**Internal Revenue Service**

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact:
, ID No.
Telephone Number:

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Date:
March 31, 2014

Legend

Taxpayer =

Dear :

This ruling replies to your letter dated May 7, 2013, and subsequent correspondence dated June 27, 2013, and November 19, 2013, submitted on behalf of Taxpayer in which you request that the Internal Revenue Service rule that fee credits earned by certain account holders are not subject to reporting under either section 6041 or section 6049 of the Internal Revenue Code (Code).

**Facts:**

Taxpayer is a bank as defined under section 581 of the Code. Taxpayer offers two different fee credit programs under which its commercial account holders and tax exempt recipients ("customers") receive an allowance ("fee credit") that can be used to offset certain fees for banking services. Both fee credit programs are offered for demand deposit accounts used for daily business operations. The services for which the fee credits may be used include the following: check processing, transaction processing, wire transfers, account analysis, deposit and withdrawals, posting of debits and credits and payment of checks.

Under both fee credit programs, the fee credit is calculated by applying a fee credit rate to the investable balance. The investable balance is the account ledger balance minus float (a portion of the balance unavailable to the customer while deposited items clear). Fee credit rates are most frequently determined by Taxpayer using a rate committee that determines the rate for a specific customer type based on

market rates and competitive factors. Fee credits may also be based on indexed rates, such as Libor or 90-day T-Bill and are subject to Taxpayer's discretion.

Under the first program (the "Noninterest Fee Credit Program"), excess or unused fee credits are not paid in cash and may not be withdrawn by the customer. However, certain government, nonprofit, educational and healthcare account holders can use excess or unused fee credits to pay for banking services provided by third party vendors through vendor contracts with Taxpayer. The services are ancillary to the customers' banking relationship with Taxpayer and include armored car services, courier services, check supplies, and lock boxes. But in certain cases, the customer, rather than Taxpayer, contracts directly with the third party vendor to provide services with respect to the customer's account.

Under the second program (the "Hybrid Fee Credit Program"), the fee credits may only be used to offset fees for banking services up to a set limit. Taxpayer pays interest on any unused account balance not required to offset fees. Taxpayer concedes that any stated interest paid on the unused account balance is interest for purposes of sections 6041 and 6049 of the Code.

Taxpayer represents that fee credit programs are extremely common in the banking industry, and has offered empirical evidence supporting that representation. Taxpayer and other banks offer the fee credit programs to encourage banking relationships with commercial customers as well as to provide an incentive to customers to maintain large balances. They are also used to manage a bank's interest expense, a significant element to which shareholders and market analysts look when evaluating banking institutions.

Taxpayer also represents that developing systems capable of reporting the amount of fee credits actually used by customers would be a large and costly administrative burden. Furthermore, a majority of the customers who receive the fee credits are exempt recipients for purposes of the reporting rules under sections 6041 and 6049. Therefore, any system established for reporting fee credits developed by Taxpayer would be used for only a small number of customers. Taxpayer states that if it actually paid interest on the deposits and charged the customers a fee for the banking services it provides, the income and deductions generated by the transaction would offset one another. The interest income received by a customer would be offset by a deduction for the bank fees, and the service fee income received by Taxpayer would be offset by a deduction for interest paid to the customer.

**Law:**

Interest generally is includible in a recipient's gross income under section 61(a)(4) of the Code and section 1.61-7 of the Income Tax Regulations (regulations). The term interest means amounts paid for the use or forbearance of money, which

includes amounts, whether or not designated as interest, paid on savings accounts and other deposit arrangements.

Section 6041(a) of the Code requires information returns from persons engaged in and making payment in the course of a trade or business of rent, salaries, wages, premiums, and income of $600 or more in a taxable year. Section 6041(a) allows certain exceptions, including payments to which section 6049(a) applies.

Section 6049(a)(1) requires information returns for payments of interest aggregating $10 or more to any other person during the taxable year.

Section 7872 recharacterizes a below-market loan as an arm's-length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory rate. As a result, the parties are treated as if the lender made a transfer of funds to the borrower, and the borrower used these funds to pay interest to the lender. The transfer to the borrower is treated as a gift, dividend, contribution of capital, payment of compensation, or other payment depending on the substance of the transaction. The interest payment is included in the lender's income and generally may be deducted by the borrower. See H.R. Conf. Rept. No. 98-861, at 1015 (1984), 1984-3 C.B. (Vol. 2) 1, 269.

