



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224
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OFFICE OF
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MEMORANDUM FOR HARRY MARTIN
FED-STATE COORDINATOR NORTH-SOUTH CAROLINA
DISTRICT

FROM: Lewis J. Fernandez
Deputy Assistant Chief Counsel
(Income Tax & Accounting)

SUBJECT: NORTH CAROLINA FLOOD RELIEF - INTEREST SUBSIDIES
FOR BUSINESS

This Technical Assistance is in response to your request for assistance dated December 15, 1999, regarding the tax treatment of state payments made to individuals and businesses of North Carolina who suffered losses due to the flood damage caused by Hurricane Floyd. Technical Assistance does not relate to a specific case and is not binding on examination or appeals. This document is not to be cited as precedent.

ISSUES:

(1) What are the federal income tax consequences to a business taxpayer who receives benefits under the following flood relief programs?

- (a) Deferred Payment Loans.
- (b) Business Advance Program.
- (c) Interest Buy-down on SBA Loans.

(2) What information reporting requirements, if any, does the State of North Carolina have with respect to payments under these flood relief programs?

CONCLUSIONS:

1) (a) Businesses that receive no-interest Deferred Payment Loans are not required to include an amount in income and are not entitled to take any deduction for interest paid or accrued.

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(b) Businesses that receive payments under the Business Advance Program are not required to include an amount in income and are not entitled to take any deduction for interest paid or accrued.

(c) Payments to businesses under the Interest Buy-Down program are includible in the gross income of the business in the year the payment is received (cash basis taxpayers) or in the year the taxpayer applies for the payment (accrual basis taxpayers). Businesses may deduct in each year of the loan the amount of interest that accrues in that year.

(2) The State must file information returns to report payments to business taxpayers that are not corporations for which the interest subsidy payments for the year total \$600 or more.

FACTS:

In response to widespread damage caused by Hurricane Floyd in 1999, the governor of North Carolina proposed a state emergency package consisting of numerous relief programs to assist individuals and small businesses in recovering from the disaster. On December 16, 1999 the legislature enacted The Hurricane Floyd Recovery Act of 1999, which appropriated funds for a package of relief programs and requires that State agencies distributing the funds inform recipients by written statement of the federal and state income tax consequences of the disbursements. Accordingly, the North Carolina Department of Revenue has requested your assistance in determining the federal income tax treatment of the disbursements.

The following disaster assistance programs are addressed in this Technical Assistance. The numbers appeared in the margin of materials in your request for assistance.

Deferred Payment Loans (6)

This program provides interest-free State-funded three year loans to small and mid-sized businesses that are economically viable but do not qualify for Small Business Administration (SBA) loans. At the end of three years the business must repay the principal amount of the loan to the State.

Business Advance Program (6)

The North Carolina Department of Commerce will provide cash advances of up to \$10,000 to businesses that have applied for SBA loans to pay for immediate needs. Under this program funds can be disbursed within 4 days as opposed to three to six weeks to receive the SBA loan proceeds. The business must repay amounts received under the Business Advance Program upon receipt of the SBA loan funds.

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Interest Buy-Down on SBA Loans (7)

North Carolina will provide grants to flood victims equal to the cost of interest on SBA loans for the first three years. This program will be administered by commercial banks. Businesses that qualify for SBA loans will take their executed SBA loan documents to the bank. The bank will calculate the amount of interest for the first three years and issue a check to the business in that amount.

LAW AND ANALYSIS:

Section 61(a) provides generally that gross income means all income from whatever source derived. Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income realized in any form. In *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), 1955-1 C.B. 207, the United States Supreme Court held that the concept of gross income encompassed accessions to wealth, clearly realized, over which taxpayers have complete dominion.

Section 451(a) provides generally that an item of gross income shall be included in gross income in the taxable year in which received by the taxpayer, unless under the taxpayer's method of accounting, the amount is to be properly accounted for in a different period. Section 446(c)(1) and (c)(2) provide generally that both the cash method and the accrual method are permissible methods of accounting.

Cash basis taxpayers generally take items into gross income in the taxable year in which they are actually or constructively received. Sections 1.451-1(a); 1.446-1(c)(i). Accrual basis taxpayers generally take items into gross income when all the events have occurred that fix the taxpayer's right to receive the income and the amount of the income can be determined with reasonable accuracy. Sections 1.451-1(a); 1.446-1(c)(ii)(A).

Section 163(a) generally permits business taxpayers to deduct all interest paid or accrued within the taxable year on trade or business indebtedness.

Section 461(a) provides generally that deductions are taken in the taxable year which is proper under the taxpayer's method of accounting. In general, deductions for cash basis taxpayers are proper in the year of payment. Section 1.461-1(a)(1). However, § 461(g) provides rules for prepaid interest and provides generally that if taxable income is computed under the cash receipts and disbursements method of accounting, interest paid by the taxpayer which is properly allocable to any period (1) with respect to which the interest represents a charge for the use or forbearance of money, and (2) which is after the close of the taxable year in which paid, shall be charged to capital account and shall be treated as paid in the period to which so allocable.

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Accrual basis taxpayers generally take deductions in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. § 461(h); § 1.461-1(a)(2). In the case of interest expense, economic performance occurs as the interest cost economically accrues. § 1.461-4(e).

Under the rules of §§ 163 and 461, taxpayers engaged in a trade or business are generally permitted to deduct interest as it accrues, that is, ratably over the period of the indebtedness. This is true regardless of whether taxpayers compute income using an accrual method of accounting or a cash method of accounting.

In general, § 7872 defines a below-market loan as any loan on which the interest rate charged is less than the applicable federal rate under § 1274(d) ("AFR"). Section 7872(b) provides that the borrower of a below-market term loan is treated as having received from the lender, on the date the loan is made, cash in an amount equal to the excess of the amount loaned over the present value of all payments required under the loan (the "imputed transfer"). Section 7872(b) further provides that a below-market term loan is treated as having original issue discount in an amount equal to the imputed transfer, which is in addition to any other original issue discount on the loan determined without regard to § 7872(b).

Section 7872 applies only to the below-market loans listed in § 7872(c)(1). Under § 7872(c)(1)(D), a tax avoidance loan is a below-market loan one of the principal purposes of the interest arrangements of which is the avoidance of any federal tax. Under § 7872(c)(1)(E), a significant effect loan is a below-market loan for which, to the extent provided in regulations, the interest arrangements of the loan have a significant effect on any federal tax liability of the lender or the borrower. No regulations have been issued under § 7872(c)(1)(E). (Section 7872(c)(1)(A), (B), (C), and (F) do not apply in this case.)

The legislative history of § 7872 indicates that most government-subsidized loans such as government insured or guaranteed student loans or residential mortgages were intended to be exempt from § 7872. S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess. 482 (1984).

Section 6041(a) provides that all persons engaged in a trade or business and making payment in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, or other fixed or determinable gains, profits, and income of \$600 or more in any taxable year must make an information return. Under § 1.6041-1(b), federal and state governments are considered persons engaged in a trade or business for purposes of § 6041. However, § 1.6041-3(c) generally exempts payments to a corporation from the information reporting requirements.

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Deferred Payment Loans and Business Advance Program

These programs are addressed together because both programs provide zero interest loans to eligible businesses, although loans under the Business Advance Program are extremely short term.

In the absence of regulations implementing § 7872(c)(1)(E), § 7872 will not apply to loans under the Deferred Payment Loans and Business Advance Programs unless they are determined to be tax avoidance loans under § 7872(c)(1)(D). Those programs were established by North Carolina to provide state-subsidized financial assistance to businesses that were damaged by the 1999 floods. The interest arrangements of loans under the programs are not structured with a principal purpose of avoiding federal tax and the loans are not tax avoidance loans for purposes of § 7872(c)(1)(D). Therefore, § 7872 does not apply to loans under these programs.

Accordingly, upon receiving a zero interest loan under the Deferred Payment Loans or Business Advance Programs, a business is not required to include an amount in income and may not take a deduction for interest paid or accrued. Because the disbursing of a loan is not taxable to the recipient, there is no information reporting requirement.

Interest Buy-Down on SBA Loans

The payment to a business taxpayer of the amount that the business is expected to pay in interest for the first three years of an SBA loan is a clear accession to wealth that is includible in the business' gross income. *Graff v. Commissioner*, 673 F.2d 784 (5th Cir. 1982, *aff'g* 74 T.C. 743 (1980); Rev. Rul. 76-75, 1976-1 C.B. 14 (interest subsidy payments made by government agency to mortgagees on behalf of mortgagor owners of lower-income rental housing constitute gross income to owners).

A cash basis taxpayer must include the amount of the payment in income in the year the payment is received. An accrual basis taxpayer must include the amount of the payment in income when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. In this case, it appears that the right to a grant becomes fixed when a business files its executed SBA loan documents with the commercial bank. Once an application is filed the remaining processing is ministerial as the bank appears to merely calculate the amount of interest on the loan for the first three years based on the loan documents supplied by the business. See *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290 (1932). Accordingly, a business using the accrual method of accounting should accrue the amount of the grant in income in the year it files for the grant with the bank even if the grant is not received until a subsequent year.

Regardless of the method of accounting, a taxpayer may deduct the interest it pays on

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the SBA loan only as the interest accrues, that is, ratably over the period of the loan.

The payments to businesses under the Interest Buy-Down program are fixed or determinable gains, profits or income to the recipients. Therefore the State must make an information return reporting a payment if the payment is \$600 or more and the recipient is not a corporation. However, the bank and not the State is required to make the information return if the bank performs management or oversight functions in connection with the payment. See Rev. Rul. 93-70, 1993-2 C.B. 294.

We suggest that you advise the State of North Carolina to describe the tax consequences of these payments to the recipients in language similar to the following:

The Internal Revenue Service has advised us that you are not required to include any amount in income as a result of receiving a zero interest loan under the Deferred Payment Loans or Business Advance Programs. You may not take a deduction for interest when you repay these loans.

If you have received a payment under the Interest Buy-Down program, you must include the amount of the payment in income in the year you received the payment if you are a cash basis taxpayer, or in the year you applied to the bank for the payment if you are an accrual basis taxpayer. You may deduct in each year of the loan the amount of interest that accrues in that year.

Taxpayers uncertain whether these principles or interpretations of tax law should apply to their situations should consider seeking a private letter ruling or, if appropriate, technical advice. Procedures for issuing letter rulings and technical advice are in Rev. Proc. 2000-1, 2000-1 I.R.B. 4, and Rev. Proc. 2000-2, 2000-1 I.R.B. 73, respectively.

If you have any further questions about this memorandum, please call George Baker at (202) 622-4920.