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TAXATION—NEITHER AN INTEREST-FREE BORROWER NOR A LENDER BE: INTEREST-FREE LOANS UNDER *HARDEE V. UNITED STATES*

The interest-free use of corporate funds by shareholders and employees is a popular business practice. The shareholder or employee receives funds from the corporation without a corresponding obligation to reimburse the corporation for the money's decreased time value utility.[1] The corporation often uses this method to increase compensation to a key employee or shareholder.[2]

Recently, in *Hardee v. United States*,[3] the United States Court of Claims rejected long-standing precedent established in the Tax Court[4] by deciding that interest-free loans result in income to the recipient. This piece analyzes the *Hardee* decision and discusses the use of interest-free loans in general. Part I provides a historical background of interest-free loan decisions. Parts II and III discuss and analyze the *Hardee* decision and explain why the Court of Claims reached the correct result. Part IV explains the present effect and possible ramifications of the *Hardee* decision.

I. Historical Background

The Tax Court of the United States first considered whether to impute income to a shareholder receiving an interest-free loan in *Dean v. Commissioner*.[5] In *Dean*, the Commissioner argued that the shareholder had realized[6] a benefit, and should have therefore recog-

1 *See* note 7 *infra* and accompanying text.

2 Phillips, *Current Tax Treatment of Interest-Free Loans*, WIS. B. J., March 1982, at 13.

3 [U.S. Tax Cases] STAND. FED. TAX REP. (CCH) ¶ 9459 (Ct. Cl. July 6, 1982) [hereinafter cited as *Hardee*].

4 Trowbridge v. Commissioner, 1981 T.C.M. (P-H) ¶ 81,190; Beaton v. Commissioner, 40 T.C.M. (CCH) 1324 (1980), *aff'd*, 664 F.2d 315 (1st Cir. 1981); Baker v. Commissioner, 75 T.C. 166 (1980); Martin v. Commissioner, 39 T.C.M. (CCH) 531 (1979), *aff'd*, 649 F.2d 1133 (5th Cir. 1981); Creel v. Commissioner, 72 T.C. 1173 (1979), *aff'd sub nom*. Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Zager v. Commissioner, 72 T.C. 1009 (1979), *aff'd sub nom*. Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Greenspun v. Commissioner, 72 T.C. 931 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982); Suttle v. Commissioner, 37 T.C.M. (CCH) 1638 (1978), *aff'd*, 625 F.2d 1127 (4th Cir. 1980); Dean v. Commissioner, 35 T.C. 1083 (1961).

5 35 T.C. 1083 (1961). In *Dean*, the taxpayers received interest-free loans exceeding $2 million from their controlled corporation. *Id*. at 1083.

6 Gains and losses that are realized must be distinguished from gains and losses that are recognized. For example, a taxpayer realizes a gain from a transaction when the transaction increases the value of the taxpayer's asset. Whether or not this gain is recognized depends on

nized an amount of income equal to the interest obligation that the shareholder would have incurred in the marketplace.[7] In so arguing, the Commissioner relied on a series of cases holding that the rent-free use of corporate property results in realized income.[8] The Commissioner argued that the benefit a shareholder obtains from an interest-free loan should similarly result in taxable income.[9]

The Tax Court, in rejecting the Commissioner's contention, distinguished the rent-free use of corporate property from the receipt of interest-free loans.[10] The *Dean* court reasoned that, had the rent-free users of corporate property procured the same benefit by expending money, the expenditures would not have been deductible.[11] On the

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its treatment under the Internal Revenue Code. Unless the Code specifically exempts the gain from taxation, the taxpayer must recognize the gain and include it in his gross income. If the gain is exempted under the Code, then, although the gain is realized by the taxpayer, the Internal Revenue Service will not recognize the gain as taxable income. The same distinction applies to transactions resulting in taxpayer losses.

7 35 T.C. at 1087. The interest obligation which the taxpayer would incur would be based on the prevailing prime interest rate. The Commissioner's argument has merit because of the time value utility of money. For example, assume that a shareholder borrows $10,000 interest-free from his corporation in 1981. If the shareholder repays the $10,000 in 1982, the corporation realizes an economic loss which is not deductible under the Internal Revenue Code, i.e., the decreased value of $10,000 over a one year period. The shareholder realizes a corresponding economic gain equal to the value of the use of $10,000 for one year. This gain is measured by the interest that the taxpayer would have paid to borrow the $10,000 in the marketplace. The Commissioner argued that, since the shareholder realized an economic gain, this gain should be recognized and taxed as gross income. *Id.*

8 Dean v. Commissioner, 187 F.2d 1019 (3d Cir. 1951) (rent-free use of corporation's house); Chester Distrib. Co. v. Commissioner, 184 F.2d 514 (3d Cir. 1950) (personal entertainment expenses paid by corporation); Silverman v. Commissioner, 28 T.C. 1061 (1957), *aff'd*, 253 F.2d 849 (8th Cir. 1958)(wife's travel expenses paid by corporation); Greenspon v. Commissioner, 23 T.C. 138 (1954), *rev'd on other grounds*, 229 F.2d 947 (8th Cir. 1956) (farm expenses paid by corporation); Paulina du Pont Dean v. Commissioner, 9 T.C. 256 (1947) (rent-free use of corporation's house); Chandler v. Commissioner, 41 B.T.A. 165 (1940), *aff'd*, 119 F.2d 623 (3d Cir. 1941)(rent-free use of corporation's apartment and lodge); Reynard Corp. v. Commissioner, 30 B.T.A. 451 (1934) (rent-free use of corporation's house); Frueauff v. Commissioner, 30 B.T.A. 449 (1934) (rent-free use of corporation's apartment).

9 35 T.C. at 1087. The Commissioner's argument was based on the distinction between realized and recognized gross income. *See* note 6 *supra*. The argument for recognizing the benefit as taxable income is supported by § 61 of the Internal Revenue Code, which states that "gross income is income from whatever source derived." I.R.C. § 61 (1976). The rent-free use of corporate property often results in income to the recipient. *See* text accompanying note 8 *supra*.

The interest-free use of corporate funds results in the same economic benefit as the rent-free use of corporate property. In each instance, the employee or shareholder obtains the free use of a corporate asset. Therefore, in both cases the free use should result in the same tax consequences—the recognition of taxable income.

10 The court stated that rent-free use of corporate property cases "bear a superficial resemblance" to interest-free loan cases, but that the two were not identical. 35 T.C. at 1090.

11 *Id.* The court's statement was based on § 262 of the Internal Revenue Code. § 262

other hand, had the taxpayers in *Dean* borrowed the funds on an interest-bearing basis, the resulting interest payments would have been deductible.[12] Thus, the Tax Court concluded that an interest-free loan results in no taxable gain to the borrower.[13]

The Tax Court did not reexamine its reasoning in *Dean* until 1979, in *Greenspun v. Commissioner*.[14] There, the court reached the *Dean* result, but through a different analysis. The *Greenspun* court agreed with the Commissioner's contention that the interest-free borrower received an economic benefit.[15] The court noted that, under section 163(a),[16] the interest-free borrower would not have been entitled to an interest deduction. However, the court ruled that basing this decision on the question of deductibility failed to recognize the economic realities of the transaction.[17] The court stated that an interest-free loan does not differ from a two-step transaction in which a corporation pays dividends or compensation to the borrower to offset the interest it charges on an interest-bearing loan.[18] The court rea-

specifically disallows, except as otherwise provided, any deduction "for personal, living, or family expenses." I.R.C. § 262 (1976).

12 35 T.C. at 1090. § 163(a) of the Internal Revenue Code allows as a deduction "all interest paid or accrued within the taxable year on indebtedness." I.R.C. § 163 (1976).

13 35 T.C. at 1090. In reaching this conclusion, the court apparently relied on the "wash" theory. Under the wash theory, the court reasoned that, had the shareholder recognized the economic benefit resulting from the use of corporate funds as gross income, a § 163(a) interest deduction (*see* note 16 *infra*) would offset this income, resulting in a "wash" transaction. This wash concept was rejected by Judge Wiese in *Hardee*. *See* notes 33-37 *infra* and accompanying text.

14 72 T.C. 931 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982). In *Greenspun*, Howard Hughes had tried to make substantial investments in the Las Vegas area. Greenspun was the owner of the Las Vegas Sun, a daily newspaper that Hughes had attempted to acquire. After Greenspun informed Hughes that he would not sell the Sun, Hughes set out to control the Sun indirectly by offering a $4 million interest-free loan to Greenspun. Concerned that the Internal Revenue Service might question the transaction, the parties later agreed on a 3% interest rate per annum for an eight-year term. The minimum rate at which Greenspun could have borrowed that amount in the marketplace was 6%. *Id.* at 931-32.

15 *Id.* at 947.

16 I.R.C. § 163 (1976). *See* note 12 *supra*.

17 72 T.C. at 951. The economic realities mentioned by the court relate to the idea of an interest-free loan coupled with increased compensation. *See* note 18 *infra*. Assume that Hughes had granted a loan at 6% interest to Greenspun and paid Greenspun cash equal to 3% of the charged interest, which Greenspun repaid to Hughes in partial satisfaction of the 6% interest. In this case, Greenspun would receive compensation and an offsetting interest deduction. The mere elimination of Hughes' formally paying Greenspun cash equal to 3% interest (which is repaid to Hughes) should not change the result.

18 *Id.* at 948. It is worthwhile to compare the two transactions. In an interest-free loan, the shareholder or employee receives money from the corporation without any obligation to pay interest. Thus, the recipient has received an asset without incurring a liability. He has thus benefitted in this situation. In the situation where compensation is increased to the extent of the interest to be repaid, the shareholder or employee receives the same benefit. The

soned that since the two-step transaction would result in a "wash",[19] the interest-free loan should also cause no taxable gain to the borrower.[20]

Although *Dean* has not yet been overruled, courts have displayed growing disfavor with the holding. The Tax Court showed disfavor with *Dean* in *Zager v. Commissioner*,[21] where it stated that *Dean* may have been overbroad.[22] Two years later, in *Beaton v. Commissioner*,[23] the Tax Court hesitantly followed *Dean*, noting that a departure from *Dean* would have resulted in uncertainty and a possible uneven application of the tax law.[24]

II. *Hardee v. United States*: The Court's Reasoning

For over twenty years, the Commissioner continued to fight a losing battle to tax interest-free loans. Finally, in *Hardee v. United States*[25] the Court of Claims departed from the precedent the Tax Court had established and adopted the Commissioner's viewpoint. In *Hardee*, the court held that a corporation's interest-free loan to a shareholder resulted in taxable income to the borrower.[26]

The Court of Claims in *Hardee*, using a two-pronged approach, rejected the Tax Court's reasoning in *Dean*.[27] The court first focused on the economic benefit attributable to the loan. The court noted that, under the principle established in *Commissioner v. Glenshaw Glass Co.*,[28] the definition of gross income in section 61[29] should be con-

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recipient receives the same asset (the loan). The recipient incurs a liability (interest expense) but, due to the increased compensation, the corporation actually reimburses him for payment of this liability. Since the additional amount of compensation will equal the expense incurred, the interest-bearing loan recipient does not "pay" for the use of these funds. He is placed in the same position, and receives the same benefit as an interest-free borrower.

19 *See* note 13 *supra*.

20 72 T.C. at 948.

21 72 T.C. 1009 (1979), *aff'd sub nom*. Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981).

22 *Id*. at 1012.

23 40 T.C.M. (CCH) 1324 (1980), *aff'd*, 664 F.2d 315 (1st Cir. 1981).

24 664 F.2d at 317.

25 *Hardee*, *supra* note 3.

26 *Id*. at 84,659. Hardee, the majority stockholder and president of a closely held corporation, had borrowed money from the corporation on an account for over twenty years. In exchange for the loans, Hardee gave the corporation noninterest-bearing notes. The Commissioner claimed that Hardee had realized an economic benefit, measured by the amount of interest Hardee would have been required to pay in an arm's-length loan transaction. Hardee's oustanding loan balances were $503,000 in 1973 and $474,000 in 1974.

27 Dean v. Commissioner, 35 T.C. 1083 (1961). *See* notes 4-12 *supra* and accompanying text.

28 348 U.S. 426 (1955).

29 *See* note 9 *supra*.

strued broadly to effect Congress's intention to "tax all gains except those specifically exempted."[30] The *Hardee* court compared using corporate funds to using other corporate assets and found that the user has an economic benefit in both situations.[31] The shareholder or employee must recognize this economic benefit as gross income.[32]

Second, the Court of Claims further vitiated *Dean* by refusing Hardee a corresponding interest deduction.[33] In *Dean*, the Tax Court had reasoned that a section 163(a)[34] interest deduction would offset the economic benefit resulting from the use of corporate funds.[35] In *Hardee*, Judge Wiese rejected this analysis and held that no statutory authority for an interest deduction existed[36] because section 163(a) permits a deduction only for interest paid or accrued.[37]

Furthermore, the court in *Hardee* rejected the *Greenspun*[38] analysis, which had attempted to give equal tax treatment to two supposedly similar economic situations.[39]eenspun had equated the tax treatment of an interest-free loan with that of an interest-bearing loan coupled with increased compensation.[40] The *Hardee* court focused only on interest-free loans, and did not equate interest-free loans with interest-bearing loans coupled with increased compensation.[41] The court added that one must focus on what actually occurred and not on what might have happened.[42] For this reason, the court rejected *Greenspun*'s "economic equivalent" analysis.

The essence of the Court of Claims's decision in *Hardee* is that an interest-free loan from a corporation to its shareholder or employee[43] gives rise to income and income only. No interest deduction is al-

30 348 U.S. at 430.

31 *Hardee*, *supra* note 3.

32 *Id.* at 84,659.

33 *Id.*

34 *See* note 15 *supra*.

35 35 T.C. at 1090. *See* notes 11-12 *supra* and accompanying text.

36 The *Hardee* court cited Commissioner v. National Alfalfa Dehydrating Co., 417 U.S. 134 (1974), which held that deductions were a matter of legislative grace and did not turn upon equitable considerations, such as a demonstration of effective economic and practical equivalence. *Id.* at 148-49.

37 *Hardee*, *supra* note 3, at 84,659. *See* note 16 *supra*.

38 72 T.C. 931.

39 *See* notes 14-18 *supra* and accompanying text.

40 72 T.C. at 931, 943. *See* note 18 *supra* and accompanying text.

41 *Hardee*, *supra* note 3, at 84,659.

42 *Id.* at 84,659.

43 Hardee was a majority shareholder and president of this closely-held corporation. The difference between an employee and shareholder is crucial when analyzing the tax consequences to the corporate lender. In general, the Commissioner's policy in situations where a

lowed under section 163(a) because the shareholder borrows without cost;[44] no interest was paid or accrued.

III. Analysis of *Hardee*

The *Hardee* decision is technically sound. It effects the congressional purpose of Internal Revenue Code section 61, which defines gross income,[45] and it literally applies section 163(a) regarding interest deductions.[46] However, the Commissioner has not been fighting for over 20 years simply to see the Internal Revenue Code literally applied. One must examine the tax consequences to both the borrower and the lender to understand the Commissioner's relentless effort to tax interest-free loans.[47]

A. *Tax Consequences to the Borrower (Employee or Shareholder)*

The tax consequences to the borrower of receiving an interest-free loan have been the subject of *Dean* and its progeny, and were the subject of *Hardee*. The *Dean* court compared the interest-free borrower to the marketplace borrower.[48] The *Greenspun* court, on the other hand, equated an interest-free loan with a supposed two-step transaction where the borrower receives an interest-bearing arm's-length loan with a corresponding increase in dividends or compensation to offset this charge.[49] In either case, however, the underlying rationale is the same: any imputed income would be offset by an equivalent imputed interest deduction under Internal Revenue Code section 163(a), thus resulting in a wash transaction.[50]

The *Hardee* court quickly dispensed with this rationale by literally interpreting section 163(a) to provide a deduction only for interest "paid or accrued."[51] Two significant flaws in the *Dean* and

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taxpayer is both an employee and a shareholder is to treat the taxpayer as a shareholder. *See* text accompanying notes 67-68 *infra*.

44 *Hardee*, *supra* note 3, at 84,659. The court reasoned that there are no "up-front" borrowing costs. For the interest-free borrower, the borrowing is truly "free". *Id.*

45 *See* text accompanying notes 28-32 *supra*.

46 *See* text accompanying notes 33-37 *supra*.

47 Neither *Dean*, *Greenspun*, nor *Hardee* have focused on the tax ramifications to the corporate lender when the corporation gives an interest-free loan. The best method of dealing with these loans is to require both the individual and the corporation to appear in court. This way the court can determine the tax ramifications to each party by examining both sides of the transaction.

48 35 T.C. at 1090. *See* text accompanying notes 11-13 *supra*.

49 *See* note 18 *supra* and accompanying text.

50 *See* note 13 *supra* and accompanying text.

51 *See* note 16 *supra*.

Greenspun reasoning support this literal interpretation of section 163(a). These flaws make it difficult to justify allowance of imputed interest deductions.

First, instances exist where interest expense may not be deductible under section 163(a). These instances involve cases where: (1) an interest deduction for investment indebtedness is limited by section 163(d),[52] (2) an interest deduction for debt incurred to purchase or carry tax-exempt securities is prohibited by section 265,[53] or (3) interest is not deductible because the taxpayer has not itemized his deductions.[54] Thus, one cannot assume that an interest deduction would be allowed in all situations.

Judge Goldberg offered an alternative to this broad assumption of deductibility in his dissent in *Martin v. Commissioner*.[55] Judge Goldberg suggested that the proper way to tax an interest-free loan is to require the borrower to include the economic benefit of the interest-free loan in his gross income. Judge Goldberg would then allow the loan recipient an interest deduction in those cases where the interest would have been deductible if paid.[56] Although Judge Goldberg's theory offers a viable solution in dealing with the *Dean-Greenspun* rationale's first flaw, it offers no help in dealing with the second.

The second flaw in the treatment of interest-free loans under the *Dean-Greenspun* rationale is attributable to the *Greenspun* court equating two different transactions. The Tax Court in *Greenspun* held that an interest-free loan was economically equivalent to a two-step arm's-length transaction where the borrower is required to pay interest, but receives a corresponding increase in compensation or dividends to cover the interest charge.[57] The *Greenspun* court reasoned that, because the interest-free loan and the two-step transaction were economically equivalent, and since the two-step transaction would

52 I.R.C. § 163(d) (1976) provides generally that a taxpayer other than a corporation is limited to an investment interest deduction of $10,000 ($5000 when married filing separately), plus the amount of net investment income plus the amount by which certain allowable deductions exceed the rental income produced by such property for the taxable year.

53 I.R.C. § 265 (1976) provides that no expenses or interest charges relating to the carrying of obligations producing tax-exempt income are deductible.

54 I.R.C. § 161 (1976). In computing taxable income, items specified in Code sections 161 to 222 are allowed as itemized deductions.

55 39 T.C.M. (CCH) 531 (1979), *aff'd*, 649 F.2d 1133 (5th Cir. 1981).

56 649 F.2d at 1142. Judge Goldberg's alternative suffers from the same drawbacks as do those of *Dean* and *Greenspun*. Judge Goldberg is willing to create an exception to § 163(a). Unfortunately, courts create difficulties when they delve into fictions and should therefore apply the Code to the actual facts. *See* note 42 *supra* and accompanying text.

57 *See* text accompanying notes 18 and 49 *supra*.

result in a wash,[58] the interest-free loan should result in no taxable gain to the borrower.[59] This reasoning is flawed, however, because the purportedly equivalent two-step transaction does not always result in a wash.[60]

In *Hardee*, the Court of Claims put the borrower in a worse position than he would have been in under *Dean* or *Greenspun*[61] by including the economic benefit conferred upon the interest-free borrower in his gross income while disallowing any imputed interest deduction. Thus, with respect to the *borrower*, the *Hardee* decision discourages the use of interest-free loans, and encourages structuring corporate loans at arm's-length with corresponding increases in dividends or compensation to the borrower.[62] This two-step transaction would cause tax treatment similar to the *Dean* treatment of interest-free loans,[63] would eliminate the need to impute an interest deduction, and would accurately reflect gross income.

B. *Tax Consequences to the Lender (Corporation)*

Although *Dean*, *Greenspun*, and *Hardee* have focused on the tax consequences to the borrower, the tax consequences to the corporate

58 *See* notes 13 and 50 *supra* and accompanying text.

59 72 T.C. at 932.

60 For example, a distortion of adjusted gross income may occur when an interest-free loan is analyzed under the *Dean-Greenspun* wash concept rather than under the two-step transaction concept. In the two-step transaction, although the taxpayer includes in gross income the same amount that he is entitled to deduct as interest expense, his adjusted gross income is higher than it would be under the *Dean-Greenspun* analysis. This is so because, under the *Dean-Greenspun* analysis, no amount is included in gross income. This distortion, or lowering of adjusted gross income under *Dean-Greenspun*, could result in higher deductions for charitable contributions and medical expenses, which are limited by the taxpayer's adjusted gross income. *See* I.R.C. § 170(b), 213(a)-(b) (1976).

61 Even under *Hardee*, the interest-free borrower is in a better tax position than the marketplace borrower. For example, an employee in the 40% tax bracket who borrows $1000 interest-free when the prevailing prime interest rate is 10% recognizes $100 as taxable income. The taxpayer's net borrowing cost is $40, the increase in his tax liablility. In contrast, an employee who borrows $1000 in the marketplace at the same 10% interest rate pays the same $100 interest expense and receives a $100 interest deduction, which saves him $40 if he is in the 40% tax bracket, assuming that the taxpayer itemizes and his itemized deductions exceed the zero bracket amount. His net borrowing cost would therefore be $60, the $100 cash outlay less the $40 tax savings. Thus, the interest-free borrower under the *Hardee* approach still receives more favorable tax treatment than the marketplace borrower. Only a taxpayer who is below the 50% tax bracket will benefit from the *Hardee* tax treatment. Once the taxpayer reaches the 50% tax bracket, he loses this favorable tax treatment.

62 This conclusion assumes that the shareholder or employee wishes to avoid paying more taxes as a result of having to include the value of the interest-free loan in gross income.

63 *See* notes 18 and 49 *supra* and accompanying text.

lender must also be examined to explain the Commissioner's persistent attack upon interest-free loans.

Under the *Dean* analysis, when gross income and a corresponding interest deduction are imputed to an employee-borrower, interest income should logically be imputed to the corporation. However, courts using reasoning similar to *Dean* have decided that interest-free loans result in no taxable income to the corporate lender.[64]

Similarly, using a *Greenspun* analysis, the interest-free loan should result in the same tax liability as the purportedly equivalent two-step transaction.[65] But whether these two transactions yield the same tax liability under pre-*Hardee* case law depends upon whether the borrower is an employee or a shareholder.

If a corporation lends money to an *employee*, the interest-free loan yields the same tax consequences as the two-step transaction approach. Under the *Dean-Greenspun* rationale and pre-*Hardee* case law, the corporation receives no income and incurs no tax liability if the transaction is structured as an interest-free loan. With the two-step transaction, the interest income that the corporation receives is offset by a corresponding compensation or wage deduction.[66] Thus, the corporation-to-*employee* loan results in the same corporate tax consequences under either analysis.

The two approaches differ, however, when the borrower is classified as a *shareholder*. Under the *Dean-Greenspun* rationale and pre-*Hardee* case law, the corporation incurs no tax liability if the loan is structured as an interest-free loan. However, in a two-step transaction, the corporation's income is increased by the amount of interest received from the borrower, but no corresponding deduction is allowed since the corporation is deemed to have paid a nondeductible dividend.[67] Thus, a corporation using a two-step transaction will be taxed on the interest payments it receives, while a corporation using an interest-free loan escapes taxation on the loan repayment. Nevertheless, if the *Hardee* decision actually discourages the use of interest-free loans and encourages the use of two-transaction loans, the practical effect of these differing tax results will be minimized.[68]

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64 *See* Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416 (1960).

65 *See* note 18 *supra*.

66 I.R.C. § 162 (1976).

67 *Id.*

68 These tax differences will be eliminated only if one assumes that interest-free loans will no longer be used. All loans would be structured instead at arm's-length in order to minimize taxes.

C. *Abuses of Interest-Free Loans Through the Professional Corporation*

A secondary purpose of the Commissioner's attack upon interest-free loans may be to solidify the separation between a professional and his professional corporation.[69] The interest-free loan is an attractive tax deferral and tax savings device[70] among these corporations. Under the *Dean-Greenspun* rule, the professional may obtain the use of money through an interest-free loan, rather than as a taxable salary.[71]

Thus, the *Hardee* decision may be an attempt to discourage this type of situation. The effectiveness and prevalence of interest-free loans for tax avoidance in a professional corporation setting sharply demonstrates why *Dean* and *Greenspun* should be questioned and ultimately overruled.

IV. Conclusion

The *Hardee* decision was originally appealed to the entire Court of Claims. However, the Court of Appeals for the Federal Circuit now has jurisdiction over the appeal under the Federal Courts Improvement Act of 1982.[72] The decisions of this new court do not bind the Tax Court.[73] *Hardee* may not significantly affect the current status of interest-free loans because this decision's adverse consequences can be easily avoided. The taxpayer can simply refuse to pay the deficiency and argue his case in the Tax Court, where twenty years of favorable precedent will support him.[74]

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69 Professional corporations are governed by state statutes. In states with professional corporation statutes, designated professionals are allowed to form corporations or associations. These statues allow professionals to enjoy many of the advantages of corporate existence while retaining personal liability for their acts and the professional acts performed under their supervision. *See generally* HENN, HANDBOOK OF THE LAW OF CORPORATIONS 104-05 (2d ed. 1970).

70 *See* note 71 *infra*.

71 For example, assume that a professional incorporated as a professional corporation earns (net of all expenses) $100,000 in a given year. Normally, the $100,000 will be paid as a salary to the professional, who will be taxed at individual rates, and the $100,000 will be deducted as salary expense by the corporation. Thus, the corporation will incur no tax liability for the $100,000 paid as salary. The professional would be taxed at a maximum individual rate of 50% on this amount. *See* Economic Recovery Tax Act of August 13, 1981, Pub. L. No. 97-34, 1981 U.S. Code Cong. & Ad. News (95 Stat.) 172. However, the professional may borrow the $100,000 interest-free from the corporation, thereby enjoying the use of the money and paying no taxes under the *Dean* rationale. The income would be held at the corporate level, where it would be taxed at lower graduated rates up to 46%. *See* I.R.C. § 11 (1976).

72 Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, § 1296, 96 Stat. 25 (1982).

73 *Id.*

74 *See* note 3 *supra*.

Nevertheless, taxpayers must be aware that interest-free loans remain a risky proposition, even in the Tax Court, as evidenced by the Commissioner's relentless attack upon interest-free loans. *Hardee* should be affirmed on appeal, giving the Commissioner a well-reasoned decision upon which to base his attack. Although *Hardee* may not presently bind the Tax Court, it presents a sound approach, and may signify an important shift in the law concerning interest-free loans.

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