Section 7872(f)(5) of the Code defines a demand loan as any loan which is payable in full at any time on demand of the lender. The legislative history of section 7872 indicates that the term "loan" should be interpreted broadly. 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. H.R. Conf. Rept. No. 98-861, at 1018 (1984), 1984-3 (Vol. 2) C.B. 1, 272.

Congress intended that section 7872 of the Code would apply only to the below-market loans enumerated in subparagraphs (A) through (F) of section 7872(c)(1): gift loans, compensation-related loans, corporation-shareholder loans, tax avoidance loans, and loans to qualified continuing care facilities. H.R. Conf. Rept. No. 98-861, at 1018, 1019 (1984), 1984-3 (Vol. 2) C.B. 272. Under section 7872(c)(1)(E), to the extent provided in regulations, a loan that is not a gift loan, compensation-related loan, corporation-shareholder loan or qualified continuing care facility loan may still be subject to section 7872 if the interest arrangement has a significant effect on the tax liability of the borrower or the lender.

Section 7872(c)(1)(B) of the Code, concerning compensation-related loans provides, in part, that section 7872 shall apply to any below-market loan directly or indirectly between an independent contractor and a person for whom such independent contractor provides services. The imputed transfer in a compensation-related loan is treated as a payment of compensation from the lender to the borrower.

Section 7872(c)(1)(D) of the Code provides that section 7872 shall apply to any below-market loan one of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax.

Section 7872(i)(1)(C) of the Code provides that the Secretary shall prescribe regulations exempting from the application of this section any class of transactions the interest arrangements of which have no significant effect on any Federal tax liability of the lender or borrower.

Section 1.7872-5T(b) of the Temporary Income Tax Regulations lists transactions that are exempt from section 7872 of the Code because the interest arrangements of such loans do not have a significant effect on the Federal tax liability of the borrower or lender, provided that they do not have a principal purpose of tax avoidance. See section 1.7872-5T(a).

Section 1.7872-5T(b)(2) of the regulations exempts from the provisions of section 7872 of the Code accounts or withdrawable shares with a bank (as defined in section 581), or an institution to which section 591 applies, or a credit union, made in the ordinary course of its business.

Section 1.7872-5T(b)(14) of the regulations exempts from the provisions of section 7872 of the Code those 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, as described in section 1.7872-5T(c)(3).

Section 1.7872-5T(c)(3) of the regulations provides that whether a loan will be considered a loan the interest arrangements of which have a significant effect on any Federal tax liability of the lender or the borrower will be determined according to all the facts and circumstances. Among the factors to be considered are (i) whether items of income and deduction generated by the loan offset each other, (ii) the amount of such items, (iii) the cost to the taxpayer of complying with the provisions of section 7872 of the Code if such section were applied, and (iv) any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the AFR and a payment by the lender to the borrower.

**Analysis:**

In the present situation, the deposit held by Taxpayer in a customer's account is a loan from the customer to Taxpayer. In lieu of paying interest on the deposit, Taxpayer provides banking services to the customer through the use of bank fee credits. The loan is a compensation-related loan under section 7872(c)(1)(B) of the Code.

Section 7872 of the Code does not give rise to taxable income, however, if the loan qualifies for an exemption under section 1.7872-5T(b) of the temporary regulations, and the loan is not recharacterized as a tax avoidance loan under section 7872(c)(1)(D).

In the present situation, Taxpayer, a bank under section 581 of the Code, pays the fee credits on certain commercial demand deposit accounts of its customers in the ordinary course of its business. See section 1.7872-5T(b)(2) of the temporary regulations. Under the facts and circumstances test described in section 1.7872-5T(c)(3), the fee credit programs have no significant effect on any Federal tax liability of the lender or the borrower under section 1.7872-5T(b)(14).

