whether any interest paid by Taxpayer on a line of credit used to make the potential loan to Foundation is "investment interest" under § 163(d)(3)(A).

LAW AND ANALYSIS

Issues 1 and 2

Section 7872(a)(1) provides that any below-market loan to which this section applies and which is a gift loan or a demand loan, the forgone interest shall be treated as transferred from the lender to the borrower and retransferred by the borrower to the lender as interest.

Section 7872(e)(2) defines "foregone interest" as the excess of – (A) the amount of interest which would have been payable on the loan for the period if interest accrued on the loan at the applicable Federal rate and were payable annually on the day referred to in subsection (a)(2) i.e., the last day of the calendar year, over (B) any interest payable on the loan properly allocable to such period.

Under § 7872(f)(2)(B), in the case of a demand loan, the applicable Federal rate shall be the Federal short-term rate in effect under § 1274(d) for the period for which the amount of foregone interest is being determined, compounded semiannually.

Section 7872(f)(3) defines a gift loan as a below-market loan in which the concession of interest is the nature of the gift.

Pursuant to § 7872(e)(1)(A), a demand loan is a "below-market loan" if interest is payable on the loan at a rate less than the applicable Federal rate. Section 7872(f)(5) defines a demand loan as any loan which is payable in full at any time on demand of the lender and includes any loan with an indefinite maturity.

Section 1.7872-5T(b)(9)) of the Procedure and Administration Temporary Regulations provides that gift loans to a charitable organization (described in § 170(c)), are exempt from § 7872, but only if at no time during the taxable year will the aggregate outstanding amount of loans by the lender to that organization exceed $250,000.

The potential loan of Amount A from the line of credit from Taxpayer to Foundation will be interest-free and payable upon demand. The loan will not be entered into at arms-length, in the ordinary course of business, or for adequate consideration. Thus, any Taxpayer loan to Foundation from the line of credit, under the same terms as described above, will be a gift loan as defined in § 7872(f)(3) and will be subject to § 7872 unless they are exempt loans, as described in § 1.7872-5T.

Due to the fact that Taxpayer intends to loan an amount in excess of $250,000 to the foundation, the exception at § 1.7872-5T(9)(b) of the Regulations will not apply.

Thus, Section 7872(a)(1) requires Taxpayers to take into account as income the interest imputed from any loan to Foundation from the line of credit. Accordingly, Taxpayer will recognized imputed interest from any loan to Foundation as gross income under § 61.

Pursuant to § 163(d)(4)(B)(i), interest received by a taxpayer is investment income if it is derived from property held for investment.

Section 163(d)(5)(A)(i) provides that "property held for investment" includes any property which produces income of a type described in Section 469(e)(1).

Section 469(e)(1) provides that in determining the income or loss from a passive activity, there shall not be taken into account the gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business (portfolio income).

Under § 469(e)(1), property that generates gross income in the form of interest (portfolio income) is within the meaning of the term "property held for investment." Therefore, the fact that any loan the Taxpayer makes from the line of credit to the Foundation will be productive of only imputed interest income that will be taxable to Taxpayer as income under § 61 is a sufficient basis for characterizing such a loan as property held for investment. Cf. Rev. Rul. 93-68, 1993-2 C.B. 72, which states that even stock in a company which had never paid a dividend was deemed property held for investment within the meaning of § 163(d)(5)(A) and 469(e)(1)(A) because stock generally produces dividend income (which is another type of portfolio income).

Accordingly, because any loan Taxpayer makes from the line of credit to Foundation will be deemed "property held for investment," Taxpayer will be required to classify the imputed interest income generated on the interest-free loan to Foundation organization as investment interest income under § 163(d)(4)(B)(i).

Issue 3

Under the general statutory scheme of § 163, the different types of interest expense are divided into distinctive categories or classifications. Interest is not freely deductible by individuals, unless it falls within certain categories such as trade or business interest or qualified residence interest. Deductions of investment interest or passive interest are allowed only to the extent of a taxpayer's net investment or passive income. Personal

interest is not generally deductible by individuals. Thus, the classification of interest that is paid by an individual taxpayer is necessary to determine if the amount paid is deductible and to what extent.

Section 163(a) of the Code provides that all interest paid or accrued is deductible within the taxable year of indebtedness. Section 163(d)(1) limits the amount of deductible investment interest expense to a taxpayer's net investment income. Section 163(d)(3)(A) provides that the term "investment interest" means any interest allowable as a deduction under this chapter which is paid or accrued on indebtedness properly allocable to property held for investment. Thus, investment interest expense is deductible if the related interest expense is properly allocable to property held for investment, but only to the extent of the taxpayer's net investment income.

Under these facts, because any loan Taxpayer makes from the line of credit to Foundation will be deemed "property held for investment," any interest expense resulting from the line of credit used to make a loan to Foundation must be classified as “investment interest” under § 163(d)(3)(A), with the deductibility of the interest expense limited to Taxpayer's net investment income under § 163(d)(1).

CONCLUSIONS

(1) The term "property held for investment" under § 163(d)(5)(A)(i) includes interest-free loans to tax exempt Foundation which are deemed to yield gross income as a result of interest imputed under § 7872.

(2) Any imputed interest income deemed received by Taxpayer on the potential loan from the line of credit to Foundation is investment income under §163(d)(4)(B)(i).

(3) Any interest paid by Taxpayer on a line of credit used to make the potential loan to Foundation is "investment interest" under § 163(d)(3)(A).

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for the ruling, it is subject to verification on examination.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

The ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

Thomas D. Moffitt
Chief, Branch 2
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosure:
Copy of letter
Copy of § 6110 purposes