



12-1-1984

From Dean and Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans

Michael D. Hartigan

Follow this and additional works at: <http://scholarship.law.nd.edu/ndlr>



Part of the [Law Commons](#)

Recommended Citation

Michael D. Hartigan, *From Dean and Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans*, 60 Notre Dame L. Rev. 31 (1984).

Available at: <http://scholarship.law.nd.edu/ndlr/vol60/iss1/2>

This Article is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

From *Dean* and *Crown* to the Tax Reform Act of 1984: Taxation of Interest-Free Loans

Michael D. Hartigan*

Until recently, taxpayers participating in interest-free loan transactions¹ paid neither income² nor gift tax.³ In 1984, however, the Supreme Court⁴ and Congress⁵ established both income and gift tax consequences for interest-free loans.

While addressing the income tax⁶ and the gift tax⁷ consequences separately, this article provides an historical background of the income and gift tax treatments of interest-free loans.⁸ In addition, the article discusses the current erosion of these historical tax treatments⁹ and identifies the proper methods for income and gift taxation of interest-free loans.¹⁰

* B.S.B.A., 1978, Stonehill College; J.D., 1981, University of Notre Dame; LL.M., 1983, Boston University; Member, Massachusetts Bar.

1 This article focuses only on demand loans unless otherwise stated, and reviews income and gift tax consequences of interest-free loans and of loans which carry a reduced rate of interest (lower than market rate). The same reasoning applies equally to both interest-free and reduced-rate loans.

2 *Parks v. Commissioner*, 686 F.2d 408 (6th Cir. 1982); *Baker v. Commissioner*, 677 F.2d 11 (2d Cir. 1982); *Commissioner v. Greenspun*, 670 F.2d 123 (9th Cir. 1982); *Beaton v. Commissioner*, 664 F.2d 316 (1st Cir. 1981); *Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981); *Suttle v. Commissioner*, 625 F.2d 1127 (4th Cir. 1980); *Dean v. Commissioner*, 35 T.C. 1083 (1961). The IRS has made many other unsuccessful attempts to overrule *Dean*, including: *Trowbridge v. Commissioner*, 1981 TAX CT. MEM. DEC. (P-H) ¶ 81,190; *Estate of Liechtung v. Commissioner*, 40 TAX CT. MEM. DEC. (CCH) 1118 (1980); *Lisle v. Commissioner*, 1976 TAX CT. MEM. DEC. (P-H) ¶ 76,140.

3 *Crown v. Commissioner*, 585 F.2d 234 (7th Cir. 1978); *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966).

4 *Dickman v. Commissioner*, 690 F.2d 812 (11th Cir. 1982) (gift tax consequences), *aff'd*, 104 S. Ct. 1086, *reh'g denied*, 104 S. Ct. 1932 (1984).

5 Tax Reform Act of 1984, Pub. L. No. 98-369, § 172, 98 Stat. 494 (to be codified at I.R.C. § 7872 (1984)).

6 See text accompanying notes 11-162 *infra*.

7 See text accompanying notes 163-290 *infra*.

8 See text accompanying notes 11-19 (income tax) and 163-95 (gift tax) *infra*.

9 See text accompanying notes 33-46 (income tax) and 196-229 (gift tax) *infra*.

10 See text accompanying notes 47-162 (income tax) and 230-90 (gift tax) *infra*.

I. Income Tax Consequences

A. *Historical Perspective: Dean Doctrine*

During 1955 and 1956, J. Simpson and Paulina duPont Dean had more than two million dollars of outstanding interest-free loans from a corporation that they controlled.¹¹ The Internal Revenue Service (the "IRS") asserted that the Deans derived an economic benefit¹² equal to the current prime interest rate¹³ from the free use of the borrowed money. The IRS relied on cases holding that the rent-free use of corporate property by a stockholder, director, officer, or employee may result in the realization of income.¹⁴ The IRS analogized an interest-free loan from a corporation to the rent-free use of corporate property. Concluding that the Deans received an economic benefit and thus realized income from the loan, the IRS determined deficiencies in income tax for 1955 and 1956.¹⁵

The United States Tax Court acknowledged that an interest-free loan results in an economic benefit to the recipient. Nevertheless, the court rejected the IRS' analogy and distinguished the interest-free use of corporate money from the rent-free use of corporate property.¹⁶ The court reasoned that had the Deans borrowed the money on interest-bearing notes, they could have fully deducted any interest payments under section 163.¹⁷ If the Deans had rented corporate property, however, instead of using it rent-free, they could not have deducted the rental payments.¹⁸ Accordingly, the Tax Court held that an "interest-free loan results in no taxable gain to the bor-

11 *Dean*, 35 T.C. at 1088.

12 *Id.* at 1087.

13 *Id.*

14 *Id.* at 1089. The Tax Court listed nine prior cases which all generally held that the rent-free use of corporate property may result in the realization of income. *Dean v. Commissioner*, 187 F.2d 1019 (3d Cir. 1951), *affg.*, *Paulina duPont Dean*, 9 T.C. 256 (1947) (rent-free use of corporation's house); *Chester Distributing Co. v. Commissioner*, 184 F.2d 514 (3d Cir. 1950) (personal entertainment expenses paid by corporation); *Alex Silverman*, 28 T.C. 1061, *aff'd*, 253 F.2d 849 (8th Cir. 1958) (wife's travel expenses paid by corporation); *Louis Green-spon*, 23 T.C. 138 (1954), *rev'd on other grounds*, 229 F.2d 947 (8th Cir. 1956) (farm expenses paid by corporation); *Rodgers Dairy Co.*, 14 T.C. 66 (1950) (personal use of corporation's automobile); *Percey M. Chandler*, 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 Corporation*, 30 B.T.A. 451 (1934) (rent-free use of corporation's house); *Charles A. Frueauff*, 30 B.T.A. 449 (1934) (rent-free use of corporation's apartment).

15 35 T.C. at 1083.

16 *Id.* at 1090.

17 *Id.*; I.R.C. § 163(a) (1984) (generally, deduction allowed for "all interest paid or accrued within the taxable year on indebtedness").

18 35 T.C. at 1090.

rower" because any economic benefits received would have been offset by an interest deduction.¹⁹

B. *Post-Dean Analysis: Commissioner Estopped By Own Laches*

If the IRS had appealed *Dean* or pursued its position in a promptly issued nonacquiescence, the courts probably would have modified or overruled the *Dean* doctrine.²⁰ But, the IRS withdrew its appeal of *Dean* and waited twelve years to announce its nonacquiescence.²¹

Before the enactment of the Tax Reform Act of 1984, seven circuits had accepted the *Dean* doctrine.²² In *Greenspun v. Commissioner*,²³ Howard Hughes loaned four million dollars to Herman Greenspun, a Las Vegas newspaper publisher. In exchange for Greenspun's promise to promote Hughes' proposed purchase of several Las Vegas casinos, Hughes charged Greenspun a reduced rate of interest.²⁴ The IRS contended that Greenspun realized gross income of the difference between the loan's reduced interest rate and the prime interest rate.²⁵ Furthermore, the IRS also claimed that Greenspun could not deduct under section 163²⁶ interest neither paid nor accrued.²⁷

In *Greenspun*, the Court of Appeals for the Ninth Circuit subtly reprimanded the IRS for not pursuing its position in *Dean*. The court of appeals implied that it might have overturned or modified the *Dean* doctrine had the IRS immediately challenged the decision.²⁸ Yet, because the IRS had not effectively attacked the *Dean* doctrine, the court acknowledged the doctrine as the controlling law.²⁹ Moreover, since taxpayers had relied on *Dean* for two decades, the court

19 *Id.*

20 *Greenspun*, 670 F.2d at 125; *Beaton*, 664 F.2d at 317; *Martin*, 649 F.2d at 1133. Stating that since the IRS had not challenged *Dean* within a reasonable time, the courts would not disturb the doctrine because the IRS' inaction caused taxpayers to rely on *Dean*.

21 1973-2 C.B. 4 (1973).

22 *Parks v. Commissioner*, 686 F.2d 408 (6th Cir. 1982); *Baker v. Commissioner*, 677 F.2d 11 (2d Cir. 1982); *Commissioner v. Greenspun*, 670 F.2d 123 (9th Cir. 1982); *Beaton v. Commissioner*, 644 F.2d 316 (1st Cir. 1981); *Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981); *Suttle v. Commissioner*, 625 F.2d 1127 (4th Cir. 1980); see also *Hardee v. United States*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459 (1982), *rev'd*, 708 F.2d 661 (Fed. Cir. 1983).

23 670 F.2d 123 (9th Cir. 1982).

24 *Id.* at 124.

25 *Id.*

26 I.R.C. § 163(a) (1984). For the general language of § 163(a), see note 17 *supra*.

27 670 F.2d at 125.

28 The court said that although it appreciated the IRS' argument, *Dean* had been controlling law for two decades and had to be followed. *Id.* The court implied that had *Dean* not been a longstanding doctrine, it might have modified or overruled it.

29 *Id.*

believed that overruling or modifying *Dean* would cause uncertainty and an uneven application of the income tax statute.³⁰ The court reasoned:

Too much water has passed under the bridge to warrant judicial re-examination of the principles underlying the [*Dean*] decision or the problems generated by it. Where, as here, the Government seeks to modify a principle of taxation so firmly entrenched in our jurisprudence, it should turn to Congress, not to the courts.³¹

Therefore, the court applied the *Dean* doctrine and held that Green-spun did not realize gross income from the reduced interest rate loan.³²

C. *Recent Analysis: Hardee v. United States*

1. Trial Court Decision

Twenty-one years after *Dean*, the IRS convinced the United States Court of Claims that the case's reasoning and result were incorrect. In *Hardee v. United States*,³³ the Court of Claims identified two fundamental problems with the *Dean* doctrine. First, section 163, the controlling statute, provides only a deduction for interest "paid or accrued within the taxable year."³⁴ The borrower of an interest-free loan, however, neither pays nor accrues interest. Thus, the "wash-out" theory³⁵ has no statutory basis.

Furthermore, in *Commissioner v. National Alfalfa Dehydrating*,³⁶ the Supreme Court stated that "[t]he propriety of a deduction does not

³⁰ *Id.* at 125-26.

³¹ *Id.* The court continued:

As noted by the Supreme Court . . . : "Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactment, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning."

Id. at 126 (quoting *United States v. Byrum*, 408 U.S. 125, 135 (1971)).

³² *Id.*

³³ 82-2 U.S. Tax Cas. (CCH) ¶ 9459 (1982). A corporation controlled by Mr. and Mrs. Hardee loaned Mr. Hardee approximately one-half million dollars on an interest-free basis. *See id.* at ¶ 9459, at 84,656.

³⁴ I.R.C. § 163(a) (1984). For the general language of § 163(a), see note 17 *supra*.

³⁵ The *Dean* doctrine also is referred to as the "wash-out" theory because any economic benefits from the interest-free loan allegedly are "washed out" by a corresponding interest deduction.

³⁶ 417 U.S. 134 (1974).

turn upon general equitable considerations, such as a demonstration of effective economic and practical equivalence. Rather, it 'depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.'"³⁷ The *Hardee* trial court found that Hardee did not pay or accrue any interest and that no specific statutory provision allows a deduction for interest neither paid nor accrued. Thus, relying on a literal interpretation of section 163, the court would not allow an interest deduction for an interest-free loan.³⁸

Second, the *Hardee* trial court objected to the result of the *Dean* doctrine.³⁹ The doctrine's purpose is to afford the same tax treatments to transactions functionally identical yet differing in form.⁴⁰ The court observed that while the *Dean* doctrine eliminated one unequal tax imposition it created another imbalance. Under *Dean*, the interest-free loan recipient avoided any adverse economic consequences by incurring neither finance charges nor taxes.⁴¹ The court concluded that the result of applying the *Dean* doctrine seemed "even more out-of-joint, economically speaking, than the discrepancy it means to overcome . . ."⁴²

Because of these two fundamental problems, the *Hardee* court chose not to follow the *Dean* doctrine. Instead, the court noted that section 61⁴³ has been broadly construed to effectuate the congressional purpose to "tax all gains except those specifically exempted."⁴⁴ The interest-free use of corporate funds gives rise to an economic benefit⁴⁵ not specifically exempted from taxation. Accordingly, the court held that Hardee realized income from the interest-free use of corporate funds and was not entitled to an interest deduction.⁴⁶

37 *Id.* at 148-49 (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)).

38 *Hardee*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,659; I.R.C. § 163(a) (1984). For the language of § 163(a), see note 17 *supra*.

39 *Hardee*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,659.

40 *Id.* The interest-free loan transaction is considered to be identical to a transaction in which the borrower receives the payment of compensation or other payment from the lender, and then the borrower makes an interest payment of the same amount to the lender.

41 *Id.*

42 *Id.*

43 I.R.C. § 61(a) (1984) (gross income includes "all income from whatever source derived").

44 *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 430 (1955).

45 *Catalano, Inc. v. Target Sales, Inc.*, 446 U.S. 643, 648 (1980); *Martin v. Commissioner*, 649 F.2d 1133, 1136 (5th Cir. 1981) (Goldberg, J., dissenting). The interest-free transfer of the use of money gives the borrower an opportunity to make additional income at no cost. Clearly, the borrower receives an economic benefit from the transfer.

46 *Hardee*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,659.

2. Court of Appeals Decision

Citing the *Dean* doctrine as controlling law, the United States Court of Appeals for the Federal Circuit reversed the trial court's decision and held that the receipt of interest-free loans did not result in taxable gain to the borrower.⁴⁷ The *Hardee* appeals court followed both the reasoning and result of the six appellate court decisions⁴⁸ rejecting the income taxation of interest-free loans, but additionally excluded the loan's benefit from taxable income at the outset. Essentially, the *Hardee* appeals court found that since the *Dean* doctrine was a "well-entrenched principle of tax law"⁴⁹ accepted by six courts of appeals, "[t]o depart from the long-standing precedent against treating such loans as a taxable benefit would create uncertainty and would result in an uneven application of the tax law."⁵⁰

In addition, the *Hardee* appeals court declared that "the definition of taxable income does not encompass the benefit a [borrower] . . . gains by the receipt of an interest-free loan."⁵¹ Thus, the court of appeals accepted the *Dean* "wash-out" theory, but also expanded the doctrine by concluding that the benefit of interest-free loans fell outside the scope of section 61.⁵²

D. Tax Reform Act of 1984: *Caveat Creditor et Debtor*

Section 172⁵³ of the 1984 Tax Reform Act amended the Internal Revenue Code by adding section 7872⁵⁴ entitled "Treatment of Loans With Below-Market Interest Rates." Section 7872 establishes both income and gift tax consequences for certain interest-free loan transactions and generally applies to interest-free loans made or outstanding after June 6, 1984.⁵⁵

47 *Hardee v. United States*, 708 F.2d 661, 667-68 (Fed. Cir. 1983).

48 *Id.* at 662; *Parks v. Commissioner*, 686 F.2d 408 (6th Cir. 1982); *Baker v. Commissioner*, 677 F.2d 11 (2d Cir. 1982); *Commissioner v. Greenspun*, 670 F.2d 123 (9th Cir. 1982); *Beaton v. Commissioner*, 664 F.2d 316 (1st Cir. 1981); *Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981); *Suttle v. Commissioner*, 625 F.2d 1127 (4th Cir. 1980). The court in *Hardee* followed these prior cases, except for its extension of the *Dean* doctrine, which is discussed in the text accompanying notes 51-52 *infra*.

49 708 F.2d at 662.

50 *Id.* at 668.

51 *Id.* at 665.

52 *Id.* at 665; at 669 (Kashiwa, J., dissenting). For a further discussion of the expansion of the *Dean* doctrine, see notes 129-34 *infra* and accompanying text. For the language of I.R.C. § 61(a), see note 43 *supra*.

53 Tax Reform Act of 1984, Pub. L. No. 98-639, § 172, 98 Stat. 494 (to be codified at I.R.C. § 7872).

54 *Id.*

55 Section 7872 does not apply to any demand loan outstanding on June 6, 1984, if such

Section 7872 applies to both term and demand loans that are "below-market loans."⁵⁶ A demand loan is a below-market loan "if . . . interest is payable on the loan at a rate less than the applicable Federal rate"⁵⁷ A term loan is a below-market loan "if . . . the amount loaned exceeds the present value of all payments due under the loan."⁵⁸

Section 7872 applies to any demand or term below-market loan that is: (1) a gift loan; (2) a corporation-shareholder loan; (3) a compensation-related loan between an employer and employee or between an independent contractor and a person for whom the independent contractor provides services; (4) a loan that has tax avoidance as one of its principal purposes; or (5) any other loan that the IRS determines by regulations has a significant effect on the federal tax liability of either the borrower or the lender.⁵⁹

The tax treatment under section 7872 depends upon the type of below-market loan.⁶⁰ Gift loans⁶¹ and demand loans⁶² incur different income tax consequences than do term loans.⁶³ The foregone interest⁶⁴ from a gift or a demand loan is "treated as . . . transferred from the lender to the borrower, [as a gift, compensation, a dividend, a

demand loan is repaid within 60 days after the date of enactment. The date of enactment was July 18, 1984; thus, the demand loans must have been repaid before Sept. 17, 1984 to be outside the scope of § 7872.

56 I.R.C. § 7872(e)(1) (1984) defines the term "below-market loan." See text accompanying notes 57-58 *infra*.

57 *Id.*; I.R.C. § 7872(f)(5) (1984) provides that a "demand loan" means "any loan which is payable in full at any time on the demand of the lender . . . [or] any loan which is not transferable and the benefits of the interest arrangements of which is conditioned on the future performance of substantial services by an individual." Section 7872(f)(2)(b) provides that the federal short-term rate in effect under I.R.C. § 1274(d) (1984) is to be used to determine foregone interest calculated under § 7872(e)(2). For a detailed explanation of the applicable federal rate under § 1274, see note 66 *infra*. A non-transferable below-market term loan where the benefits of the interest arrangement are conditioned on future performance of substantial services by an individual is converted under § 7872(f)(5) to a demand loan for purposes of § 7872.

58 *Id.*; 26 I.R.C. § 7872(f)(6) (1984) defines "term loan" to mean "any loan which is not a demand loan."

59 I.R.C. § 7872(c) (1984) lists the five types of loans that come within its scope. The type of the loan involved determines certain other tax consequences. For example, the initial imputed transfer between the lender and the borrower may be a gift subject to gift tax, or a payment of wages includable in the borrower's taxable income. See text accompanying notes 60-93.

60 *Id.*

61 I.R.C. § 7872(f)(3) (1984) defines "gift loan" to mean "any below-market loan where the foregoing of interest is in the nature of a gift."

62 "Demand loan" is defined at note 57 *supra*.

63 "Term loan" is defined at note 58 *supra*.

64 I.R.C. § 7872(e)(2) (1984) defines the term "foregone interest" to mean:

capital contribution, or other payment] . . . and retransferred by the borrower to the lender as interest [income]."⁶⁵ Thus, the lender is deemed to have made a loan at an imputed "applicable Federal rate,"⁶⁶ and the borrower is deemed to have paid the lender imputed interest. The imputed interest is calculated daily and considered transferred and retransferred on the last day of the calendar year.⁶⁷ The lender must include the imputed interest in his gross income.⁶⁸ The borrower is entitled to an interest deduction under section 163 as if he had actually made the interest payments.⁶⁹

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 . . . [last day of the calendar year] . . . , over

(B) any interest payable on the loan properly allocable to such period.

65 I.R.C. § 7872(a)(1) (1984). See the example at note 67 *infra*.

66 I.R.C. § 7872(f)(2)(A) and (B) define the applicable federal rate to be used to calculate imputed interest for term and demand loans. The imputed interest rate for demand loans is the federal short-term rate under I.R.C. § 1274(d) (1984). For term loans, the applicable federal rate that a lender and a borrower must use is determined by reference to the term of the loan in accordance with § 1274(d) the following rates apply as of the date the loan was made:

<i>Term of Loan</i>	<i>Interest Rate</i>
Not more than three years	Federal short-term rate
More than three years but less than ten years	Federal mid-term rate
More than nine years	Federal long-term rate

From June 7, 1984 until Jan. 1, 1985, the applicable federal rate is ten (10%) percent, compounded semiannually. In a news release dated Nov. 11, 1984, the IRS announced the rates that will apply beginning Jan. 1, 1985 IR-84-115. Thereafter, the applicable federal rate is set for the six-month periods beginning Jan. 1 and July 1 of each year, and is based on the average market yield on outstanding marketable securities of the United States with comparable maturities for the six-month periods ending on the preceeding Sept. 30 and March 31, respectively.

67 I.R.C. § 7872(a)(2) (1984). A demand loan is considered a series of one day term loans with foregone interest calculated on a daily basis using the federal short-term rate.

68 I.R.C. §§ 7872(a) and (b) (1984). For example, on July 1, 1984, a corporation loans its employee \$250,000 on a demand basis at a rate of five (5%) percent per annum. For 1984, foregone interest considered to be transferred and retransferred between the parties is approximately \$6284 ($\$250,000 \times 10\% \times 184/366$ over $\$250,000 \times 5\% \times 184/366$). The corporation may deduct the \$6284 as compensation paid, subject to reasonable compensation rules, but it must include the same amount in income as imputed interest. The employee must include the \$6284 in taxable income as wages and may be entitled to an interest deduction under § 163 for the same amount. The employee is considered to have paid the imputed \$6284 along with the actual interest paid under the terms of the loan.

For demand loans and gift loans, although the amounts deemed transferred and retransferred are not subject to withholding under Chapter 24 of the Internal Revenue Code, the conference agreement states that the imputed interest, in a compensation-related loan, is treated as wages for purpose of Chapters 21 (F.I.C.A.), 22 (R.R.T.A.), and 23 (F.U.T.A.).

69 The borrower is entitled to an interest deduction on a below-market loan so long as such deduction would be allowed had the borrower actually paid the interest thereon. No

With non-gift term loans, the lender is treated as transferring and the borrower is treated as receiving "cash in an amount equal to the excess of the amount loaned, over the present value of all payments which are required to be made under the terms of the loan."⁷⁰ The imputed excess is deemed transferred and received on the date the loan is made or on the first day section 7872 applies, whichever is later.⁷¹ In addition, the lender receives interest income and the borrower pays interest of the daily total of the imputed original issue discount for every day the loan is outstanding during the tax year.⁷²

If the borrower receives a term loan that is also a corporation-shareholder loan or a compensation-related loan, the borrower recognizes income of all of the imputed excess on the date the loan is made.⁷³ Thus, if a corporation makes a below-market term loan to a shareholder, on the loan date the shareholder receives a dividend of the imputed excess. The corporation is not entitled to a deduction. However, with a corporate loan to an employee, on the loan date the imputed excess constitutes ordinary income to the borrower. The lender is allowed a deduction for a compensation expense. During the life of the loan, however, in both situations the lender receives and the borrower deducts the imputed interest because the imputed excess is deemed to be original issue discount.⁷⁴

Section 7872 treats a below-market gift term loan as a demand loan for income tax purposes and as a term loan for gift tax pur-

interest deduction is permitted if the borrower does not itemize his deductions. Similarly, no interest deduction would be allowed in excess of the limitation on interest on investment indebtedness under § 163(d), or where the borrower used the loan proceeds to purchase or carry tax-exempt income instruments under § 265.

The Treasury Department is authorized to promulgate regulations to assure that the tax positions of the borrower and the lender are consistent. I.R.C. § 7872(g)(1)(B) (1984). The Joint Explanatory Statement of the Committee of Conference provides that the regulations may condition the § 163 deduction for deemed interest under § 7872 on adequate identification of the lender (i.e., lender's name, address, and taxpayer identification number).

130 CONG. REC. H6649 (1984).

70 I.R.C. § 7872(b)(1) (1984).

71 *Id.*

72 *Id.* at § (b)(1) and (2). For an explanation of the treatment of original issue discount under § 1272, see note 87 *infra*. For rules to determine the amount of original issue discount, see I.R.C. § 1273 (1984).

73 *Id.*

74 *Id.* The borrower encounters a special tax problem in that the borrower is required to recognize the original issue discount amount up-front as taxable income. However, the borrower cannot deduct the same amount in the same tax year. The borrower is entitled to deduct the imputed interest excess of § 7872(b) over the life of the loan. Thus, a timing imbalance occurs in that the recognition of income and allowance of a corresponding deduction may occur in different tax years.

poses.⁷⁵ For gift tax purposes, on the later of the loan date or the date section 7872 applies, the lender is deemed to give the borrower the excess of the amount loaned over the present value of all principal and interest payments required under the loan.⁷⁶ For income tax purposes, the foregone interest, imputed on the last day of the calendar year, is considered to be retransferred from the borrower to the lender.⁷⁷

Section 7872 contains essentially three exceptions to the imposition of income tax on an interest-free loan.⁷⁸ First, the section provides a \$10,000 *de minimis* exception.⁷⁹ Gift loans between individuals are not subject to section 7872 for any day on which the total amount of loans between the parties does not exceed \$10,000, if the loan proceeds are not used to purchase or carry income-producing assets.⁸⁰ In addition, section 7872 does not apply to compensation-related loans or to corporation-shareholder loans for any day on which the total amount of loans between the parties does not exceed \$10,000, unless the principal purpose of the loans is federal tax avoidance.⁸¹ The conference agreement indicates that all loans between the lender and borrower are included in ascertaining if the total amount exceeds the \$10,000 limitation.⁸² Moreover, if the taxpayer is married, loans to the taxpayer's spouse are also included in com-

75 I.R.C. § 7872(d)(2) (1984). The Joint Explanatory Statement of the Committee of Conference provides the following example:

[A]ssume that on January 1, P, a calendar year taxpayer, makes a \$200,000 loan to S, [also] a calendar year taxpayer, for two years at 5 percent simple interest payable annually. If the applicable Federal rate is 12 percent compounded semiannually, the amount treated as transferred by the lender to the borrower for gift tax purposes would be \$27,760 (i.e., the excess of \$200,000 over the present value of all payment due under the loan discounted at the applicable Federal rate). The amount treated as retransferred by the borrower to the lender on the last day of each of the two calendar years would be \$14,720 (i.e., the excess of interest computed at the applicable Federal rate (compounded semiannually) over the interest actually payable on the loan). This amount, which would be included in income by the lender and, subject to the rules governing the deductibility of interest, deductible by the borrower, would be in addition to the \$10,000 actually due each year under the terms of the loan.

130 CONG. REC. H6648 (1984).

76 *Id.*

77 *Id.*

78 I.R.C. § 7872(c)(2) and (3) (\$10,000 *de minimis* exception), (d) (\$100,000 gift loan exception), and (g)(1)(C) (1984) (IRS-sanctioned exceptions by regulations).

79 *Id.* at § (c)(2) and (3).

80 *Id.* at § (c)(2)(A) and (B).

81 *Id.* at § (c)(3)(A) and (B).

82 130 CONG. REC. H6647 (1984). This aggregation rule is designed to prevent structuring a series of small loans between the same parties to come within the *de minimis* exception.

puting the \$10,000 limitation.⁸³ If section 7872 applies to a non-gift term loan on any day, then the de minimis exception does not prevent the imposition of income tax. Thus, section 7872 would apply to a non-gift term loan even if the outstanding balance fell below \$10,000.⁸⁴

The second exception deals with gift loans of \$100,000 or less. The imputed interest income under section 7872 is limited to the borrower's net investment income if the gift loan is between individuals and the outstanding balance for any day does not exceed \$100,000.⁸⁵ The borrower's net investment income is deemed to be zero and no interest income is imputed if the borrower's net investment income for the year does not exceed \$1,000.⁸⁶ Section 7872's definition of net investment income incorporates the definition provided in section 163(d). Additionally, net investment income includes any income recognized under the original discount provision of section 1272⁸⁷ as if that provision applied to all deferred payment obligations, including those exempted in section 1272. Thus, section 7872 specifies that those deferred payment obligations include U.S. savings bonds, market discount bonds, annuities, short-term obligations and other similar obligations.⁸⁸ All loans between the parties are counted toward the \$100,000 limitation.⁸⁹ In addition, if more than one gift loan is outstanding, the borrower's net investment income is allocated among the outstanding gift loans in proportion to the amounts that would be considered as retransferred by the borrower notwithstanding this exception.⁹⁰ This exception does not apply to loans made with the principal purpose of tax avoidance.⁹¹

The third exception under section 7872 gives the IRS authority

83 I.R.C. § 7872(f)(7) (1984) treats a husband and wife as one person.

84 *Id.* at § 7872(f)(10).

85 *Id.* at § (d)(1)(A).

86 *Id.* at § (d)(1)(E)(ii).

87 Tax Reform Act of 1984, Pub. L. No. 98-369, § 1272, 98 Stat. 494 (to be codified at I.R.C. § 1272 (1984)). Section 1272 is entitled: "Current Inclusion in Income of Original Issue Discount." Section 1272 requires the holder of an original issue discounted instrument to include the accrued portion of the discount in his gross income. Yet, § 1272 exempts certain instruments, such as United States savings bonds, short-term obligations, and other similar obligations.

However, I.R.C. § 7872 (1984) does not adopt the exemptions in § 1272. Hence, the accrued discount of such obligations and other such instruments covered by § 1272 must be included in investment income under § 7872.

88 I.R.C. § 7872(d)(1)(E)(i), (iii), and (iv) (1984).

89 See note 82 *supra*.

90 I.R.C. § 7872(d)(1)(C) (1984).

91 *Id.* at § (d)(1)(B).

to promulgate regulations exempting certain transactions if the below-market interest arrangement does not significantly affect the federal tax liability of either party.⁹² Unless one of these three exceptions is satisfied, a below-market loan gives rise to income tax consequences.⁹³

E. *Suggested Analysis: Income Taxation of Interest-Free Loans*

Five analyses of the taxation of interest-free loans have been proposed: (1) the IRS' "income/no deduction" analysis;⁹⁴ (2) the "no income/no deduction" analysis adopted by *Dean*;⁹⁵ (3) the "modified no income/no deduction" analysis suggested by legal scholars;⁹⁶ (4) the "income exemption" analysis of *Hardee*;⁹⁷ and (5) the "two-payment transaction" analysis first outlined in the dissent to *Martin v. Commissioner*⁹⁸ and now codified in section 7872 of the Tax Reform Act.⁹⁹ This section of the article critiques the first four analyses and argues that the fifth analysis provides the correct approach to the income taxation of interest-free loans.

1. "Income/No Deduction" Analysis

The "income/no deduction" analysis proposed by the IRS interprets and applies sections 61 and 163 literally to impose income tax on the recipient of an interest-free loan.¹⁰⁰ The IRS asserts that section 61 describes gross income broadly and that the courts should construe the term literally to effectuate Congress' intent to tax income comprehensively.¹⁰¹ As support, the IRS cites *Commissioner v.*

92 *Id.* at § (g)(1)(C). In addition, § 7872(g) provides that the IRS shall prescribe necessary and appropriate regulations to carry out the purposes of § 7872, including, but not limited to:

(A) regulations providing that where, by reason of varying rates of interest, conditional interest payments, waivers of interest, disposition of the lender's or borrower's interest in the loan, or other circumstances, the provisions of this section do not carry out the purposes of this section, adjustments to the provisions of this section will be made to the extent necessary to carry out the purposes of this section. . . .

93 I.R.C. § 7872 (1984).

94 *Hardee v. United States*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,659.

95 *Dean v. Commissioner*, 35 T.C. 1083 (1961).

96 *See, e.g., Sneed, Unlabeled Income and Section 483*, 1965 S. CAL. TAX INST. 643.

97 *Hardee v. United States*, 708 F.2d 661 (Fed. Cir. 1983).

98 649 F.2d 1133, 1134-45 (Goldberg, J., dissenting).

99 I.R.C. § 7872 (1984).

100 I.R.C. § 61(a) (1984) (gross income includes "all income from whatever source derived") and § 163(a) (1984) (a deduction is allowed for "all interest paid or accrued within the taxable year on indebtedness"); *Hardee*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,657-59; *cf.* cases cited at note 2 *supra*.

101 *Hardee*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,658.

*Glenshaw Glass*¹⁰² where the Supreme Court, discussing section 61's predecessor,¹⁰³ commented:

This court has frequently stated that this language [in section 22(a)] was used by Congress to exert in this field "the full measure of its taxing power." Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a literal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted.¹⁰⁴

In addition, the IRS' argument depends upon cases upholding income taxation for the rent-free use of corporate assets.¹⁰⁵ The IRS contends that interest-free loans similarly confer a financial benefit upon the recipient who therefore must include the value of that benefit in gross income.¹⁰⁶

Having established that the borrower realized income from the free use of the loan money, the IRS also contests the deductibility of interest that the borrower neither paid nor accrued.¹⁰⁷ On the deductibility issue, the IRS again reads section 163 literally and concludes that the interest-free loan recipient has neither paid nor accrued interest as required for a deduction.¹⁰⁸ Thus, under the IRS' interpretation, no interest deduction would be available to offset the borrower's realized income.

The IRS' position is inconsistent. In seeking to tax the economic benefit of an interest-free loan, the IRS argues that the "substance of the thing done and not the form it took"¹⁰⁹ should govern the loan's tax treatment. Yet, the IRS' denial of an interest deduction would exalt the form of the transaction over the substance.¹¹⁰ In essence, the IRS would apply the "substance over form" doctrine to the income aspects of interest-free loans, but would reject the doctrine's application to the interest deduction.¹¹¹

102 348 U.S. 426 (1955).

103 I.R.C. § 22(a) (1939) is the predecessor to I.R.C. § 61 (1984). The language of § 22(a) is similar to that of § 61(a).

104 *Glenshaw Glass*, 348 U.S. at 429-30.

105 See note 14 *supra*.

106 *Hardee*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,656-57.

107 *Id.* at ¶ 9459, at 84,657.

108 *Id.*; I.R.C. § 163(a) (1984) allows a deduction for "all interest paid or accrued within the taxable year on indebtedness."

109 Commissioner v. Ashland Oil & Ref. Co., 99 F.2d 588, 591 (6th Cir. 1938), *cert. denied*, 306 U.S. 661 (1939).

110 *Martin*, 648 F.2d at 1137 (Goldberg, J., dissenting).

111 *Id.*

In his dissenting opinion in *Martin v. Commissioner*,¹¹² Circuit Judge Goldberg observed that the IRS interprets the income and deduction provisions independently and literally to ignore the economic reality of an interest-free loan transaction. Judge Goldberg concluded not only that the IRS' position created a gross injustice but also that such an "illogical and unjust result is neither required by nor even permitted under a fair and proper application of the Internal Revenue Code."¹¹³

2. "No Income/No Deduction" Analysis

In *Dean v. Commissioner*,¹¹⁴ the Tax Court adopted the "no income/no deduction" analysis. The *Dean* doctrine established that the borrower of an interest-free loan does not realize a taxable gain because any economic benefit received would be offset by an interest deduction.¹¹⁵

Yet, the *Dean* doctrine has three basic flaws: (1) the underlying assumption of an available interest deduction; (2) the conclusion that the borrower need not include in gross income the economic benefit from the interest-free loan; and (3) the timing problems inherent in the inclusion and deduction provisions left unaddressed in *Dean*. These three weaknesses have been the basis of the attack on the *Dean* doctrine since it was announced.

First, both the concurring and dissenting opinions¹¹⁶ in *Dean* sharply criticized the majority's holding that a borrower does not realize any taxable gain from an interest-free loan. Underlying the majority's holding was the generalization that a borrower always would be allowed to take an interest deduction.¹¹⁷ This assumption ignores the Internal Revenue Code provisions specifically disallowing an interest deduction.¹¹⁸ Thus, the *Dean* majority's generalization

112 *Id.*

113 *Id.* The "income/no deduction" analysis was employed in *Hardee v. United States*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459 (1982), *rev'd*, 708 F.2d 661 (Fed. Cir. 1983). The lower court's holding in *Hardee* is wrong because it rests on faulty reasoning.

114 *Dean v. Commissioner*, 35 T.C. 1083 (1961).

115 *Id.* at 1090. For a more detailed description of the *Dean* doctrine, see notes 11-19 *supra* and accompanying text.

116 *Id.* at 1090 (Opper, J., concurring); *id.* at 1091 (Bruce, J., dissenting).

117 *Id.*

118 See I.R.C. § 265(a) (1984) (disallowance of interest paid for tax-exempt investments); I.R.C. § 63 (1984) (no interest deduction if taxpayer does not itemize his deductions); I.R.C. § 264 (1984) (life insurance premium debt interest disallowed); I.R.C. § 163(d)(1) (1984) (investment interest limitations); *Knetsch v. United States*, 364 U.S. 361, 362-70 (1960) (no interest deduction in sham transactions).

about the availability of an interest deduction creates a potential injustice.

Second, since a "wash-out" occurred, the Tax Court in *Dean* determined that the borrower need not include the alleged economic benefit in gross income.¹¹⁹ This determination creates both conceptual and practical problems. Focusing on the income aspects of interest-free loans, the theoretical rationale for including the value of rent-free use of corporate property in gross income¹²⁰ also applies to interest-free loans.¹²¹ Moreover, as a practical matter, the determination not to include the economic benefits from an interest-free loan may result in overstating or understating any deductions calculated using the adjusted gross income.¹²²

Finally, the "no income/no deduction" analysis disregards the timing method established in the inclusion¹²³ and deduction¹²⁴ provisions. Generally, with an interest-free loan, the tax year in which a taxpayer would include the economic benefits would not coincide with the tax year in which a taxpayer may be allowed an interest deduction for constructive interest paid.¹²⁵ But, the *Dean* doctrine violates these fundamental timing principles by assuming that the recipient could include the economic benefit in gross income and deduct the constructive interest in the same tax year.

3. "Modified No Income/No Deduction" Analysis

Attempting to correct the *Dean* doctrine's flaws, commentators

119 *Dean*, 35 T.C. at 1091 (Opper, J., concurring).

120 See note 14 *supra*.

121 See note 119 *supra*; see also text accompanying notes 14-19 *supra*. A borrower receives an economic benefit from an interest-free loan, similar to the economic benefit transferred by the rent-free use of property. Such a benefit could be included in gross income. However, the *Dean* doctrine does not place its focus on these similar income aspects, but instead focuses on the dissimilar deduction aspects. See text accompanying notes 16-18 *supra*.

122 See, e.g., I.R.C. §§ 63, 165, 170, 213 (1984). Section 63 defines "taxable income" as adjusted gross income increased and decreased by certain items. The deductions permitted under § 165 (casualty losses), § 170 (charitable contributions), and § 213 (medical expenses), vary according to the taxpayer's amount of adjusted gross income. For example, § 170 permits a deduction of certain charitable contributions up to 50% of adjusted gross income. If the taxpayer had an interest-free loan and had made charitable contributions in excess of the 50% limitation, the taxpayer's § 170 deduction would be understated because, if the economic benefits of the loans were included in income, the taxpayer's adjusted gross income would have been higher and the 50% limitation figure would have been larger. Thus, a larger charitable deduction would have been allowed.

123 I.R.C. §§ 451-458 (1984). These sections govern the timing of recognition of items of income.

124 I.R.C. §§ 461-466 (1984). These sections govern the timing of allowable deductions.

125 See notes 123-24 *supra*.

suggested the "modified no income/no deduction" analysis.¹²⁶ Proponents of this analysis reject the *Dean* doctrine's assumption of the availability of an interest deduction. Therefore, this modified analysis proposes that before asserting the *Dean* doctrine, the taxpayer must plead and prove that an interest deduction would have been available had he actually paid interest.¹²⁷ This modification of the *Dean* doctrine, however, eliminates only one of the doctrine's three flaws.¹²⁸ Accordingly, the "modified no income/no deduction" analysis does not correctly characterize the income tax consequences of interest-free loans.

4. "Income Exemption" Analysis

In *Hardee v. United States*,¹²⁹ the Court of Appeals for the Federal Circuit held that "the definition of taxable income does not encompass the benefit of such an interest-free loan in the first place"¹³⁰ and thus expanded the *Dean* doctrine. The court reasoned that the *Dean* doctrine did not depend on the availability of an interest deduction because an interest-free loan does not give rise to any taxable income.¹³¹

The *Hardee* court misinterpreted the *Dean* doctrine. The *Dean* doctrine did not suggest that all interest-free loans "result in no taxable gain to the borrower."¹³² The court of appeals in *Hardee* interpreted the *Dean* doctrine more expansively than did the Tax Court which announced the doctrine. The Tax Court required an interest deduction under section 163 before holding that the borrower of an interest-free loan has no taxable gain.¹³³ Logic suggests that courts applying the *Dean* doctrine should defer to the Tax Court's interpretation of its own doctrine. Moreover, the *Hardee* "income exemption" analysis conflicts with the well-established judicial interpretation of section 61 as a broad and sweeping inclusion provision.¹³⁴ Thus, the

126 See, e.g., Sneed, *supra* note 96, at 652-57.

127 *Id.*

128 See text accompanying notes 114-25 *supra*.

129 *Hardee v. United States*, 708 F.2d 661, 664-67 (Fed. Cir. 1983).

130 *Id.* at 665.

131 *Id.* at 664-65. The *Hardee* court believed that the "wash-out" theory announced in *Dean* was merely dicta in response to an IRS position, and not the basis of the Tax Court's holding in *Dean*.

132 *Dean v. Commissioner*, 35 T.C. 1083, 1090 (1961); *Hardee*, 708 F.2d at 670-71 (Kashiwa, J., dissenting).

133 *Dean*, 35 T.C. at 1090, 1090-92 (Opper, J., concurring, and Bruce, J., dissenting); *Greenspun v. Commissioner*, 72 T.C. 931, 947-50 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982).

134 *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955).

"income exemption" analysis does not represent the correct income tax treatment of interest-free loans.

5. "Two-Payment Transaction" Analysis

In his dissenting opinion in *Martin*,¹³⁵ Circuit Judge Goldberg outlined the "two-payment transaction" analysis¹³⁶ which has been codified in section 7872 of the Tax Reform Act.¹³⁷ This analysis equates the economic situation of an interest-free loan recipient to that of a taxpayer who used additional compensation or dividends from a corporation to pay interest on interest-bearing notes.¹³⁸ Judge Goldberg concluded that two taxpayers participating in economically identical transactions should incur similar tax liability.¹³⁹

Under this analysis, an interest-free loan recipient must include in gross income any economic benefit derived from the free use of the borrowed money.¹⁴⁰ However, the borrower may claim an interest deduction equivalent to the amount included in gross income, if a section 163 interest deduction would have been allowed had interest actually been paid.¹⁴¹ Thus, two taxpayers in identical economic situations would receive the same tax treatment.

This analysis applies the "substance over form" doctrine consistently to both the income and deduction aspects of interest-free loans.¹⁴² In addition, since an interest deduction is permitted only when and if the deduction would otherwise be allowable, the first and third flaws of the *Dean* doctrine are eliminated.¹⁴³ Moreover, including the economic benefits of an interest-free loan in gross income also avoids the *Dean* doctrine's second flaw.¹⁴⁴ Accordingly, un-

135 *Martin v. Commissioner*, 649 F.2d 1133, 1145 (5th Cir. 1981).

136 The term "two-payment transaction" analysis is used to describe the economic realities of an interest-free loan. Such a loan is similar to a situation in which the borrower first receives the payment of compensation or a dividend from the lender, and then makes an interest payment of a comparable amount to the lender.

137 I.R.C. § 7872 (1984).

138 *Martin*, 649 F.2d at 1137, 1137-38 n.12.

139 *Id.*

140 *Id.* at 1144 (Goldberg, J., dissenting); I.R.C. § 61(a) (1984). For the language of § 61(a), see note 100 *supra*.

141 649 F.2d at 1144-45 (Goldberg, J., dissenting); I.R.C. § 163(a) (1984). For the language of § 163(a), see note 100 *supra*.

142 See text accompanying notes 100-13 *supra* (noting that the "substance over form" doctrine is not consistently applied to the income and deduction aspects of interest-free loans under the "income/no deduction" analysis).

143 See text accompanying notes 116-18, 123-25 *supra*.

144 See text accompanying notes 119-22 *supra*.

like the four analyses previously discussed,¹⁴⁵ the "two-payment transaction" analysis effectively avoids all three of the *Dean* doctrine's faults.

Before section 7872 was enacted,¹⁴⁶ two objections had been raised to the implementation of the "two-payment transaction" analysis: (1) the lack of statutory authority for a deduction for interest neither paid nor accrued;¹⁴⁷ and (2) the proper valuation method for both the amount included in gross income and the interest deduction.¹⁴⁸ Section 7872 solves these two problems by creating a constructive interest payment¹⁴⁹ that is deductible under section 163 and by establishing a valuation method.¹⁵⁰ Yet, neither problem ever presented a major obstacle to applying the "two-payment transaction" analysis.

First, section 163, the controlling statute, allows a deduction for "all interest paid or accrued within the taxable year on indebtedness."¹⁵¹ Thus, section 163 does not literally permit an interest deduction for an interest-free loan. At first glance, this argument appears insurmountable; however, this objection ignores the "quality of rationality" doctrine.¹⁵² This statutory interpretation doctrine requires a court to apply the provisions of the tax code to achieve a "quality of rationality" in every case.¹⁵³ Therefore, constructively imputing income to the recipient of an interest-free loan and yet denying a constructive interest payment deduction would violate the "quality of rationality" doctrine.

Furthermore, allowing a deduction for constructive interest payments can be analogized to allocating a cost basis to property received as compensation.¹⁵⁴ Section 163 should be applied flexibly to

145 See text accompanying notes 100-34 *supra*.

146 I.R.C. § 7872 (1984). Section 7872 applies to below-market loans made or outstanding after June 6, 1984. See note 55 *supra*.

147 *Hardee v. United States*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,658.

148 *Martin*, 649 F.2d at 1134.

149 See text accompanying notes 64-69 *supra*.

150 *Id.*

151 I.R.C. § 163(a) (1984). Section 163 literally allows a deduction only for interest that is "paid or accrued." In the case of an interest-free loan, no interest has been "paid or accrued." Therefore, no statutory authority under § 163 exists to permit an interest deduction for interest-free loan transactions where interest has not been "paid or accrued." See *Hardee*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,658.

152 *Martin*, 649 F.2d at 1143 n.17 (Goldberg, J., dissenting). The dissenting opinion in *Martin* stated that "[i]t is a court's duty to bestow upon the [tax] code's provisions 'a quality of rationality'." *Id.*

153 *Id.*

154 See I.R.C. § 83 (1984) (gross income includes property transferred in connection with performance of services) and I.R.C. § 1012 (1984) (the basis of property is the cost of such

interest-free loans to achieve a rational result.¹⁵⁵ Accordingly, to achieve rationality in our tax law, a borrower receiving constructive income from an interest-free loan should be allowed a constructive interest deduction.

The second alleged problem with the two-payment transaction analysis was the valuation of the economic benefit derived from an interest-free loan.¹⁵⁶ The valuation problem centered upon determining "at what [interest] rate, and how, . . . the interest benefit allowed [should] be calculated, for purposes of both gross income and the counter-balancing deduction."¹⁵⁷ The main difficulty was not choosing the valuation method, but rather consistently applying the chosen method to ensure "national uniformity in the application of our tax laws."¹⁵⁸ Legislative action was the best option to achieve such uniformity in the tax system.¹⁵⁹

Recently, Congress took legislative action and codified the "two-payment transaction" analysis in section 7872.¹⁶⁰ Section 7872 provides that a transfer and a retransfer are deemed to occur in a below-market loan.¹⁶¹ By enacting section 7872, Congress has established the "two-payment transaction" analysis as the method for the income taxation of interest-free loans.

property), and the Treasury Regulations promulgated thereunder; *Greenspun v. Commissioner*, 72 T.C. 931, 951 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982) (interest-free loans as an exception to the general rule of deductibility); Keller, *The Tax Consequences of Interest-Free Loans From Corporations To Shareholders and From Employers to Employees*, 19 B.C.L. REV. 231, 241 (1978). Under § 83, when property is received by an employee as compensation, generally the excess of the fair market value of the property over the amount paid is includible in the gross income of the employee. Under § 1012, the basis of property is the cost of such property. Although the employee did not pay any monetary consideration for the property received, he still incurred a "cost" in that he had to recognize income equal to the fair market value of the property. The term "cost" does not literally apply to such a transaction. However, by slightly stretching its literal meaning, the "cost" of such property is considered to be the amount that the employee must recognize as income.

¹⁵⁵ See note 152 *supra*.

¹⁵⁶ *Martin*, 659 F.2d at 1134.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ The two options available to effectuate the replacement of the *Dean* doctrine were: (1) judicial interpretation; and (2) legislative enactment. The courts were reluctant, and rightfully so, to alter the *Dean* doctrine because the judicial system cannot provide the necessary national uniformity and certainty in the application of the tax laws. See text accompanying notes 20-32 *supra*. Accordingly, the best option available to effectuate the implementation of the "two-payment transaction" analysis was legislative enactment because it provides the necessary national uniformity in the tax system.

¹⁶⁰ I.R.C. § 7872 (1984).

¹⁶¹ *Id.*; see notes 53-93 *supra* and accompanying text.

II. Gift Tax Consequences

A. *Historical Perspective: The Crown Doctrine*

In *Crown v. Commissioner*,¹⁶² a partnership, over several years, made interest-free loans totaling eighteen million dollars to trusts established for the partners' children and other close relatives.¹⁶³ The IRS asserted that each partner of the partnership had made a taxable gift of the foregone interest on the outstanding loan balance for each tax year.¹⁶⁴ Accordingly, the IRS sent a notice of deficiency to each partner.¹⁶⁵ One of the partners, Lester Crown, filed suit attacking the alleged deficiency. The Tax Court held that Crown "is not subject to gift tax on his proportionate share of the partnership's outstanding loans because the making of non-interest-bearing loans under these circumstances is not a taxable event."¹⁶⁶

The IRS appealed the Tax Court's ruling and proposed three alternative theories to support its position. First, the IRS characterized the transaction at the time of the loan as an "unequal exchange" under section 2512(b)¹⁶⁷ of the lender's property—the loan money¹⁶⁸—for the borrower's promise to repay the money upon demand.¹⁶⁹ The IRS argued that such a promise to repay is less in "money's worth" than the money loaned¹⁷⁰ and that an "unequal exchange" within the scope of section 2512(b) therefore occurred.¹⁷¹ Second, the IRS contended that the loan constituted an outright gift of a property right: the right to use money for an indefinite period.¹⁷² Third, instead of contending that a gift occurred at the time of the loan, the IRS asserted that the lender made a continuous gift during the time that he refrained from demanding repayment of the

162 585 F.2d 234 (7th Cir. 1978).

163 *Id.* at 235. See *Crown v. Commissioner*, 67 T.C. 1060 (1977), for complete factual details. Although most of the money loaned in *Crown* was on open account (87%) and not evidenced by any notes payable, this factual distinction is not relevant to the interest-free loan analysis because the form of the transaction is outweighed by its interest-free substance.

164 *Id.* at 235.

165 *Id.*

166 *Crown*, 67 T.C. at 1060.

167 585 F.2d at 238; I.R.C. § 2512(b) (1984) (a gift occurs when property is transferred for less than adequate and full consideration).

168 H.R. REP. NO. 708, 72d Cong., 1st Sess. 28, 30 (1932) (1939-1 C.B. 457, 478 (1939)); S. REP. NO. 665, 72d Cong., 1st Sess. 39, 42 (1932) (1939-1 C.B. 496, 526 (1939)): "The word 'property' in the gift tax law includes money."

169 *Crown*, 585 F.2d at 238.

170 *Id.* Under the concept referred to as the "time-value of money," a promise to repay money in the future is considered as being less in value than the money loaned.

171 *Id.*

172 *Id.* at 239.

loan.¹⁷³

To support these three theories, the IRS focused primarily on sections 2512(b) and 2501¹⁷⁴ of the Internal Revenue Code. Section 2512(b), the "unequal exchange" provision, states that a gift will be deemed to have been made where any "property is transferred for less than adequate and full consideration in money or money's worth."¹⁷⁵ In addition, section 2501 provides for a gift tax on any "transfer of property by gift" during the taxable year.¹⁷⁶ Congress intended section 2501 to "cover and comprehend all transactions . . . whereby and to the extent . . . that property or a property right is donatively passed to or conferred upon another, regardless of the means or device employed in its accomplishment."¹⁷⁷ The sweeping purpose of section 2501 also indicates Congress' attempt to reach every transfer of property by gift.¹⁷⁸ Moreover, Congress adopted a very broad definition of "property": "[t]he terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense; the term 'property' reaching every species of right or interest protected by law and having an exchangeable value."¹⁷⁹ Accordingly, the IRS reasoned that an interest-free demand loan was a taxable transfer of property by gift.¹⁸⁰

Although sympathetic to the IRS' argument,¹⁸¹ the *Crown* court reasoned that the analysis underlying this position presented both theoretical and practical difficulties.¹⁸² First, the court pointed out the inconsistencies in the IRS' "unequal exchange" analysis. The court stated that the economic value of an interest-free demand loan at the time the loan was made is "both unknown and unknowable."¹⁸³ Because the IRS did not establish that this type of loan was

173 *Id.* at 239-40.

174 *Id.* at 237; I.R.C. §§ 2512(b) and 2501 (1984).

175 I.R.C. § 2512(b) (1984).

176 I.R.C. § 2501 (1984).

177 H.R. REP. NO. 708, 72d Cong., 1st Sess. 22 (1932) (1939-1 C.B. 457, 476 (1939)); S. REP. NO. 665, 72d Cong., 1st Sess. 39 (1932) (1939-1 C.B. 496, 524 (1939)).

178 *See, e.g.*, Commissioner v. Wemyss, 324 U.S. 303, 306 (1944); Robinette v. Helvering, 318 U.S. 184, 187 (1943); Smith v. Shaughnessy, 318 U.S. 176, 180 (1942). All these cases stand for the general proposition that one of the purposes of the gift tax is to reach every kind of transfer by gift, however conceptual or contingent, that is not an ordinary business transaction.

179 H.R. REP. NO. 708, *supra* note 177, at 27; S. REP. NO. 665, *supra* note 177, at 39.

180 *Crown*, 585 F.2d at 234-38; I.R.C. § 2501 (1984).

181 585 F.2d at 241. The court stated that judicial construction was not the proper avenue by which to fill the alleged significant loophole in the gift tax statute created by interest-free loans. The court felt that its hands were tied, and expressed its sympathy to the IRS.

182 *Id.* at 238.

183 *Id.*

uniformly traded at less than face value, the court refused to hold that an "unequal exchange" took place at the time of the loan.¹⁸⁴

In addition, the court found that the IRS' proposed method for determining the timing and amount of the taxable gift arising from the loan conflicted with the "unequal exchange" theory. The IRS would have assessed the amount of the gift by applying the market interest rate to the outstanding loan balance in any calendar quarter of the tax year, not at the time of the loan.¹⁸⁵ This valuation method could have caused a taxpayer with a continuously outstanding loan to pay more gift tax than if the money had been transferred outright.¹⁸⁶ For all of these reasons, the court concluded that the "unequal exchange" theory was not the proper approach.¹⁸⁷

After analyzing the IRS' second and third arguments, the court found no evidence that an interest-free loan borrower received a legally protectible interest with an ascertainable exchange value.¹⁸⁸ Therefore, the loan recipient's right to use the loan money indefinitely was not characterized as "property" or a "property right" within the meaning of section 2501.¹⁸⁹ The court noted that to hold otherwise would broaden the concept of "property" or "property right" beyond Congress' intended scope.¹⁹⁰ Moreover, to further fortify its conclusion, the court quoted the Tax Court:

"[O]ur income tax system does not recognize unrealized earnings or accumulations of wealth and no taxpayer is under any obligation to continuously invest his money for a profit. The opportunity cost of either letting one's money remain idle or suffering a loss from an unwise investment is not taxable merely because a profit *could have been made* from a wise investment."¹⁹¹

184 *Id.* at 238, 240. The Tax Court acknowledged that interest-free term loans are not the same as interest-free demand loans in that only the former gives rise to gift tax consequences under the "unequal exchange" theory of I.R.C. § 2512(b) (1984). *See Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966); *Blackburn v. Commissioner*, 20 T.C. 204 (1953).

185 585 F.2d at 238-39. In the Tax Court, the IRS proposed to value the gift by multiplying any outstanding balance in any calendar quarter by a market rate of interest. *See Crown v. Commissioner*, 67 T.C. 1060 (1977).

186 585 F.2d at 239. For example, if a parent gives \$100,000 to his child, the parent's gift tax liability is approximately \$23,800. However, if a parent loans his child \$100,000 interest-free for 20 years, the parent's gift tax liability would be approximately \$36,000 (\$100,000 x 10% of assumed imputed interest x 20 years x gift tax rate). Both cases ignore any effects of the unified credit of § 2505 and the annual exclusion of § 2503(b).

187 *Id.*

188 *Id.*

189 *Id.*; *see* text accompanying note 179 *supra*.

190 585 F.2d at 240.

191 *Id.* at 236 (quoting *Crown v. Commissioner*, 67 T.C. 1060, 1067 (1977)) (emphasis in original).

While mentioning other problems with the IRS' position,¹⁹² the *Crown* court in essence reasoned that imposing a gift tax on interest-free demand loans would tax what a taxpayer could have done with his money rather than what he actually did.¹⁹³ Therefore, the court refused to impose a gift tax on the lender of interest-free demand notes.¹⁹⁴

B. *Recent Analysis*: *Dickman v. Commissioner*

1. Court of Appeals Decision

In *Dickman v. Commissioner*,¹⁹⁵ the taxpayers made interest-free demand loans to their son and to a closely-held corporation that the taxpayers and the son owned.¹⁹⁶ As in *Crown*,¹⁹⁷ the IRS asserted that the lenders had made a taxable gift of the interest foregone on the outstanding loan balance during the tax year.¹⁹⁸ Accordingly, the taxpayers were sent statutory notices of gift tax deficiencies.¹⁹⁹ The Tax Court followed the *Crown* decision and held that the taxpayers did not incur gift tax liability on the loans.²⁰⁰ The IRS appealed, and the Court of Appeals for the Eleventh Circuit reversed the Tax Court's ruling.

Having analyzed the applicable sections of the Internal Revenue Code,²⁰¹ the *Dickman* appeals court determined that the lender of

192 *Id.* at 240-41. The court noted the following three problems. First, since no statute or regulation contained standards to determine a reasonable imputed interest rate, a court would have no guidelines to follow to establish the interest rate. Second, the IRS' position could include transactions that the court felt should not be subject to the gift tax statute (i.e., borrowing your neighbor's lawnmower, or lending a child tuition fees). Finally, the court stated that equitable considerations supported its decision. The IRS had only recently asserted that the gift tax statute applied to interest-free loans. Moreover, the IRS did not appeal or immediately nonacquiesce in the unfavorable decision of *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966), the only case on all fours with *Crown*.

193 *Id.* at 240.

194 585 F.2d at 241.

195 690 F.2d 812 (11th Cir. 1982).

196 *Id.* at 813-14 n.2.

197 *Crown v. Commissioner*, 585 F.2d 234 (7th Cir. 1978); see 1978-2 C.B. 3 (1978) (IRS' "nonacquiescence" in the *Crown* decision).

198 *Dickman*, 690 F.2d at 814.

199 *Id.*

200 *Id.* at 813.

201 *Id.* at 814-16; I.R.C. § 2501(a)(1) (1984) (a tax is imposed on the transfer of property by gift); I.R.C. § 2511(a) (1984) (gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether property is real or personal, tangible or intangible) and I.R.C. § 2512(a)(b) (1984) (the value of the property at the date of the gift is the amount of the gift; and if property is transferred for less than full and adequate consideration, the excess of the property value over the consideration paid is deemed a gift).

an interest-free demand loan essentially gives the borrower a right to use property—money—indefinitely.²⁰² Courts previously have held that this right itself constitutes “property” and may be the subject of a taxable gift.²⁰³ The *Dickman* appeals court acknowledged that in the case before it, the lenders had retained dominion and control of the property, but observed that this fact alone did not prevent a taxable gift.²⁰⁴ The court cited Treasury Regulation 25.2511-2(f)²⁰⁵:

[I]n the case of a transfer of property which is an incomplete gift because the donor retains dominion and control, the “receipt of income or other enjoyment of the transferred property by the transferee” during the period before the gift is complete “constitutes a gift of such income or other such enjoyment taxable as of the calendar quarter . . . of its receipt.”²⁰⁶

In conclusion, the court of appeals held that a lender incurs gift tax liability for the value of the borrower’s beneficial use of the money loaned when he makes a gratuitous interest-free loan.²⁰⁷

2. Supreme Court Decision

In a 7-2 decision,²⁰⁸ the Supreme Court affirmed the appellate court ruling and held that “interest-free demand loans . . . resulted in taxable gifts of the reasonable value of the use of the money lent.”²⁰⁹ After reviewing the language and the legislative histories of sections 2501(a)(1) and 2511(a), the Court determined that “[t]he language of these statutes is clear and admits of but one reasonable interpretation: transfers of property by gift, by whatever means effected, are subject to the federal gift tax.”²¹⁰ The Court also reasoned that “Congress intended the gift tax statute to reach all

202 690 F.2d at 814-16; see note 168 *supra*.

203 690 F.2d at 815; see *Abbott v. United States*, 74-2 U.S. Tax Cas. (CCH) ¶ 13,040 (S.D. Miss. 1974) (gift tax valuation for the right to use property during the life of another); *Thriftmart, Inc. v. Commissioner*, 59 T.C. 598, 615-16 (1963) (charitable deduction and lease terminable by owner upon sale of premises); *Passailaigue v. United States*, 224 F. Supp. 682, 686 (M.D. Ga. 1963) (charitable deduction for right to use real estate for such time as the owner permits); *Sullivan v. Commissioner*, 16 T.C. 228, 231 (1951) (charitable deduction for right to use property for duration of war); Rev. Rul. 63-61, 1973-1 C.B. 408 (1973) (right to use property for an indefinite period, terminable at will by the owner, is property).

204 690 F.2d at 815.

205 *Id.* at 815-16; Treas. Reg. 25.2511-2(f) (1981).

206 690 F.2d at 815-16.

207 *Id.* at 819-20. The court rested its decision not only on Treas. Reg. 25.2511-2(f), but also on the gift tax statute, the statute’s legislative history, judicial interpretation, and the policy considerations underlying the statute.

208 *Dickman v. Commissioner*, 104 S. Ct. 1086, *reh’g denied*, 104 S. Ct. 1932 (1984).

209 *Id.* at 1094-95.

210 *Id.* at 1089.

gratuitous transfers of any valuable interest in property.”²¹¹

Next, the Court analyzed the interest-free loan transaction to determine whether the gratuitous transfer of the right to use money was a “transfer of property” under section 2501(a)(1). The legislative history of the gift tax statute was said to reflect Congress’ intention that section 2501(a) “encompass all transfers of property and property *rights* having significant value.”²¹² The Court noted that it previously had stated that the gift tax statute was sufficiently broad to reach every transfer of “property, however conceptual or contingent.”²¹³

Moreover, the Court analogized a tenancy at will as an interest in real property to the use of money as an interest in personal property.²¹⁴ The recipient of either property right does not acquire the legal title to the underlying property. Instead the transferee receives only the beneficial title: the right to use and control the underlying property to the exclusion of all others, subject only to the interest retained by the legal owner.²¹⁵ Since the right to use the underlying property is the most essential element of property,²¹⁶ the Court thus had “little difficulty accepting the theory that the use of valuable property—in this case money—is itself a legally protectible property interest.”²¹⁷

Attempting to strengthen its rationale, the Court observed that its holding protected the income and estate tax systems and thereby achieved one of the major purposes of the gift tax.²¹⁸ In addition, the Court refuted each of the taxpayer’s major arguments against imposition of the gift tax.²¹⁹

211 *Id.*

212 *Id.* at 1089-90 (emphasis in original).

213 *Id.* at 1090 (quoting *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943)); *see also* *Robinet v. Helvering*, 318 U.S. 184, 187 (1943). Both cases stated that the gift tax statute should be interpreted broadly to carry out the clear and obvious intent of Congress.

214 *Id.* at 1090-91.

215 *Id.* at 1091.

216 *Id.* The *Dickman* Court quoted the definition of “property” in *Passailaigue v. United States*, 224 F. Supp. 682, 686 (M.D. Ga. 1963): “Property is composed of constituent elements and of these elements the right to *use* the physical thing to the exclusion of others is the most essential and beneficial” (emphasis in original).

217 *Id.* at 1090. The Court noted that the demand status of the loan may reduce, but will not eliminate, the value of the transferred benefit in that a demand loan has little exchangeable value that a transferee of the borrower would pay the borrower for. *Id.* at 1091.

218 *Id.* at 1091-92. The imposition of gift tax on interest-free loan transactions minimizes the use of such loans to shift income from high tax bracket taxpayers to low tax bracket ones and thus protects the income tax. In addition, it prevents the diminution of the transferor’s estate so as to avoid estate tax.

219 *Id.* at 1092-94. The taxpayer made three arguments against imposition of the gift tax.

The two dissenting Justices believed that the majority's holding was "ill-advised and inequitable."²²⁰ According to the dissent, the Court should not have overruled the long-standing rule for gift taxation of interest-free loans. Instead, it should have deferred to Congress, the forum best able to resolve such complex and far-reaching policy issues as the gift taxation of interest-free loans.²²¹

Although the Court held that interest-free demand loans are subject to gift tax, it did not determine the method of timing and of valuation of such gifts.²²² The Court stated that the IRS "need not establish that the funds loaned did in fact produce a particular amount of revenue; it is sufficient for the Commissioner to establish that a certain yield could readily be secured and that the reasonable value of the use of the funds can be reliably ascertained."²²³

Relying on this language, the IRS issued a news release²²⁴ that established the valuation formula for a gift created by an interest-free demand loan made before January 1, 1984.²²⁵ In the news release,

First, the taxpayer asserted that to impose gift tax on interest-free loans essentially imposed a tax on unrealized earnings. The lender had no duty to invest the loan proceeds for profit; however, if the lender did not invest the proceeds the IRS would impose a gift tax on the lender. Second, the taxpayer contended that the IRS would have potentially broad discretion to impose a gift tax on de minimis loan transactions. Finally, the taxpayers urged that to impose a gift tax in this situation would contradict the IRS' former practice and prevent taxpayers from relying on prior case law even though the IRS did not challenge the unfavorable law.

As to the taxpayers' first argument, the Court stated that it would impose gift tax on the transfer and not on what the borrower may do with the loan proceeds after the gift occurred. *Id.* at 1092. Concerning the second argument, the Court assumed that the IRS would exercise its discretion reasonably and not focus on traditional familial or de minimis matters. *Id.* at 1093. Finally, the Court rejected the taxpayers' detrimental reliance argument because it is well established that the IRS can change its prior interpretation of the law, even retroactively. *Id.* at 1093-94; see *Dixon v. United States*, 381 U.S. 68, 72-75 (1965); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 183-84 (1957) (both establishing that the IRS can change its interpretation of the tax law and apply its ruling retroactively).

220 104 S. Ct. at 1099 (Powell and Rehnquist, J.J., dissenting). The dissenting Justices believed that the majority was wrong to reject a longstanding principle of tax law and to create a new and anomalous rule of tax law.

221 *Id.* at 1097-99 (Powell and Rehnquist, J.J., dissenting); see I.R.C. § 7872 (1984) (Treatment of Loans with Below-Market Interest Rates) and text accompanying notes 227-38 *infra*.

222 *Id.* at 1095 n.14. The Court did not determine the method of timing and valuation of interest-free gift loans because these questions were not addressed in the record. The court of appeals had declined to address the question and had remanded to the Tax Court for consideration.

223 *Id.*

224 1984-15 I.R.B. 19 (5-11-84).

225 In this news release, the IRS announced that the donors of gifts created by interest-free demand loans made before January 1, 1984, must compute the value of the gifts by multiplying the average outstanding loan balance for that calendar quarter by the lesser of either the statutory interest rate for refunds and deficiencies or the annual average rate for three-month

the IRS not only established the valuation method for pre-1984 gifts in interest-free demand loan transactions, but it also announced several administrative exemptions from gift tax.²²⁶ Although the news release does not apply to interest-free demand loan gifts occurring on or after January 1, 1984, the rules probably will be extended to cover the period from January 1, 1984 to the effective date of section 7872.²²⁷

Treasury bills. *Id.* For pre-1984 gifts, the applicable interest rates for years as far back as 1960 are as follows:

1983— 8.6%	1971—4.3%
1982—10.6%	1970—6.0%
1981—12.0%	1969—6.0%
1980—11.5%	1968—5.3%
1979— 6.0%	1967—4.3%
1978— 6.1%	1966—4.8%
1977— 5.2%	1965—3.9%
1976— 4.9%	1964—3.5%
1975— 5.8%	1963—3.1%
1974— 6.0%	1962—2.7%
1973— 6.0%	1961—2.3%
1972— 4.0%	1960—2.9%

The applicable interest rates for all years before 1960 are the annual average rates for three-month Treasury bills in that the above-described statutory interest rates are greater than such Treasury bill rates. *Id.*

226 *Id.* No gift tax return must be filed either if the average annual outstanding interest-free demand loan balance did not exceed \$50,000 per year for each donee (\$100,000 if made by married couples), or if the amount of the gift calculated pursuant to the news release was less than the annual exclusion under I.R.C. § 2503(b) (1984) for the year in question. The present interest exclusion under § 2503(b) was \$3,000 from the years 1971 through 1981, and \$10,000 thereafter.

Examples: (1) During 1983, a married couple could have interest-free demand loans outstanding in the amount of \$232,558 per donee and be exempt from the gift tax filing requirements. This result is reached because the amount of the gift calculated pursuant to the news release does not exceed the \$10,000 annual exclusion under I.R.C. § 2503(b) (1984) when the split-gift election of I.R.C. § 2513 (1984) is timely made. ($\$232,558 / 2 \times 8.6\% = \$9,999.999$).

(2) During 1978, a married couple could have such loans outstanding in the amount of \$98,360 per donee and avoid the reporting requirement under the news release. ($\$98,360 / 2 \times 6.1\% = \$2,999.98$). The annual exclusion under I.R.C. § 2503(b) (1984) of \$3,000 was not exceeded along with the loan balance being less than \$100,000. Thus, no gift tax return need be filed.

In addition, if the only reason a married couple would file a gift tax return for pre-1984 gifts related to an interest-free demand loan is to elect the split-gift provision of I.R.C. § 2513 (1984), then no gift tax return must be filed for such gifts. Moreover, pre-1984 interest-free demand loan gifts that are not in excess of the above administrative reporting exceptions are disregarded for purposes of calculating the estate tax and gift tax even though the donor made other gifts to the same donee during the same tax year.

227 The IRS plans to publish a revenue ruling to incorporate the language contained in 1984-15 I.R.B. 19 (5-11-84) and a table for valuing interest-free demand loans outstanding before 1960.

C. *Tax Reform Act of 1984: Caveat Creditor*

Under section 7872, below-market gift loans incur gift tax, unless specifically exempted.²²⁸ Thus, section 7872 essentially codifies the *Dickman* decision and imposes gift tax consequences on below-market loans.²²⁹ The type of loan involved determines the amount subject to gift taxation.²³⁰

The lender of a below-market gift demand loan is deemed to have made a gift on the last day of the calendar year to the borrower of any interest foregone during the year.²³¹ The amount of foregone interest treated as a gift equals the amount of imputed interest recognized by the lender as income under the income tax provisions of section 7872 previously discussed.²³²

With a below-market gift term loan, the lender is deemed to have given the borrower the excess of the amount loaned over the present value of all payments required under the loan agreement.²³³ The gift occurs on the date the loan is made.²³⁴ The amount of the gift equals the amount that the lender recognizes as original issue discount under the income tax rules of section 7872 previously discussed.²³⁵

Interest-free loans are subject to gift taxation unless either the \$10,000 de minimis exception²³⁶ or the "IRS regulations" excep-

228 I.R.C. §§ 7872(a) and (b) (establishing gift tax liability); and (c)(2) and (g)(1)(c) (1984) (exempting certain transactions). Section 7872 establishes a transfer of property which may be a gift subject to tax under § 2501.

229 *Dickman v. Commissioner*, 104 S. Ct. 1086, *reh'g denied*, 104 S. Ct. 1932 (1984), established gift tax liability for interest-free demand loans only.

230 I.R.C. §§ 7872(a) (demand loans: *see* text accompanying notes 230-31 *infra*), (b), and (d)(2) (1984) (term loans: *see* text accompanying notes 232-33 *infra*).

231 *Id.* at §§ (a)(1) and (2). For example, a single parent loans his child \$250,000 on a demand basis at a rate of five per cent per annum. Donative intent is assumed. For 1984, the parent must report a gift subject to the gift tax statute if the gift exceeds the annual exclusion under I.R.C. § 2503(b) (1984). Here, the gift is approximately \$6,284, which is not in excess of such annual exclusion. Thus, no gift tax is imposed. In addition, the parents must recognize imputed interest income of the same \$6,284, as well as the actual interest received from the child. The child may be entitled to an interest deduction for the imputed and actual interest paid to the extent allowable. This example illustrates that § 7872 integrates the income and gift tax consequences arising from any below-market gift loan. *See* example at note 67 *supra* explaining the income tax consequences.

232 *Id.*; *see also* text accompanying notes 60-69 *supra*.

233 I.R.C. § 7872(b)(1)(A) and (B) (1984).

234 *Id.* at § (b)(1). If § 7872 does not apply when the loan is made, then the gift is deemed to occur on the first day that § 7872 does apply.

235 *Id.* at §§ (b)(1) and (2); *see also* text accompanying notes 70-74 *supra*.

236 I.R.C. § 7872(c)(2) (1984). For a discussion of the \$10,000 de minimis exception, *see* text accompanying notes 79-84 *supra*.

tion²³⁷ applies. Section 7872 does not apply to a gift loan between individuals with a total outstanding loan balance less than \$10,000, unless the loan proceeds are used directly to purchase or carry income-producing assets.²³⁸ In addition, the IRS can enact regulations that exempt certain transactions from section 7872 if the transactions do not significantly affect the tax liability of either the lender or the borrower.²³⁹

D. *Suggested Analysis: Gift Taxation of Interest-Free Loans*

Although the factual situations differed, both *Dickman*²⁴⁰ and *Crown*²⁴¹ addressed the basic issue of whether taxable gifts resulted from interest-free demand loans to the lender's relatives.²⁴² The *Crown* court held that no taxable gift resulted from the transaction at issue.²⁴³ The *Dickman* Court, however, rejected both the reasoning and result of *Crown* and held that there was a taxable gift.²⁴⁴ An analysis of the major arguments supporting the imposition of the gift tax to interest-free loan transactions reveals that the application of the "continuous gift" theory,²⁴⁵ now codified in section 7872, produces the proper result.

In its effort to apply the gift tax statute to interest-free demand loans, the IRS advanced three theories: (1) the "unequal exchange" theory;²⁴⁶ (2) the "outright gift of a property right" theory;²⁴⁷ and (3) the "continuous gift" theory.²⁴⁸ None of these theories conforms to a literal construction of the gift tax statute.²⁴⁹ Under a broader statutory interpretation, however, the application of the gift tax statute to interest-free demand loans under the "continuous gift" theory would be consistent with the IRS' proposal for timing and valuing gifts.²⁵⁰

237 I.R.C. § 7872(g)(1)(C) (1984). For a discussion of the "IRS regulations" exception, see text accompanying note 92 *supra*.

238 I.R.C. § (c)(2)(A) and (B) (1984).

239 *Id.* at § (g)(1)(C).

240 *Dickman v. Commissioner*, 690 F.2d 812, 813-14 (11th Cir. 1982), *aff'd*, 104 S. Ct. 1086, *reh'g denied*, 104 S. Ct. 1932 (1984).

241 *Crown v. Commissioner*, 585 F.2d 234, 235 (7th Cir. 1978).

242 *Id.* at 234-35; *Dickman*, 690 F.2d at 813.

243 *Crown*, 585 F.2d at 241.

244 *Dickman*, 690 F.2d at 818-20.

245 See notes 261-82 *infra* and accompanying text.

246 *Crown*, 585 F.2d at 238.

247 *Id.* at 239.

248 *Id.* at 239-40.

249 *Id.* at 238-40. See text accompanying notes 251-90 *infra* for an explanation of why these theories are not appropriate if the gift tax statute is interpreted literally and technically.

250 See text accompanying notes 262-93 *infra*.

1. "Unequal Exchange" Theory of Section 2512(b)

Although the "unequal exchange" theory has been applied to below-market term loans,²⁵¹ this theory is not appropriate for interest-free demand loans.²⁵² The IRS' application of this theory to interest-free demand loans²⁵³ was theoretically creative, but not persuasive. The "unequal exchange" theory focuses on the borrower's promise of repayment made at the time of the loan. The IRS considered a promise to repay less in "money's worth" than the money loaned²⁵⁴ and therefore argued that the loan transaction constituted an unequal exchange.

In *Crown*, the court correctly rejected this theory as impractical because at the time of the loan the value of the promise to repay cannot be ascertained. Thus, when the loan is made the transfer of any economic benefits is incomplete and cannot be subject to gift tax.²⁵⁵ Moreover, the "unequal exchange" theory conflicts with the IRS' method for timing and valuation of the gift arising from the loan.²⁵⁶

2. "Outright Gift of Property Right" Theory

The IRS alternatively has characterized the interest-free loan as an outright gift at the time of the loan. The IRS has argued that the borrower's right to use the lender's money indefinitely constitutes a "property right" under the gift tax statute.²⁵⁷ The technical and literal meaning of the terms "property" and "property rights" includes rights or interests "protected by law and having an exchangeable value."²⁵⁸

The *Dickman* Court held that the transfer of the right to use money has an exchangeable value, is a legally protected interest, and

251 See *Blackburn v. Commissioner*, 20 T.C. 204 (1953); *Berkman v. Commissioner*, 387 TAX CT. MEM. DEC. (CCH) 183 (1979). Both cases held that the difference between the fair market value of the property conveyed or money loaned and the fair market value of the note received in exchange constituted a gift.

252 *Crown*, 585 F.2d at 239; see text accompanying notes 181-87 *supra*.

253 Commissioner's Brief at 20-21, 36-37, *Dickman v. Commissioner*, 690 F.2d 812 (11th Cir. 1982).

254 *Id.*

255 *Id.*; *Crown*, 585 F.2d at 238.

256 *Id.* The "unequal exchange" theory measures the gift at the time the loan was made. However, the IRS proposed measuring the gift as occurring in subsequent periods as long as the loan is outstanding.

257 Commissioner's Brief at 17, 34, *Dickman v. Commissioner*, 690 F.2d 812 (11th Cir. 1982); see also *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960) (detached and disinterested generosity necessary for finding of a gift).

258 See text accompanying notes 179, 188-90 *supra*.

therefore constitutes "property" within the meaning of section 2501.²⁵⁹ But the Court did not hold that the transfer of the right to use money through an interest-free demand loan was an outright gift of "property" or of a "property right" subject to gift tax.²⁶⁰ As with the "unequal exchange" theory, the "outright gift of property right" theory measures the gift at the time of the loan; therefore this theory cannot be applied consistently with the IRS' methods of timing and valuation.²⁶¹

3. "Continuous Gift" Theory

The "continuous gift" theory of interest-free demand loans, now codified in section 7872, establishes that the gift continuously occurs during the period that the loan is outstanding.²⁶² The "continuous gift" theory provides the proper analysis for imposing a gift tax on interest-free demand loans. Since the amount of the gift depends on the period the loan remains outstanding,²⁶³ this theory is consistent with the timing and valuation methods originally proposed by the IRS²⁶⁴ and now codified in section 7872.²⁶⁵

Until *Dickman*, though, the courts were confronted with a conceptual problem: "[t]o characterize the mere use of property as a transfer of a property right implies a broader concept of what constitutes a property right under the gift tax laws than has heretofore been recognized."²⁶⁶ Moreover, the IRS, in a different context, had construed the terms "property" and "property right" technically. The IRS had previously concluded that the revocable transfer of the mere use of property is not a "legally enforceable conveyance" and does not constitute a gift of "property" or a "property right."²⁶⁷

Nevertheless, the IRS argued the "continuous gift" theory in

259 *Dickman v. Commissioner*, 104 S. Ct. 1086, 1090-91 (1984).

260 *Dickman*, 104 S. Ct. at 1090-91 and n.14.

261 *Crown*, 585 F.2d at 238.

262 *Id.* at 239-40.

263 See note 264 *infra*.

264 585 F.2d at 239-40; Solicitor General's Brief at 9, *Dickman*, 104 S. Ct. 1086 (1984). Under the "continuous gift" theory, the gift is measured by multiplying the outstanding balance of the loan at the end of each calendar quarter by a market rate of interest.

265 I.R.C. § 7872 (1984).

266 *Crown*, 585 F.2d at 240 (footnote omitted).

267 See text accompanying notes 168, 179, and 188-90 *supra* for an explanation of the term "property." Although the IRS was not ruling on a gift tax issue in I.T. 3918, 1948-2 C.B. 33 (1948) and Rev. Rul. 70-477, 1970-2 C.B. 62 (1970), the IRS asserted that a donation of the use of property that is revocable at the donor's will does not constitute a gift of "property" within the meaning of the charitable contribution provisions of I.R.C. § 170 (1984), as opposed to the gift tax statute.

Dickman, and the Supreme Court accepted the argument.²⁶⁸ The *Dickman* Court concluded that the transfer of the mere use of property was a "transfer of property" subject to the gift tax statute.²⁶⁹ In addition, in his concurring opinion in the *Dickman* appellate court decision, Circuit Judge Fay presented the most persuasive argument for the gift taxation of interest-free demand loans:

Taxpayers have given away no property, no interests and no rights but surely they have made a gift. . . . When one lets another use large sums of money for no charge, who would doubt that there has been conferred a valuable gift? The fact that the receipt given for the money is a demand note makes no difference

. . . . Feeling that courts should avoid "slavish" interpretation of the [Internal Revenue] Code and that the taxpayers in this instance are the ones relying on a "crabbed reading" of the words used by Congress, I join with Judge Hill [and hold that gratuitous interest-free loans do have gift tax consequences]. Any other result makes no sense.²⁷⁰

The "substance over form" and the "quality of rationality" doctrines implicitly underlie Judge Fay's reasoning.²⁷¹ By using an interest-free demand loan, a taxpayer attempts to avoid a gift tax on the transfer of an economic benefit.²⁷² Under the "substance over form" doctrine, the substance of the transaction determines the tax treatment.²⁷³ Applying the "substance over form" doctrine to an interest-free demand loan identifies the valuable economic benefit conferred upon the recipient.²⁷⁴

Normally, the transfer of a valuable economic benefit is subject to gift taxation.²⁷⁵ Nevertheless, until *Dickman* and the enactment of section 7872, taxpayers successfully applied the gift tax statute literally and thus avoided gift taxation.²⁷⁶ Before the enactment of sec-

268 See note 264 *supra*; see also *Dickman*, 104 S. Ct. 1086 (1984).

269 *Dickman*, 104 S. Ct. at 1090-91.

270 *Dickman v. Commissioner*, 690 F.2d 812, 820 (11th Cir. 1982) (Fay, J., concurring).

271 See text accompanying notes 109-13 ("substance over form" doctrine) and 152-55 ("quality of rationality" doctrine). Although the court did not explicitly mention these doctrines, the court's decision and its underlying rationale indicate that the court relied on the "substance over form" and "quality of rationality" doctrines.

272 See *Crown v. Commissioner*, 585 F.2d 234 (7th Cir. 1978); *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966).

273 See text accompanying notes 109-13 *supra*.

274 The borrower of an interest-free demand loan receives the opportunity to make money at no cost. See note 45 *supra*.

275 I.R.C. § 2501 (1984) (a tax is imposed on the transfer of property by gift).

276 See *Crown v. Commissioner*, 585 F.2d 234 (7th Cir. 1978); *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966).

tion 7872, even applying the "substance over form" doctrine would not alone have warranted gift taxation of interest-free demand loans.

Yet, the "quality of rationality" doctrine also would have demanded that the lender of a gratuitous interest-free demand loan pay gift tax. This doctrine would have prevented the IRS from imputing interest income to the lender while simultaneously denying a constructive interest deduction to the borrower of an interest-free loan.²⁷⁷ The "quality of rationality" doctrine is a double-edged sword that requires a court to interpret and apply gift tax provisions rationally.²⁷⁸ In *Dickman*, the Supreme Court held that interest-free loan transactions are "transfers of property" within the broad meaning of the gift tax statute.²⁷⁹ While claiming only "to effectuate Congress' intent," the Court actually expanded its interpretation of the gift tax statute to achieve a quality of rationality.²⁸⁰

Moreover, judicial interpretation and the legislative history of the gift tax statute support the *Dickman* decision. These sources indicate that "gift" is to be interpreted in the "broadest and most comprehensive sense" regardless of the means or device used to make the taxable gift.²⁸¹ This definition of "gift" supports the expansion of gift taxation to interest-free demand loans. In conclusion, even without the gift tax consequences recently created by section 7872, under an expanded concept of "property" or "property right," the gratuitous transfer of the right to use money interest-free indefinitely is a "transfer of property" under section 2501.²⁸²

Section 7872 subjects interest-free demand loans to gift taxation; however, the proper method of timing and valuation of these gifts must still be established. Under section 7872, the gift arising from an interest-free demand loan is deemed transferred as of the last day of the calendar year and is measured by totaling the daily foregone interest for the year.²⁸³ A Treasury Department regulation²⁸⁴ provides for recognition of a gift of beneficial enjoyment of transferred prop-

277 See text accompanying notes 152-55 *supra*.

278 *Dickman*, 104 S. Ct. at 1094-95.

279 *Id.* at 1094.

280 See text accompanying notes 152-55 *supra*.

281 *Crown*, 585 F.2d at 238; see text accompanying notes 174-80 *supra*.

282 See text accompanying notes 269-81 *supra*.

283 I.R.C. § 7872(a) (1984).

284 Treas. Reg. 25.2511-2(f) (1981) provides that in the case of a transfer of property that is an incomplete gift because the donor retains dominion and control, the receipt of income or other enjoyment of the transferred property during the period before the gift is complete "constitutes a gift of such income or of such other enjoyment taxable as of the calendar 'period' . . . of its receipt."

erty in the calendar quarter of its receipt. Section 7872, however, postpones recognition of the gift until the end of the year.²⁸⁵

Section 7872's gift valuation method creates theoretical and practical hurdles that are not present with the section's timing rule.²⁸⁶ Section 7872 provides that the gift will be valued at the federal short-term rate for interest-free demand loans.²⁸⁷ This statutory interest rate is a fair and favorable rate because most taxpayers would have a higher interest rate on an ordinary loan.²⁸⁸

Nevertheless, taxpayers would argue that this arbitrary rate of interest would not reflect the variations possible with interest-free loan transactions. For example, what happens if the recipient of an interest-free demand loan does not invest the money loaned? And what will be the tax consequences if such a loan is continuously outstanding for many years even if the recipient does invest the money loaned? In both situations, the valuation method under section 7872 would lead to an unjust result. In the first situation, the taxpayer would be taxed on what the recipient could or should have earned from the loan, and not what he actually earned.²⁸⁹ In the second situation, a taxpayer could pay more in gift taxes than he would have had he made an outright gift of the amount loaned.²⁹⁰

To ensure a just application of the tax laws, Congress must establish a valuation standard that will avoid these two potential injustices. The following proposal exemplifies such a uniform standard. For interest-free demand loans, the gift should be deemed to occur on each day with outstanding interest-free loans and should be measured as provided under section 7872. But, if the taxpayer proved that the assigned value of the benefit transferred exceeds the benefit's actual value, then only the gift's actual value should be taxed. Fur-

285 I.R.C. § 7872(a)(2) (1984).

286 See text accompanying notes 287-90 *infra*. Even though I.R.C. § 2503(b) (1984) allows an annual \$10,000 exclusion that eliminates the possibility of gift taxation of de minimis gifts, the method of valuation chosen must be fundamentally fair so that the donor is taxed only on the fair and reasonable value of the benefit transferred.

287 I.R.C. § 7872(f)(2)(B) (1984). The interest rates used in *Dickman* were the same as those established under I.R.C. § 6621 (1984), as made applicable by I.R.C. § 6601 (1984) to underpayments in tax. *Dickman*, 690 F.2d at 814 n.4. In *Crown*, however, the IRS proposed the use of an interest rate equal to the market rate of interest charged on similar loans. *Crown*, 585 F.2d at 235. The IRS has not asserted any specified interest rate consistently and has thus generated valuation problems of great magnitude. See *Dickman*, 104 S. Ct. at 1097-98 (Powell and Rehnquist, J.J., dissenting).

288 Commissioner's Brief at 21 n.18, *Dickman v. Commissioner*, 690 F.2d 812 (11th Cir. 1982).

289 *Crown*, 585 F.2d at 240.

290 *Id.* at 239. For examples, see note 186 *supra*.

thermore, if the taxpayer established that the gift taxes assessed exceed the tax he would have paid for an outright gift, then the gift tax due should be limited to the tax for an outright gift. Essentially, this proposal modifies section 7872's valuation method to avoid the two injustices potentially arising from a strict application of section 7872.

III. Conclusion

The courts and Congress have recognized that an interest-free demand loan is economically equivalent to a two-payment transaction involving an interest-bearing loan and an increase in dividend or compensation comparable to the interest payment. Under the *Dean* doctrine, the courts attempted to impose similar income tax consequences on these economically identical transactions. The application of the *Dean* doctrine, however, did not achieve its intended result. The "two-payment" transaction theory is the only method that properly imposes income tax on interest-free loans. This theory eliminates the *Dean* doctrine's flaws and provides comparable interest-free tax treatment to taxpayers participating in economically identical transactions, such as an interest-free loan and a two-payment transaction.

Under the *Dean* doctrine, interest-free demand loans outstanding prior to June 7, 1984, are not subject to income taxation.²⁹¹ In addition, such loans outstanding on June 6, 1984, and repaid before September 17, 1984, are exempt from income tax under section 7872.²⁹² However, all interest-free demand loans outstanding on June 6, 1984, and not repaid before September 17, 1984, are subject to the rules of section 7872 establishing income tax consequences.

Until recently, a gratuitous interest-free demand loan was not considered an event subject to gift taxation. Now, a gratuitous interest-free demand loan results in the imposition of gift tax under both

291 See cases cited at note 2 *supra*; see also *Hardee v. United States*, 708 F.2d 661 (Fed. Cir. 1983). Although the *Dean* doctrine is considered to be the controlling law, the IRS now has strong support to seek imposition of the income tax statute to taxpayers using interest-free loan transactions in the geographic locations covered by the six remaining circuits. The rationale of the Supreme Court underlying *Dickman* applies to all interest-free loan transactions. It is unlikely that the IRS would pursue such a course of action, but if the IRS did so, and a conflict among the circuits developed, the Court could alter *Dean* and apply its decision retroactively. Such a result would be as disastrous to taxpayers as the *Dickman* decision was.

292 On Aug. 28, 1984, the IRS explained in news release IR-84-95 that a loan is considered to be "repaid" within the meaning of § 7872 if the loan is repaid, forgiven, cancelled, or otherwise retired, or if the interest rate of the loan is changed in any way, before Sept. 17, 1984. This special exception does not alter the gift tax consequences under *Dickman* applicable to loans outstanding before the effective date of § 7872.

the *Dickman* decision and the Tax Reform Act.²⁹³ The *Dickman* holding applies to all gratuitous interest-free demand loans outstanding prior to June 7, 1984, or to such loans outstanding on June 6, 1984, that are repaid before September 17, 1984. The *Dickman* holding was codified in section 7872, which encompasses not only interest-free demand loans specifically covered in *Dickman*, but also all below-market loans, whether demand, term, gift, non-gift, or any combination of these. Now, under section 7872, a below-market or an interest-free loan will have significant income or gift tax consequences, or both, unless one of the enumerated statutory exceptions applies.

293 Although § 7872 may apply, § 2503(b) allows an individual to give up to \$10,000 annually to each donee before incurring any gift tax liability. In addition, a married couple may give each beneficiary up to \$20,000 annually before incurring any gift tax liability under the split-gift provision of § 2513. Moreover, even if the annual exclusion is exceeded, no gift tax liability will result until the § 2505 unified credit has been exhausted.