The items of income and deduction generated by the loan would offset each other if section 7872 of the Code were applied to the fee credits with respect to both Taxpayer and its customers. The imputed interest income received by a customer would be offset by a deduction for the bank fees and charges that are reduced by the fee credits. Likewise, the service fee income received by Taxpayer would be offset by a deduction for imputed interest deemed paid to the customer. The costs to Taxpayer of complying with section 7872 of the Code would be significant and would have little if any Federal tax impact. Developing systems capable of tracking the amount of fee credits actually used by customers would be a large and costly administrative burden. Furthermore, as noted above, most customers in the fee credit programs are exempt recipients under the reporting rules. Therefore, the costs for Taxpayer to comply with the provisions of section 7872 outweigh the benefits of requiring Taxpayer to comply with the provision if it were applied.

Taxpayer has offered a number of non-tax reasons for structuring the transaction as a below-market loan. The fee credit programs encourage banking relationships with commercial customers and provide an incentive to customers to maintain large balances. Taxpayer has represented that fee credit programs are industry wide and are used to manage Taxpayer's interest expense, a significant element to which shareholders and market analysts look when evaluating banking institutions. For the reasons discussed above, the application of section 7872 of the Code to the fee credit programs would not have a significant effect on the tax liability of Taxpayer or its customers.

The fee credit programs will be classified as tax avoidance loans under section 7872(c)(1)(D) of the Code if a principal purpose of Taxpayer or the customers of using the below-market arrangement of the loan is to avoid tax. 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, rather than as a loan requiring the payment of interest at a rate that equals or exceeds the AFR and a payment by the lender to the borrower. See H.R. Rep. No. 98-861, at 1019; 1984-3 (Vol. 2) C.B. 273.

The fee credit program used by Taxpayer does not have tax avoidance as a principal purpose. Taxpayer has offered a number of non-tax reasons for structuring the transaction as a below-market loan. Furthermore, because the items of income and deduction for both parties would offset each other if the transaction were not structured as a below-market loan, there is no tax to be avoided. Therefore, tax avoidance is not a principal purpose of the fee credit program. Accordingly, for the reasons explained above the fee credit program is not subject to tax under section 7872 of the Code.

In contrast, section 7872 of the Code does not apply to the fee credits earned in lieu of interest that the account holder uses to pay for third party vendor services if the account holder selects and contracts the third party vendor. This situation is not a compensation-related loan described in section 7872(c)(1)(B) because Taxpayer does not directly or indirectly provide the services. Therefore, the fee credits earned in lieu of interest that are used to pay the third party vendor for services result in interest income to the customer under section 61(a)(4). Accordingly, in this case, payments made by Taxpayer to third party vendors on behalf of its account holders are reportable as interest under section 6049 unless the account holder is an exempt recipient.

**Conclusion:**

Below-market loans as described above that are made pursuant to the Noninterest Fee Credit Program and the Hybrid Fee Credit Program are compensation-related loans under section 7872 of the Code but qualify for exemption under section 1.7872-5T of the temporary regulations. Because these loans will not generate imputed interest under section 7872, there is no reportable interest under section 6049 or other reportable income under section 6041. However, fee credits used to pay third party vendors selected and contracted by the account holder give rise to interest income under section 61(a)(4) reportable under section 6049.

**Holdings:**

(1) The fee credits earned and used to offset Taxpayer's bank fees with respect to "Noninterest Bearing Accounts" in the first program are not subject to the information reporting requirements imposed by sections 6049 or 6041 of the Code;
(2) Fee credits that are used to pay a third party vendor in lieu of interest where Taxpayer subcontracts directly with the vendor to provide ancillary banking services are not subject to information reporting (under either section 6049 or section 6041 of the Code) to the account holder, whether or not the account holder is an exempt recipient;
(3) Fee credits that are used to pay a third party vendor in lieu of paying the account holder interest are reportable as interest on Form 1099-INT where the account holder selects and contracts with the third party vendor unless the account holder is an exempt recipient;

(4) The fee credits described above, with the exception of interest on any unused balances, earned and used to offset Taxpayer's bank fees with respect to "Hybrid Accounts" are not subject to the information reporting requirements imposed by sections 6049 and 6041of the Code; and
(5) The stated interest on any unused balances paid to "Hybrid Accounts" is subject to Form 1099-INT reporting under section 6049 when paid to a non-exempt recipient.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

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 rulings, it is subject to verification on examination.

Sincerely,

Pamela Wilson Fuller
Senior Technician Reviewer
(Procedure & Administration)

cc: