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Recent Developments Affecting The Income And Gift Tax Consequences Of Interest-Free Loans

RECENT DEVELOPMENTS AFFECTING THE INCOME AND GIFT TAX CONSEQUENCES OF INTEREST-FREE LOANS*

The sale of property brings tax consequences for both the seller[1] and the buyer.[2] When a seller sells property, the Internal Revenue Service (Service) imposes an income tax if the seller realizes a gain.[3] The Service determines the amount of gain by measuring the difference between the seller's basis[4] in the property and the consideration the seller receives for the property from the buyer.[5] If the seller realizes no gain, the Ser-

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* The decision of the United States Court of Appeals for the Federal Circuit in *Hardee v. United States* is the most recent development affecting the income tax consequences of interest-free loans. *See infra* note 151 (brief analysis of Federal Circuit's decision in *Hardee*).

[1] *See* I.R.C. § 61(a)(3)(West 1983) (seller's gross income includes gains derived from dealings in property).

[2] *See* I.R.C. § 1012 (West 1983) (with limited exception, buyer's basis in property is cost of property).

[3] *See* I.R.C. § 61(a)(3)(West 1983) (gross income includes gains derived from dealings in property). Under § 1001(a) of the Internal Revenue Code (Code), the gain from the transfer of property is the amount realized from the transfer less the adjusted basis. *Id.* § 1001(a). Section 1001(b) defines "amount realized" as the sum of any money plus the value of other property the taxpayer received from the transfer of the property. *Id.* § 1001(b). The basis of property is the cost of the property, and the adjusted basis is the cost of the property adjusted for certain additions and reductions. *See id.* § 1011 (adjusted basis for determining loss or gain); *id.* § 1016 (allowable adjustments to basis). If the taxpayer's adjusted basis in property exceeds the amount realized from the sale of the property, the taxpayer suffers a loss. *See id.* § 1001(a) (determination of loss). Under § 1001(c), the taxpayer is obligated to recognize the entire amount of gain or loss. *Id.* § 1001(c).

[4] *See supra* note 2 (basis in property is cost of property).

[5] *See* I.R.C. § 1001(b)(West 1983) (amount realized from the transfer of property is sum of any money realized plus fair market value of property received). The amount realized includes the amount of seller's obligations that the buyer assumes or cancels as part of the purchase price. *See* Evangelista v. Commissioner, 629 F.2d 1218, 1219-21 (7th Cir. 1980) (taxpayer realized gain on transfer of cars to trust for children when trust assumed and paid taxpayer's indebtedness on cars); Brodhead v. Commissioner, 48 T.C.M. (P-H) ¶ 79,113 at 488-92 (1979) (same); Stevenson Consol. Oil Co. v. Commissioner, 23 B.T.A. 610, 615 (1931) (amount seller realized included buyer's assumption of seller's indebtedness to third party). Compensation payment in the form of property of value in excess of basis results in taxable gain to the employer. *See* Riley v. Commissioner, 328 F.2d 428, 429 (5th Cir. 1964) (employer's gain was extent value of employee's services exceeded employer's adjusted basis in property); International Freighting Corp. v. Commissioner, 135 F.2d 310, 313 (2d Cir. 1943) (employer's gain was excess of fair market value of property at time of transfer over employer's basis in property). When a husband transfers property to his wife in settlement of his obligation to support her, the husband realizes a gain to the extent the value of the rights the wife releases exceed the husband's basis in the property. *See* United States v. Davis, 370 U.S. 65, 71-74 (1962) (transfer of stock to wife to satisfy property settlement was taxable event and resulted in realized gain to husband to extent fair market value of stock exceeded husband's basis); Wallace v. United States, 439 F.2d 757, 759 (8th Cir.) (same), *cert. denied*, 404 U.S. 831 (1971).

vice views the proceeds from the sale as a return of the seller's investment and imposes no income tax.[6] The consideration the buyer gave for the property is the buyer's basis in the property.[7] The buyer will use this basis to compute gain on subsequent sale of the property.[8]

When a seller gratuitously transfers property for less than the fair market value of the property,[9] the seller realizes a gain only if the amount the buyer pays for the property exceeds the seller's basis in the property.[10] To the extent the amount the seller receives for the property is less than the fair market value of the property, the seller has made a gift.[11] The Internal Revenue Code (Code) defines gift as any transfer of property from one person to another without adequate and full consideration in money or money's worth.[12] Under the Code, property includes every legally protected right or interest that has an exchangeable value.[13] The Service

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[6] *Cf.* Treas. Reg. § 1.1001-1(a)(1957) (computation of gain or loss realized on sale of property).

[7] *See* I.R.C. § 1012 (West 1983). With limited exception, § 1012 of the Code provides that a buyer's basis in property is the cost of the property. *Id.* The cost of the property is the amount paid in cash or other property. Treas. Reg. § 1.1012-1(a) (1957); *see* Consolidated Coke Co. v. Commissioner, 70 F.2d 446, 447-49 (3d Cir. 1934) (buyer's basis includes amount of seller's liabilities buyer assumed); Roberts v. Granquist, 4 A.F.T.R.2d (P-H) ¶ 59-5297 at 5972 (Or. 1959) (same); Oxford Paper Co. v. United States, 86 F. Supp. 366, 368 (S.D.N.Y. 1949) (same); *see also* Crane v. Commissioner, 331 U.S. 1, 11 (1947) (buyer's basis includes amount of mortgage subject to which buyer acquired property).

[8] *See* I.R.C. § 1001(a)(West 1983) (gain from sale of property is amount realized less adjusted basis); *supra* note 3 (computation of gain on sale of property).

[9] *See* Treas. Reg. § 1.170A-1(c)(2)(1972). Treasury Regulation § 1.170A-1(c)(2) defines "fair market value" as the price at which property would change hands between a willing buyer and a willing seller when neither is under any compulsion to sell and both have reasonable knowledge of relevant facts. *Id.*

[10] *See* I.R.C. § 1001(a)(West 1983) (gain from sale of property is amount realized from sale less adjusted basis); *supra* note 3 (adjusted basis).

[11] *See* I.R.C. § 2512 (West 1983); Treas. Reg. § 25.2512-8 (1958). The gift tax is not limited to transfers made without valuable consideration. *Id.* The gift tax also extends to sales of property for consideration to the extent the value of the property transferred exceeds the value of the consideration given. *Id.*; *see* J. George Spitz Trust v. Commissioner, 40 T.C.M. (P-H) ¶ 71,008 at 54-56 (1971) (sale of real estate for less than value was taxable gift); Casnet v. Commissioner, 9 B.T.A.M. (P-H) ¶ 40,189 at 241 (1940) (value of property conveyed from father to daughter had value in excess of consideration given and amount in excess was subject to gift tax). A sale of property in the ordinary course of business is considered made for adequate and full consideration. Treas. Reg. § 25.2512-8. A sale made in the ordinary course of business is a transaction which is bona fide, at arm's length, and free from donative intent. *Id.*; *see* Commissioner v. Wemyss, 324 U.S. 303, 306, 307 (1945) (transfer not made in ordinary course of business subject to gift tax when not made for adequate and full consideration); Small v. Commissioner, 38 T.C.M. (P-H) ¶ 69,211 at 1214 (1969) (transfer of property to children not transfer in ordinary course of business but transfer made for less than adequate and full consideration and thus taxable to extent value of property transferred was greater than consideration received). When the consideration given is not reducible to a value in money or money's worth, then the entire value of the property transferred constitutes the amount of the gift. Treas. Reg. § 25.2512-8.

[12] *See* I.R.C. § 2512(b)(West 1983) (definition of gift).

[13] H.R. REP. No. 708, 72d Cong., 1st Sess. 27-28, *reprinted in* 1939-1 C.B. (Part 2) 457, 476; S. REP. No. 665, 72 Cong., 1st Sess. 39, *reprinted in* 1939-1 C.B. (Part 2) 496, 524.

imposes on a donor a gift tax on any transfer of property by gift a donor makes during the taxable year.[14] The gift tax is not a tax on property, but a tax on the exercise of a donor's right during life to transfer property to others in the form of gifts.[15]

Ordinarily when a lender loans property to another, no gift tax consequences arise for the lender and no income tax consequences occur for the borrower.[16] The borrower assumes not only an obligation to repay the face amount of the loan, the borrower also pays the lender an interest fee for the use of the loan.[17] The Code treats interest payments as income to the lender[18] and, with few exceptions, allows the borrower to deduct the interest payment from gross income.[19] When the borrower assumes

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[14] *See* I.R.C. § 2501(a)(1)(West 1983). Section 2501(a)(1) of the Code imposes a tax on the transfer of property by gift. *Id.* The donor is liable for the tax imposed under § 2501. *Id.* § 2502(c). *But see* Ekman, *Liability of the Donee for Donor's Gift Tax, 14 INST. ON EST. PLAN.* ¶ 1000, ¶ 1002.1 (1980) (donee may be liable in some circumstances for donor's unpaid gift tax).

[15] Treas. Reg. § 25.0-1(b)(1958). The gift tax is a tax on the transfer of property by individuals and thus not applicable to transfers by corporations or persons other than individuals. *Id.*; *see also* H.R. REP. No. 708, *supra* note 13, at 27-28 (gift tax designed to cover all transactions in which a property right is donatively passed to another).

[16] *See* Fisher v. Commissioner, 30 B.T.A. 433, 439 (1934) (loans not income to recipient).

[17] *See* Deputy v. DuPont, 308 U.S. 488, 498 (1940) (defining interest as compensation for use or forbearance of money); *see also* Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 145 (1974) (*quoting* Deputy v. DuPont); United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965) (same); I.R.C. § 461(g)(1)(A)(West 1983) (interest defined as charge for use or forbearance of money).

[18] *See* I.R.C. § 61(a)(4)(West 1983) (gross income includes income received from interest payments).

[19] *See* I.R.C. § 163(a)(West 1983). Section 163(a) of the Code allows a taxpayer to deduct all interest paid or accrued during the taxable year on indebtedness. *Id.* Unlike many other deductions, the Code allows a taxpayer to deduct interest expenses the taxpayer paid or accrued whether the expenses served a business purpose or not. *See* Preston v. Commissioner, 132 F.2d 763, 766 (2d Cir. 1942) (interest paid on mortgage no less permissible deduction under Code § 163 than interest paid on loan for business purposes); Woodward v. United States, 106 F. Supp. 14, 21 (N.D. Iowa 1952) (indebtedness under Code § 163 not limited to debts incurred to produce income, but includes any actual indebtedness, even though incurred for taxpayer's personal reasons), *aff'd*, 208 F.2d 893 (8th Cir. 1953); McNutt-Boyce Co. v. Commissioner, 38 T.C. 462, 465 (1962) (under Code § 163 Congress intended to allow taxpayer to deduct all interest paid on indebtedness whether or not ordinary and necessary expense or incurred in carrying on of trade or business), *aff'd per curiam*, 324 F.2d 957 (5th Cir. 1963). To qualify for the interest deduction, the Code requires an indebtedness, that interest developed on the indebtedness, and that the taxpayer paid or accrued the interest expense during the taxable year. *See* Commissioner v. Philadelphia Transp. Co., 174 F.2d 255, 256 (3d Cir.) (requirements for interest expense deduction), *aff'd per curiam*, 338 U.S. 883 (1949); Baltimore & Ohio R.R. Co. v. Commissioner, 29 B.T.A. 368, 372 (1933) (same), *aff'd*, 78 F.2d 460 (4th Cir. 1935).

Deductions are not allowed for all interest expenses. Greenspun v. Commissioner, 72 T.C. 931, 948 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982); *see* I.R.C. § 163 (interest expense deduction). For example, the Code does not permit a taxpayer who does not use a loan for business purposes and does not itemize deductions to deduct interest payments on the loan. *See* I.R.C. § 63(b) (taxable income defined). Even taxpayers who itemize deductions may not deduct under the Code interest payments on indebtedness incurred to purchase

an obligation to repay the principal of the loan plus interest, no gift occurs because the face amount of the loan plus interest constitutes adequate consideration for the loan.[20]

When a lender loans money interest-free, the borrower assumes an obligation to repay the face amount of the loan but has no obligation to pay an interest expense.[21] Although the Service imputes no gross income to the lender,[22] the Service analogizes the interest-free use of money to the rent-free use of property and argues that to the extent the lender relieves the borrower of any duty to pay interset, the borrower realizes a taxable gain.[23] The Service uses this same property analogy in arguing that interest-free loans to a relative constitute gifts from the lender to the borrower and as such fall under the gift tax provisions of the Code.[24] The Tax Court has refused to accept the Service's property analogy and chooses instead to equate interest-free loans to interest-bearing loans.[25]

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investments paying tax exempt interest. *Greenspun*, 72 T.C. at 948; *see* I.R.C. § 265(2) (interest relating to tax exempt income). A taxpayer may not deduct under the Code interest paid or accrued on indebtedness incurred to secure single premium life insurance endowment, or annuity contracts. Goldman v. United States, 273 F. Supp. 137, 141 (W.D. Okla. 1967), *aff'd*, 403 F.2d 776 (10th Cir. 1968); *see* I.R.C. § 264 (interest relating to insurance contracts). The Code also disallows a deduction for certain interest expenses a noncorporate taxpayer paid or accured to carry investment property which produces little or no current income. Emmons v. Commissioner, 31 T.C. 26, 32 (1958), *aff'd sub nom.* Weller v. Commissioner, 270 F.2d 294 (3d Cir. 1959); *see* I.R.C. § 163(d)(1) (interest relating to investment indebtedness). In addition, a taxpayer may not take an interest expense deduction in certain sham transactions. *See, e.g.*, Knetsch v. United States, 364 U.S. 361, 362-70 (1960) (no interest expense deduction allowed taxpayer in transaction which created no actual indebtedness). *See generally* Martin v. Commissioner 649 F.2d 1133, 1140-41 (5th Cir. 1981) (Goldberg, J., dissenting) (nondeductible interest expenses).

[20] *Cf.* Treas. Reg. § 25.2512-8 (1958) (transfers for insufficient consideration).

[21] *Cf.* Deputy v. DuPont, 308 U.S. 488, 498 (1940) (defining interest as compensation for use or forbearance of money); I.R.C. § 461(g)(West 1983) (interest defined as charge for use or forbearance of money).

[22] *See* Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416, 447 (1960) (no accrual of interest to lender on interest-free loans), *acq.*, 1960-2 C.B. 4.

[23] *See, e.g.*, Commissioner v. Greenspun, 670 F.2d 123, 124 (9th Cir. 1982) (Service argues that interest-free use of corporate funds should occasion same income tax results as rent-free use of other corporate assets); Martin v. Commissioner, 649 F.2d 1133, 1133 (5th Cir. 1981) (same); Suttle v. Commissioner, 625 F.2d 1127, 1128 (4th Cir. 1980) (same); Dean v. Commissioner, 35 T.C. 1083, 1087 (1961) (same), *nonacq.*, 1973-2 C.B. 4.

[24] *See* Dickman v. Commissioner, 690 F.2d 812, 815 (11th Cir. 1982) (Service argued lender made gift to borrower of value of use of interest-free loan); Crown v. Commissioner, 585 F.2d 234, 235 (7th Cir. 1978) (same); Johnson v. United States, 254 F. Supp. 73, 76 (N.D. Tex. 1966) (same); I.R.C. §§ 2501-2524 (Code gift tax provisions).

[25] *See, e.g.*, Zager v. Commissioner, 72 T.C. 1009, 1011 (1979) (tax benefit of excluding from income use value of interest-free loan matches benefit attributable to interest deduction on interest-bearing loan), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Greenspun v. Commissioner, 72 T.C. 931, 947-48 (1979) (interest-free loan is in substance no different from a loan on which interest is charged), *aff'd*, 670 F.2d 123 (9th Cir. 1982); Dean v. Commissioner, 35 T.C. 1083, 1090 (1961) (borrowers of interest-free loans entitled to same tax treatment as borrowers of interest-bearing loans), *nonacq.*, 1973-2 C.B. 4.

The Tax Court takes the position that because interest-free loans are economically indistinguishable from interest-bearing loans, interest-free loans pose neither gift tax consequences for the lender[26] nor income tax consequences for the borrower.[27] Although failing in the Tax Court and in the Seventh Circuit, the Service recently has been successful in convincing the Eleventh Circuit of the gift tax consequences of interest-free loans to family members[28] and in convincing the Court of Claims that the interest-free use of corporate money constitutes a gain taxable to the borrower.[29]

The seminal case on the income tax consequences of interest-free loans is *Dean v. Commissioner*.[30] The taxpayers in *Dean* received interest-free loans from their wholly-owned corporation.[31] The Service asserted a deficiency in the amount of the economic benefit the taxpayers derived from their interest-free use of corporate funds.[32] The Service relied on several cases in which courts found the rent-free use of property to constitute gross income and argued that no difference existed between a taxpayer's use of property for less than adequate consideration and a taxpayer's use of money for less than the market rate of interest.[33] The Tax Court

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[26] *See* Dickman v. Commissioner, 41 T.C.M. (CCH) 620, 624 (1980) (Tax Court held interest-free loans not taxable as gifts), *rev'd*, 690 F.2d 812 (11th Cir. 1982); Crown v. Commissioner, 67 T.C. 1060, 1064-65 (1977) (same), *aff'd*, 585 F.2d 234 (7th Cir. 1978).

[27] *See, e.g.*, Parks v. Commissioner, 40 T.C.M. (CCH) 1228, 1230 (1980) (Tax Court held interest-free loans did not constitute taxable benefit to borrower), *aff'd*, 686 F.2d 408 (6th Cir. 1982); Martin v. Commissioner, 39 T.C.M. (CCH) 531, 535 (1979) (same), *aff'd*, 649 F.2d 1133 (5th Cir. 1981); Greenspun v. Commissioner, 72 T.C. 931, 945-50 (1979) (same), *aff'd*, 670 F.2d 123 (9th Cir. 1982); Suttle v. Commissioner, 37 T.C.M. (CCH) 1638, 1639 (1978) (same), *aff'd*, 625 F.2d 1127 (4th Cir. 1980); Dean v. Commissioner, 35 T.C. 1083, 1090 (1961), *nonacq.*, 1973-2 C.B. 4.

[28] *See* Dickman v. Commissioner, 690 F.2d 812, 813, 819-20 (11th Cir. 1982) (court held interest-free loans subject to gift tax).

[29] *See* Hardee v. Commissioner, 50 A.F.T.R.2d (P-H) ¶ 82-5079 at 5256 (Ct. Cl. 1982) (court held value of interest-free loan includible in taxpayer's income).

[30] 35 T.C. 1083 (1961), *nonacq.*, 1973-2 C.B. 4.

[31] 35 T.C. 1083. The taxpayers in *Dean* obtained interest-free loans in excess of $2 million from a corporation the taxpayers controlled. *Id.* at 1088.

[32] *Id.* at 1087. The Service argued that the taxpayers realized income to the extent of the economic benefit derived from the free use of borrowed funds. *Id.* According to the Service, the economic benefit was equal to the market rate of interest. *Id.*

[33] *Id.* at 1089-90. As support for the position that the interest-free use of corporate funds results in a taxable benefit, the Service in *Dean* relied primarily upon a series of cases holding that a stockholder's or officer's rent-free use of corporate property results in realization of income. *Id.*; *see* Dean v. Commissioner, 187 F.2d 1019, 1020 (3d Cir. 1951) (rent-free use of corporate house held to result in taxable income); Chandler v. Commissioner, 119 F.2d 623, 626-28 (3d Cir. 1941) (rent-free use of corporate house and farm held to result in taxable income); Rogers Dairy Co. v. Commissioner, 14 T.C. 66, 73-74 (1950) (personal use of corporate automobile held to result in taxable income); Reynard Corp. v. Commissioner, 30 B.T.A. 451, 453 (1934) (rent-free use of corporate house held to result in taxable income); Frueauff v. Commissioner, 30 B.T.A. 449, 451 (1934) (rent-free use of corporate apartment held to result in taxable income); *cf.* Silverman v. Commissioner, 253 F.2d 849, 853 (8th Cir. 1958) (payment of taxpayer's wife's trip to Europe by taxpayer's

distinguished *Dean* on the fact that if the taxpayers in *Dean* actually had paid interest, the taxpayers then could have deducted their interest payments from gross income.[34] The *Dean* majority reasoned that because an equivalent deduction from gross income would have balanced the inclusion in income of the benefit of the interest-free loan, no reason existed to include the benefit in the taxpayers' gross income.[35] Concurring[36] and dissenting[37] opinions disagreed with the *Dean* majority's conclusion that

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corporation resulted in taxable benefit to taxpayer); Greenspun v. Commissioner, 229 F.2d 947, 956 (8th Cir. 1956) (living expenses paid by taxpayer's corporation constituted taxable gain); Chester Distrib. Co. v. Commissioner, 184 F.2d 514, 515 (3d Cir. 1950) (entertainment expenses held to be nondeductible business expenses).

[34] 35 T.C. at 1090. The *Dean* court distinguished *Dean* from the cases the Service cited on the basis of the deductibility of the value of the benefit the taxpayers received. *Id.* According to the *Dean* court, the taxpayers in each of the cited cases received a benefit in circumstances that if the taxpayers had purchased the benefit, the taxpayers could not have deducted the expense. *Id.*; *see supra* note 33 (case authority for Service's position in *Dean*).

[35] 35 T.C. at 1090; *see* I.R.C. § 163 (West 1983) (interest expense deductible).

[36] *See* 35 T.C. at 1090-91 (Opper, J. concurring). Judge Opper characterized the majority's statement that an interest-free loan results in no taxable gain to the borrower as much too broad a generalization. *Id.* at 1091 (Opper, J. concurring); *see id.* at 1090 (*Dean* majority's statement). Although Judge Opper agreed with the ultimate holding of the *Dean* majority, Judge Opper disagreed with the majority's presumption of a deduction for interest payments on an interest-bearing loan. *See id.* at 1090-91 (Opper, J. concurring); *see id.* at 1090 (*Dean* majority's holding). To refute the rationale for the majority's opinion that the borrower of an interest-free loan should not recognize income because the borrower of an interest-bearing loan receives an interest expense deduction, Judge Opper cited § 265(2) of the Code. *See id.* at 1091 (Opper, J. concurring); *id.* at 1090 (rationale for *Dean* majority's holding); I.R.C. § 265(2)(West 1983). Section 265(2) of the Code denies a deduction for interest or indebtedness which the borrower incurs to purchase tax exempt securities. *See id.* According to Judge Opper, the recipient of an interest-free loan recognizes gross income which a corresponding interest deduction may or may not offset depending on the nature of the loan. 35 T.C. at 1091 (Opper, J. concurring). Judges Tietjens, Withey, and Drennen agreed with Judge Opper's concurrence. *See id.*

[37] *See* 35 T.C. at 1091-92 (Bruce, J. dissenting). Judge Bruce agreed with Judge Opper's concurrence to the *Dean* decision in which Judge Opper characterized the *Dean* majority's statement that an interest-free loan results in no taxable gain to the borrower as much too broad a generalization. *Id.* at 1091 (Bruce, J. dissenting); *see id.* (Opper, J. concurring); *id.* at 1090 (*Dean* majority's holding). Judge Bruce also characterized as too broad the majority's holding that had the taxpayers borrowed the funds in question on interest-bearing notes, the taxpayers could have deducted their interest payments under § 163 of the Code. *Id.* at 1092 (Bruce, J. dissenting); *see* I.R.C. § 163 (West 1983) (deduction allowed for interest expenses paid or accrued). Judge Bruce relied on § 265 of the Code to refute the majority's presumption that borrowers of interest-bearing loans may deduct interest expenses. 35 T.C. at 1092 (Bruce, J. dissenting); *see id.* at 1091 (Opper, J. concurring) (Judge Opper's reliance on § 265 to refute *Dean* majority's holding); I.R.C. § 265(2) (denial of deduction for interest on indebtedness which borrower incurs to purchase tax exempt securities). According to Judge Bruce, the taxpayers failed to prove that § 163 of the Code would have entitled them to an interest expense deduction had the taxpayers actually paid an interest expense. 35 T.C. at 1092 (Bruce, J. dissenting).

an interest-free loan results in no taxable gain to the borrower.[38] Despite the Service's nonacquiescence in the *Dean* decision,[39] the Tax Court has continued its offsetting deductibility rationale in holding that the interest-free use of money does not result in a taxable gain.[40]

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[38] 35 T.C. at 1090-92. In *Greenspun v. Commissioner*, the Tax Court re-examined its holding in *Dean*. *See* 72 T.C. 931, 945-50 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982). The taxpayer in *Greenspun* received a low interest-bearing loan from an unrelated party in return for certain services. *Id.* at 945. The Service in *Greenspun* argued that the bargain interest element of the loan was income to the taxpayer because no arm's length loan would have carried as low an interest rate. *Id.* at 941. Although the Tax Court found that the granting of the interest-free loan was in consideration for future services, the court relied on *Dean* in holding that the taxpayer realized no taxable income. *Id.* at 946. The *Greenspun* court reasoned that an interest-free loan is in reality no different from the making of a loan in which the lender charges the borrower a deductible interest expense. *Id.* at 948. Despite the Tax Court's use of the offsetting-deductibility rationale in both *Dean* and *Greenspun*, the *Greenspun* court held that the *Dean* court's finding of no taxable income to the borrower was not grounded on an imputed interest deduction but on the conclusion that an interest-free loan results in no taxable gain to the borrower. *Id.* at 946; *see id.* at 948 (*Greenspun* court's use of offsetting-deductibility rationale to deny taxation of interest-free loans); 35 T.C. at 1090 (*Dean* court's use of offsetting-deductibility rationale to deny taxation of interest-free loans). *But see* 72 T.C. at 946 (*Greenspun* court's holding that court's finding of no taxable income in *Dean* was not founded on an offsetting-deductibility rationale). The *Greenspun* court's explanation of the court's rationale in *Dean* is not entirely clear. *See* Comment, *Interest-Free Loans and the Tax Court: A New Look at an Old Problem*, 30 CATH. U. L. REV. 497, 504 n.36 (1981) (*Greenspun* court's explanation of *Dean* court's rationale less clear than *Dean* rationale).

Although affirming the court's decision in *Dean*, the *Greenspun* court did admit to some possible exceptions to the *Dean* court's holding that interest-free loans result in no taxable gain to the borrower. 72 T.C. at 947-49; *see* 35 T.C. at 1090 (*Dean* court's holding). According to *Greenspun*, exception to the *Dean* holding that interest-free loans result in no taxable gain to the borrower would apply to cases in which the equating of interest-bearing and noninterest-bearing loans would result in a wide discrepancy in tax treatment. 72 T.C. at 950. One exception to the *Dean* court's holding would apply to the taxpayer who invested the proceeds of an interest-free loan in tax exempt securities. *Id.* at 948-49; *see* I.R.C. § 265(2)(West 1983) (interest deduction denied for interest payments on loans used to secure tax exempt securities). The *Greenspun* court held, however, that such a situation did not confront the court and that until such time as the question did present itself, the issue of *Dean's* applicability to § 265(2) loans would remain open. 72 T.C. at 950.

In *Zager v. Commissioner*, the Tax Court reiterated the *Greenspun* court's § 265(2) exception to the *Dean* holding. 72 T.C. 1009, 1012 (1979), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981). The *Zager* court also noted that in reality little difference exists between interest-free use of corporate funds and a shareholder's rent-free use of corporate property. *Id.* at 1011. Despite the fact that the *Zager* court found that conceptually the gratuitous use of corporate funds and corporate property should result in the same tax treatment, the *Zager* court sustained its holding in *Dean*. *Id.* 1014. The *Zager* court relied in large part on the previous failure of the Service to assert the taxability of interest-free loans. *Id.* at 1013. The *Zager* court recommended that if the Service now wished to tax interest-free loans, authority for such action should come from the legislature rather than a judicial departure from the rule of stare decisis. *Id.* at 1014.

[39] *See* 1973-2 C.B. 4. (Service's nonacquiescence in *Dean* decision).

[40] *See supra* note 27 (Tax Court decisions following holding in *Dean*).

Although four of the circuit courts of appeals have followed the Tax Court's decision in *Dean*,[41] the Court of Claims in *Hardee v. United States*[42] recently departed from the *Dean* decision.[43] The taxpayer in *Hardee* obtained interest-free loans from a corporation of which he was president and majority shareholder.[44] The Service assessed a deficiency as measured by the interest the taxpayer would have paid in an arm's length transaction.[45] Analogizing the interest-free use of corporate money to the gratuitous use of corporate property, the Court of Claims agreed with the Service's position that the interest-free use of corporate money brings no less a taxable economic gain to the borrower than the rent-free use of corporate property.[46] The Court of Claims disagreed with the *Dean* court's off-setting deductibility rationale.[47] Citing statutory authority, the *Hardee* court reasoned that the Code provides a deduction only for interest the taxpayer paid or accrued during the taxable year.[48] Because the taxpayer in *Hardee* neither paid nor accrued an interest expense, the

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[41] *See* Parks v. Commissioner, 686 F.2d 408, 409 (6th Cir. 1982) (reliance on Tax Court's holding in *Dean*), *aff'g*, 40 T.C.M. (CCH) 1228 (1980); Commissioner v. Greenspun, 670 F.2d 123, 125 (9th Cir. 1982) (same), *aff'g*, 72 T.C. 931 (1979); Martin v. Commissioner, 649 F.2d 1133, 1134 (5th Cir. 1981) (same), *aff'g*, 39 T.C.M. (CCH) 531 (1979); Suttle v. Commissioner, 625 F.2d 1127, 1128 (4th Cir. 1980) (same), *aff'g*, 37 T.C.M. (CCH) 1638 (1978).

[42] 50 A.F.T.R.2d (P-H) ¶ 82-5079 (Ct. Cl. 1982), *reversed*, 708 F.2d 661 (Fed. Cir. 1983).

[43] *See id.* at 82-5254 (*Hardee* court departs from Tax Court's decision in *Dean*). *But see infra* note 151 (*Hardee* reversal).

[44] *Id.* at 82-5253.

[45] *Id.*

[46] *Id.* at 82-5254. The *Hardee* court cited statutory and case authority to support the court's departure from the *Dean* decision. *Id.*; *see* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955) (Court supports liberal construction of § 61 to include all gains as taxable income); I.R.C. § 61 (West 1982) (gross income includes gains or profits and income derived from any source whatever). According to the *Hardee* court, in-kind benefits represent taxable gain as much as cash benefits. 50 A.F.T.R.2d at 82-5254; *see* Commissioner v. Smith, 324 U.S. 177, 181 (1945) (taxable income includes any economic or financial benefit regardless of form or mode). The *Hardee* court relied on case authority to conclude that the economic benefit realized through the free use of corporate assets compels the recognition of income to the extent of the market value of that use. 50 A.F.T.R.2d at 82-5254; *see* Gardner v. Commissioner, 613 F.2d 160, 160 (6th Cir. 1980) (free use of company owned car held to result in taxable gain); Chandler v. Commissioner, 119 F.2d 623, 626-28 (3d Cir. 1941) (rent-free use of corporate residence held to result in taxable gain); Challenge Mfg. Co. v. Commissioner, 37 T.C. 650, 658-63 (1962) (rent-free use of company owned boat held to result in taxable gain); Frueauff v. Commissioner, 30 B.T.A. 449, 451 (1934) (rent-free use of corporate apartment held to result in taxable gain). The *Hardee* court also relied on cases holding that third party payment of taxpayer's debt results in taxable gain. 50 A.F.T.R.2d at 82-5255; *see* Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929) (corporation's payment of employee's taxes resulted in taxable gain); Dolese v. United States, 605 F.2d 1146, 1152 (10th Cir. 1979) (corporation's payment of shareholder's litigation expenses resulted in taxable gain), *cert. denied*, 445 U.S. 961 (1980).

[47] 50 A.F.T.R.2d at 82-5255 to 5256; *see supra* text accompanying notes 34 & 35 (*Dean* court's off-setting deductibility rationale).

[48] 50 A.F.T.R.2d at 82-5255; *see* I.R.C. § 163(a)(West 1983) (taxpayer allowed to deduct expenses paid or accrued during taxable year).

taxpayer could not take a deduction.[49] The *Hardee* court held that regardless of whether the interest-free loan is economically indistinguishable from an interest-bearing loan with its corresponding deduction, the Code does not permit a taxpayer to deduct a cost he neither paid nor accrued.[50] A deduction does not depend upon general equitable considerations but upon legislative grace, and nowhere does the Code allow a deduction for a cost the taxpayer does not incur.[51] The court reasoned that sound administration of tax law demands that courts base decisions on actual facts rather than possible facts.[52] Besides statutory impediments

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[49] 50 A.F.T.R.2d at 82-5256.

[50] *Id.* at 82-5255; *see* I.R.C. § 163(a)(West 1983) (taxpayer allowed to deduct expenses paid or accrued during taxable year).

[51] 50 A.F.T.R.2d at 82-5255. To support the conclusion that a taxpayer cannot take a deduction when a taxpayer has not incurred an expense, the *Hardee* court relied on the Supreme Court's decision in *Commissioner v. National Alfalfa Dehydrating. Id.*; *see* 417 U.S. 134, 152-55 (1974) (no interest deduction allowed when no cost was incurred).

[52] 50 A.F.T.R.2d at 82-5255. In *Greenspun v. Commissioner*, the Tax Court dismissed the Service's argument that § 163(a) of the Code does not entitle the recipient of an interest-free loan to a deduction. 72 T.C. 931, 951 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982). The Service reasoned that the recipient of an interest-free loan fails to satisfy the § 163(a) requirement granting a deduction only for interest expenses actually paid or incurred. *Id.*; *see* I.R.C. § 163(a) (West 1983) (deduction allowed for all interest paid or accrued within the taxable year on indebtedness). The Service relied on case authority to support the contention that a taxpayer must incur an interest expense before § 163(a) will allow a deduction. 72 T.C. at 951; *see* Christiansen v. Commissioner, 40 T.C. 563, 577-78 (1963) (cash basis taxpayer may deduct accrued interest only when actually paid); D. Loveman & Son Export Corp. v. Commissioner, 34 T.C. 776, 805-806 (1960) (interest may not be accrued and deducted when no obligation to pay interest exists), *aff'd*, 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 (1962); Howell Turpentine Co. v. Commissioner, 6 T.C. 364, 394 (1946) (interest deduction must be taken in taxable year during which taxpayer incurs interest expense), *rev'd on other grounds*, 162 F.2d 316 (5th Cir. 1947). The *Greenspun* court dismissed the cases the Service relied on because none of the cases dealt with interest-free loans. 72 T.C. at 951. The *Greenspun* court reasoned that the need to recognize the economic realities of the interest-free loan necessitated an exception to the general rule requiring payment or accrual before a taxpayer may deduct an interest expense. *Id.*

In *Martin v. Commissioner*, Judge Goldberg in his dissenting opinion not only faulted the majority for its failure to depart from *Dean*, he also criticized the Service for its technical reading of §163(a). 649 F.2d 1133, 1136-37 (5th Cir. 1981) (Goldberg, J. dissenting). According to Judge Goldberg, the Service's literal interpretation of § 163(a) as requiring the payment or accrual of an interest expense before allowing a deduction puts the recipient of an interest-free loan in a less advantageous tax position than the recipient of an interest bearing loan. *Id.* In support of his proposition, Judge Goldberg gave the example of two taxpayers (A and B) who earn incomes of $10,100 and $10,000 respectively. *Id.* at 1137. Taxpayer A secures an interest-bearing loan of $1000 for $100. *Id.* Taxpayer B secures an interest-free loan of $1000. *Id.* Taxpayer A, because of the § 163(a) interest expense deduction allowance, pays income tax on only $10,000. *Id.* Taxpayer B, on the other hand, must pay income tax on $10,100, which amount represents taxpayer B's earned income plus the value of his interest-free loan. *Id.* The net effect of making a deduction dependent upon a paid or accrued expense is to impose different tax liability on two taxpayers who are in identical economic positions. *Id.* In place of the Service's strict interpretation of § 163(a), Judge Goldberg suggests that the Service first examine whether the recipient of an interest-free loan would have been

to the *Dean* court's conclusion, the Court of Claims also found that the *Dean* court's attempt to equalize the tax treatment of the noninterest-paying borrower with the interest-paying borrower actually reversed any disparity in favor of the noninterest paying borrower.[53]

The first case to question the taxability of interest-free loans to family members was *Johnson v. United States*.[54] In *Johnson*, the taxpayer made a series of noninterest-bearing loans to his children.[55] Analogizing the receipt of an interest-free loan to the rent-free use of property, the Service attempted to impose on the lender a gift tax on the value of the use of the money transferred.[56] The *Johnson* court ruled against the imposition of a gift tax.[57] Essential to the district court's decision in *Johnson* was the court's determination that the loans in question were not veiled attempts to reduce estate taxes by means of inter vivos transfers.[58] The *Johnson* court also reasoned that taxpayers are under no obligation to invest money for profit.[59] Because no investment duty exists, the court refused to impute a gift tax on the amount of profit the lender would have earned if the lender had invested the loaned funds at the current market rate of interest.[60]

The Service announced its nonacquiescence in *Johnson* in Revenue Ruling 73-61.[61] In Revenue Ruling 73-61, the Service held that low interest

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entitled to an interest expense deduction if the taxpayer had paid or accrued an interest expense. *Id.* When the taxpayer could have deducted the interest on an interest-free loan if he actually had paid or accrued the expense, the Service should charge no net taxable income as a result of the interest-free loan. *Id.*

[53] 50 A.F.T.R.2d at 82-5255 to 5256. The *Hardee* court reasoned that the *Dean* decision yielded the disproportionate result of permitting the interest-free borrower to enjoy the benefit of a loan without any adverse economic consequences whatsoever. *Id.* According to the *Hardee* court, the interest-free borrower has no up-front borrowing costs, nor does the borrowing occasion any tax consequences. *Id.*

[54] 254 F. Supp. 73 (N.D. Tex. 1966).

[55] *Id.* The loans in *Johnson* were repayable on demand. *Id.* The borrowers repaid most of the loans the taxpayer made prior to the taxpayer's death. *Id.*

[56] *Id.* The Service in *Johnson* argued that in each of the years in question, the taxpayer made a gift of the value of the use of the money at 3 1/2% per year on the average unpaid balance for each year. *Id.*

[57] *Id.* at 77.

[58] *Id.* The *Johnson* court based its finding that the taxpayer was not attempting to diminish his estate taxes on the fact that the borrowers of the loans had repaid most of the loans prior to the taxpayer's death. *Id.* The court also found that the unpaid amount of the loans appeared on the taxpayer's books and was includible as an asset of the estate in arriving at estate taxes. *Id. See generally* Tax Reform Act of 1976, 26 U.S.C. § 2502 (1976) (unified gift and estate tax rates). Previous to the Tax Reform Act of 1976 when Congress placed gift taxes on an equal basis with estate taxes, taxpayers could avoid the higher estate taxes on transfers of property at death by making inter vivos property transfers at the lower gift tax rates. *Cf. id.*

[59] 254 F. Supp. at 77.

[60] *Id.*

[61] 1973-1 C.B. 408; *see infra* note 77 (Seventh Circuit in *Crown* faults Service for waiting seven years to announce nonacquiescence in *Johnson*).

term and demand loans constitute taxable gifts.[62] In distinguishing term from demand loans, the Service held that low interest term loans are taxable on the date made.[63] By contrast, demand loans are gifts in each calendar quarter during which the loans remain outstanding.[64]

The Tax Court decided *Crown v. Commissioner*[65] after the district court's decision in *Johnson*[66] and after the issuing of the Service's opinion in Revenue Ruling 73-61.[67] In holding for the taxpayer, the Tax Court in *Crown* chose to rely on *Johnson* and disregard Revenue Ruling 73-61.[68] The taxpayer in *Crown* made various interest-free demand loans to relatives.[69] The *Crown* court relied on *Johnson* in finding that no taxable gift resulted from making an interest-free loan.[70] The Tax Court noted that the Service only recently has begun to assert that the making of noninterest-bearing loans constitutes a taxable event, even though the statutory authority the Service relied on had been available since the beginning of the income and gift tax laws.[71] Citing *Dean*, the Tax Court also found that courts uniformly have rejected every attempt by the Service to subject the making of noninterest-bearing loans to income and gift taxes.[72] The Seventh Circuit affirmed the Tax Court's decision in *Crown*[73] on the grounds of the administrative difficulties the taxing of intrafamily loans would cause[74] and the uncertain use value of an interest-free de-

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[62] 1973-1 C.B. at 408. *See generally* United States v. Bennett, 186 F.2d 407, 410 (5th Cir. 1951) (Revenue Rulings are opinions of Internal Revenue Service's legal staff and have no more binding or legal force than the opinion of any other lawyer).

[63] 1973-1 C.B. at 408. The Service in Revenue Ruling 73-61 reiterated the Service's previous position that for federal gift tax purposes, the donor has made a completed gift when he has relinquished dominion and control over the property and has no power to change the disposition of the property. *Id.*; *see* Rev. Rul. 69-347, 1969-1 C.B. 227 (restriction on donor's control over trust property).

[64] 1973-1 C.B. at 409. The Service in Revenue Ruling 73-61 held that the value of interest on a demand loan is the value of the use of the money for that portion of the year during which the donor in fact allows the donee to use the money. *Id.* According to the Service, the value of the use of the money during the calendar quarter is calculable as of the last day of each calendar quarter during which the donor has granted the donee such use. *Id.*

[65] 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978).

[66] 254 F. Supp. 73 (N.D. Tex. 1966); *see supra* text accompanying notes 54-60 (*Johnson* decision).

[67] 1973-1 C.B. 408; *see supra* text accompanying notes 62-64 (Rev. Rul. 73-61).

[68] *See* 67 T.C. at 1062 (*Crown* court's reliance on *Johnson* and rejection of Revenue Ruling 73-61).

[69] *Id.* at 1060-61.

[70] *Id.* at 1063-65.

[71] *Id.* at 1063. *See generally* I.R.C. § 2501 (West 1983) (imposition of gift tax); *id.* § 2511 (general scope of gift tax); Treas. Reg. § 25.2511-1(c)(1958) (specific scope of gift tax).

[72] 67 T.C. at 1064; *see supra* text accompanying notes 30-38 (discussion of *Dean*).

[73] Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978), *aff'g*, 67 T.C. 1060 (1977).

[74] 585 F.2d at 241. The Seventh Circuit in *Crown* reasoned that the logical extension of the Service's unequal exchange theory for imposing a gift tax in *Crown* would lead to the imposition of a gift tax in circumstances in which a father lends $1000 to his son graduating from college until the son can get established, or when a office worker lends a fellow employee

mand loan.[75] The lack of specific statutory authority to support the imposition of a gift tax on intrafamily loans[76] and past avoidance of the issue by the Commissioner of Internal Revenue (Commissioner)[77] also influenced the Seventh Circuit to affirm the Tax Court's decision in *Crown* not to impose a gift tax on the making of interest-free demand loans.[78]

Recently, the Eleventh Circuit disagreed with the Seventh Circuit's affirmation of the Tax Court's decision in *Crown*.[79] The Eleventh Circuit's decision in *Dickman v. Commissioner*[80] marks a departure from *Crown* and

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$10 until the following payday. *Id.* Similar reasoning would necessitate the imposition of a gift tax when a neighbor borrows a lawn mower and fails to return it immediately, or when friends provide out-of-town guests with a night's lodging. *Id. See generally infra* note 117 (unequal exchange theory).

[75] 585 F.2d at 238-41. According to the Seventh Circuit in *Crown*, the imposition of a gift tax at the time the lender extends an interest-free loan is impossible because the value of the lender's right to repayment is unknown and unknowable. *Id.* at 238; *see* I.R.C. § 2512(a) (West 1983) (value of gift determined as of date of gift). Furthermore, the uncertain due date of the loan precludes application of a present discounted value formula to determine the value of the gift. 585 F.2d at 238; *see infra* note 117 (time value of money). The reason for the lack of certainty of the value of the loan at the time of the loan is that the transfer of the economic benefit is incomplete at that point, being totally dependent on the lender's continuing willingness to refrain from demanding repayment. 585 F.2d at 238.

The Seventh Circuit also faulted the Service's cancellation of indebtedness method for measuring the amount and timing of the gift. *Id.* at 238-39. According to the *Crown* court, basing the gift tax on the market rate of interest at the close of each taxable quarter results in a theoretically inaccurate measurement of the difference in value at the time of the loan between the money loaned and the promise to repay. *Id.*; *see* I.R.C. § 2512(a) (value of gift determined as of date of gift). The *Crown* court further reasoned that the finding of a taxable gift from the lender to the borrower is equivalent to saying that the lender had a right to receive interest, which indebtedness he forgave. 585 F.2d at 240. The lack of a borrower's legal obligation to pay interest, absent a contractual provision, militates against the Service's cancellation of indebtedness approach to finding a taxable gift. *Id.*

[76] 585 F.2d at 237. The *Crown* court reasoned that policy considerations alone are insufficient to impose a gift tax on interest-free loans. *Id.* The Service also must show that the taxation of interest-free loans is within the contemplation of the gift tax statute. *Id.* To date, no statutory language or legislative history deals specifically with interest-free loans. *Id.* Broadly construing the present gift tax statutes to include interest-free loans leads to theoretical and practical problems. *Id.* at 239-41; *see supra* note 75 (problem of valuing interest free loan).

[77] 585 F.2d at 241. The Seventh Circuit in *Crown* faulted the Service for previously failing to interpret the gift tax statutes as requiring the imposition of a gift tax on interest-free loans. *Id.*; *see* I.R.C. §§ 2501-2524 (West 1983) (Code gift tax provisions). The Seventh Circuit also faulted the Service for failing to appeal the *Johnson* decision and for waiting seven years to announce the Service's nonacquiescence in the *Johnson* decision. 585 F.2d at 241; *see supra* text accompanying notes 54-60 (discussion of *Johnson*); *supra* text accompanying notes 61-64 (Service announces nonacquiescence in *Johnson* decision in Rev. Rul. 73-61).

[78] 585 F.2d at 241; *see supra* text accompanying notes 65-72 (Tax Court's decision in *Crown*).

[79] *See infra* text accompanying notes 80-112 (discussion of *Dickman*); *supra* text accompanying notes 65-78 (discussion of *Crown*).

[80] 690 F.2d 812 (11th Cir. 1982), *rev'g*, 41 T.C.M. (CCH) 620 (1980).

represents a split among the circuit courts[81] and between the Eleventh Circuit and the Tax Court[82] on the gift tax consequences of interest-free loans. The taxpayer in *Dickman* made interest-free loans to a relative and to a closely held corporation.[83] The Tax Court found that the loans were on a demand basis[84] and, relying on *Johnson* and *Crown*, held that the loans involved no gift tax consequences.[85] In reversing the Tax Court's decision, the Eleventh Circuit held that the borrower of an interest-free loan receives a taxable gift.[86] Rather than calling for additional legislation,[87] the Eleventh Circuit found the scope of current Code provisions[88] sufficient to impose a gift tax on the lender of an interest-free loan.[89]

The Eleventh Circuit reasoned that section 2501(a)(1)[90] of the Code imposes a gift tax on any transfer of property by gift made by an individual during the taxable year.[91] Section 2511(a)[92] provides that the tax applies whether the transfer is in trust or otherwise, whether direct or indirect, and whether the property is real or personal, tangible or intangible.[93] Relying on the legislative history of the gift tax provisions,[94] the *Dickman* court interpreted the term "property" to include every kind of right or interest protected by law and having a tangible exchange value.[95] The

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[81] *Compare Dickman*, 690 F.2d at 819 (Eleventh Circuit's holding that gratuitous interest-free loans have gift tax consequences) *with Crown*, 585 F.2d at 235 (Seventh Circuit's holding that gratuitous interest-free loans are not taxable as gifts).

[82] *Compare Dickman*, 690 F.2d at 819 (Eleventh Circuit's holding that gratuitous interest-free loans have gift tax consequences) *with Dickman*, 41 T.C.M. (CCH) at 624 (Tax Court's holding that no gift tax consequences arise from making interest-free loans) *and Crown*, 67 T.C. at 1065 (Tax Court refuses to view use value of money as taxable event for gift tax purposes).

[83] 41 T.C.M. (CCH) at 621-22.

[84] *Id.* at 622.

[85] *Id.* at 624; *see supra* text accompanying notes 54-60 (discussion of *Johnson*); *supra* text accompanying notes 65-78 (discussion of *Crown*).

[86] Dickman v. Commissioner, 690 F.2d 812, 813 (11th Cir. 1982) (interest-free loans are subject to gift tax whether loans made for fixed term or on demand basis), *rev'g*, 41 T.C.M. (CCH) 620 (1980).

[87] *Compare* 690 F.2d at 815 (Eleventh Circuit's finding in *Dickman* that language of gift tax statute is broad enough to include all property arrangements) *with Crown*, 585 F.2d at 240 (Seventh Circuit's finding that to characterize mere use of property as a transfer of a property right implies a broader concept of what constitutes a property right under gift tax laws than previously has been recognized) *and Crown*, 67 T.C. at 1065 (Tax Court's finding that expansion of scope of Code gift tax provisions should come through congressional action and not through unnecessarily broad judicial interpretation).

[88] *See* I.R.C. §§ 2501-2524 (West 1983) (Code gift tax provisions).

[89] *See* 690 F.2d at 814-15 (broad statutory reach of current gift tax provisions).

[90] I.R.C. § 2501(a)(1)(West 1983).

[91] 690 F.2d at 814.

[92] I.R.C. § 2511(a)(West 1983).

[93] 690 F.2d at 814.

[94] *See* H.R. REP. No. 708, *supra* note 13, at 27-28 ("gift" applies to all donative transfers of property); S. REP. 665, *supra* note 13, at 39 (same).

[95] 690 F.2d at 814-15.

court interpreted the gift transfer provision of section 2501 to include all transactions in which a taxpayer gratuitously passes or transfers property or property rights or interests to another regardless of the means or device the taxpayer employs.[96] Citing to previous court decisions,[97] the Eleventh Circuit broadly construed the gift tax provisions of the Code and held that the right to use property, however contingent, constitutes property for tax purposes.[98]

The *Dickman* court's major departure from the Seventh Circuit's decision in *Crown* was the *Dickman* court's holding that the demand nature of an interest-free loan does not control gift tax consequences.[99] The Seventh Circuit in *Crown* reasoned that because the donor of a demand loan could demand repayment of the loan at anytime, the recipient of the loan did not possess a legally protected property interest.[100] In contrast to *Crown*, the *Dickman* court held that receipt of a demand loan is a property interest, notwithstanding the absence of any rights with regard to the transferor.[101] The *Dickman* court reasoned that the property interest the demand loan transfers has an exchangeable value because the recipient is free to transfer the property to another.[102] According to the *Dickman* court, the right to use money is the property right the taxpayer transfers and the period of use is the means of valuing the gift.[103]

The Eleventh Circuit in *Dickman* criticized the *Johnson* and *Crown* courts for their previous failure to recognize the gift tax consequences of interest-free loans.[104] While agreeing with the *Johnson* court's finding that a taxpayer has no duty to invest property for profit,[105] the *Dickman* court held that the absence of an investment duty is irrelevant to the gift tax consequences of property a taxpayer transfers for less than adequate consideration.[106] The *Dickman* court also faulted the *Johnson* court's

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[96] *Id.* at 814.

[97] *See* Commissioner v. Wemyss, 324 U.S. 303, 306 (1945) ("gift" intended to have broad and comprehensive application); Robinette v. Helvering, 318 U.S. 184, 187 (1943) (gift tax intended to reach every kind or type of transfer by gift); Smith v. Shaughnessy, 318 U.S. 176, 180 (1943) (gift tax statute broad enough to reach property interest however real or personal, tangible or intangible, conceptual or contingent).

[98] 690 F.2d at 815-19.

[99] *Compare id.* at 818 (*Dickman* court's finding that an "at will" interest in property is a property right taxable under Code) *with Crown*, 585 F.2d at 239 (Seventh Circuit's finding that no evidence exists to show recipient of loan payable on demand has legally protected property interest).

[100] 585 F.2d at 237-39.

[101] 690 F.2d at 818.

[102] *Id.*

[103] *Id.* at 819.

[104] *Id.* at 816-19; *see supra* text accompanying notes 54-60 (discussion of *Johnson*); *supra* text accompanying notes 65-78 (discussion of *Crown*).

[105] 690 F.2d at 816-19; *see supra* text accompanying notes 59-60 (*Johnson* court's finding of no duty to invest for profit).

[106] 690 F.2d at 817.

finding that interest-free loans do not diminish estate taxes.[107] The *Dickman* court reasoned that because of the possibility of a discount for collection as well as possible delay in repayment, the value of the lender-decedent's right to repayment might be worth less than the face amount of the loan.[108]

The *Dickman* court disagreed with the Tax Court's finding in *Crown* that the Commissioner's previous failure to assert the taxability of noninterest-bearing loans precluded the assertion in *Crown*.[109] According to *Dickman*, the Commissioner is free to correct previous mistakes.[110] The *Dickman* court also faulted the Seventh Circuit's interpretation in *Crown* of the gift tax laws to exclude the use of property from the meaning of property right taxable under the Code.[111] According to the *Dickman* court, the right to use money constitutes a valuable property right taxable under the federal gift tax provisions.[112]

Statutory authority and policy considerations support the Eleventh Circuit's finding in *Dickman* that the making of an interest-free loan constitutes the giving of a valuable property interest.[113] Secton 2501 of the Code imposes a gift tax on the transfer of property for less than adequate consideration.[114] The purpose of the gift tax provisions is to compensate for any diminution in estate tax payable on the donor's death.[115] The theory is that if the decedent-donor had not made an *inter vivos* gift, the property would have been part of his gross estate when he died.[116] Taxation of interest-free loans complies with the purpose of the gift tax provisions because as long as the lender of an interest-free loan permits the loan

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[107] *Id.*; *see supra* text accompanying note 58 (*Johnson* court's finding that purpose of loans was not to diminish estate taxes).

[108] 690 F.2d at 817.

[109] *Id.*; *see supra* text accompanying note 71 (Tax Court's rationale in *Crown* for rejecting Service's gift tax assertion).

[110] 690 F.2d at 818. The *Dickman* court relied on case authority to support the court's proposition that the Commissioner is free to change his earlier incorrect interpretations of the law. *See* Dixon v. United States, 381 U.S. 68, 72 (1965) (Commissioner's withdrawal of acquiescence); Automobile Club of Mich. v. Commissioner, 353 U.S. 180, 183 (1957) (Commissioner entitled to revoke erroneous interpretation of law).

[111] 690 F.2d at 818; *see supra* text accompanying note 100 (Seventh Circuit's rationale in *Crown* for rejecting Service's gift tax assertion).

[112] 690 F.2d at 819.

[113] *See infra* text accompanying notes 114-126 (rationale for imposing gift tax on use value of interest-free loan); *supra* text accompanying notes 80-112 (*Dickman* decision).

[114] I.R.C. § 2501(a)(West 1983); *see supra* text accompanying notes 9-15 (donor's gift tax liability for gifts made during the taxable year).

[115] *See* H.R. REP. No. 708, *supra* note 13, at 28 (purpose of gift tax to supplement income and estate taxes and to preclude avoidance of these taxes through a practice of *inter vivos* giving); S. REP. No. 665, *supra* note 13, at 40 (same).

[116] *Cf.* H. R. REP. No. 708, *supra* note 13, at 28 (design and purpose of Code gift tax provisions); S. REP. No. 665, *supra* note 13, at 40 (same). Prior to the Tax Reform Act of 1976, the gift tax rates were only 75% of the estate tax rates. Solomon, *Gifts in Light of Tax Reform*, 12 INST. ON EST. PLAN. ¶ 1700, 17-3 (1978). The lower gift tax rates provided an obvious incentive for lifetime transfers. *Id.*

to remain outstanding, the lender accepts less than the equal value of the money he has transferred and consequently diminishes his estate for estate tax purposes.[117]

The holdings of the *Johnson* and *Crown* courts that the making of an interest-free demand loan does not diminish the decedent-lender's estate because a lender has no duty during life to invest for profit[118] fails to recognize economic reality. The argument has little validity when the borrower of an interest-free demand loan profits from investing the proceeds of the loan.[119] Such a scheme effects a double tax avoidance because the scheme not only diminishes the lender's gross estate but also allows the

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[117] *See* E. HELFERT, TECHNIQUES OF FINANCIAL ANALYSIS 140-43 (1982) (time value of money); Blum, *An Introduction to the Mathematics of Tax Planning*, 57 TAXES 707, 708 (1979) (same). In an economy of continuing inflation, the lessening real value of the dollar provides borrowers an advantage over creditors. *Id.* Inflation coupled with the diminishing earning power of money causes the present nominal value of a dollar paid in the future to be less than a dollar paid immediately. *Id.* To the extent a present dollar is more valuable than a future dollar, delayed repayment enables a borrower to make repayment in cheaper dollars. *Id. See generally* Pulliam, *Income and Gift Tax Implications of Nonbusiness Interest-Free Loans: Looking a Gift Horse In the Mouth*, 58 TAXES 675, 679 (1980) (lender's potential estate reduced by time value of money loaned).

Because the present value of a dollar is worth more than the value of a future dollar, a loan given in exchange for a promissory note to repay in the future only the principal of the loan results in an unequal exchange. O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. LAW REV. 1085, 1088 (1974). The difference between the present value of the loan and the future value of the promissory note represents the amount of the gift. *Id.* Ordinarily, the date of the gift controls the valuation of the gift. *See* I.R.C. § 2512(a) (West 1983) (valuation of gift determined on date gift made). In the case of term loans, the due date of the loan makes valuation of the promissory note on the date of the gift relatively easy because on the date the lender issues the loan the Service can discount the face value of the promissory note to reflect the rate of inflation over the period of the loan. *See* O'Hare, *supra*, at 1088 (suggested formula for determining gift value of interest-free term loans).

In contrast to term loans, the gift value of an interest-free demand loan on the date the lender issues the loan is more difficult to compute because of the demand loan's uncertain due date. *Cf.* I.R.C. § 2512(a) (valuation of gift determined on date gift made). The uncertain gift value of the demand loan on the date of issuance has influenced courts to rule against the taxability of interest-free demand loans. *See, e.g.*, Crown v. Commissioner, 585 F.2d 234, 237-39 (7th Cir. 1978) (difficulties encountered in determining gift value of interest-free demand loan). The Service's solution to the valuation problem is to view the interest-free demand loan as incomplete when the lender makes the loan. *See* Rev. Rul. 73-61, 1973-1 C.B. 408, 409. The Service in Revenue Ruling 73-61 reasoned that because the borrower of an interest-free demand loan enjoys the right to use the loan only as long as the lender refrains from recalling the loan, the value of the borrower's right is not ascertainable on the date of exchange. *Id.* According to the Service, the gift of the interest-free demand loan becomes complete only at the close of each calendar quarter during which the lender refrains from recalling the loan. *Id.*

[118] *See Johnson*, 254 F. Supp. at 77 (parents under no duty to lend or invest money); *Crown*, 67 T.C. at 1063-64 (taxpayer under no obligation to invest for profit).

[119] *See* I.R.C. § 61(a) (4) (gross income includes interest). *See generally* Comment, *Crown v. Commissioner: Gift Taxation And Interest-Free Loans Among Family Members*, 19 WM. & MARY L. REV. 361, 371 (1977) (tax avoidance opportunities after *Crown*).

lender to split taxable income.[120] Because of the present progressive tax rate, the free transfer of income from high to low tax brackets undermines the design and purpose of the income tax structure.[121] Incentive for such transactions is especially strong with respect to intrafamily transfers in which the lender can allocate his total wealth among individual family members in varying tax brackets while at the same time retaining his wealth within the family unit.[122]

The demand loan recipient's lack of exclusive control over the loan was a determining factor for the Tax Court in both *Crown* and *Dickman* in deciding that an interest-free demand loan did not represent a valuable property interest.[123] The Tax Court's emphasis on the borrower's lack of exclusive control, like the Tax Court's emphasis on the lender's lack of an investment duty, also fails to recognize the economic context surrounding the interest-free demand loan.[124] When divorced from a nonbusiness context, the rights of the demand loan recipient appear less exclusive than the rights of the term loan recipient. Distinguishing tax consequences on this distinction becomes specious, however, when the demand loan is viewed in its intrafamily context.[125] Because the majority of interest-free demand loans are made between family members on a friendly basis in which the likelihood of indiscriminate recall is remote, the Tax Court's focus on the demand nature of the loan ignores the substance of the transaction and encourages the use of income shifting as a tax avoidance device.[126]

In regard to the tax consequences of interest-free loans made outside the family context, the difference between the *Hardee* court's analysis and the *Dean* court's analysis stems from an attempt by both courts to equalize the tax treatment of the interest-free loan borrower with the Code treatment of other property users.[127] The *Dean* court equated the

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[120] *See* Comment, *supra* note 119, at 371 (tax avoidance opportunities after *Crown*).

[121] *See* H.R. REP. No. 708, *supra* note 13, at 28 (purpose of gift tax is to supplement income and estate taxes and to preclude avoidance of these taxes through a practice of inter vivos giving); S. REP. No. 665, *supra* note 13, at 40 (same); *see also* Smith v. Shaughnessy, 318 U.S. 176, 179 n.1 (1943) (gift tax provisions intended not only to prevent estate tax avoidance but also to prevent income tax avoidance through reducing gross income and thereby escaping effect of progressive surtax rate). *See generally* Harriss, *Legislative History of Federal Gift Taxation*, 18 TAXES 531,533 (1940) (congressional intent in enacting Code gift tax provisions).

[122] *See* Pulliam, *supra* note 117, at 679 (tax incentives for making interest-free loans to family members).

[123] *See Dickman*, 41 T.C.M. at 623 (demand and open account loans do not result in taxable gifts); *Crown*, 67 T.C. at 1065 (no gift tax attaches to mere permissive use).

[124] *See* Pulliam, *supra* note 117, at 679 (majority of interest-free demand loans made within family setting).

[125] *Id.*

[126] *Id.*

[127] *Compare* 50 A.F.T.R.2d at 82-5255 (*Hardee* court equates interest-free loan to rent-

borrower of an interest-free loan with the borrower of an interest-bearing loan.[128] The *Dean* court reasoned that because the Code allows the borrower of an interest-bearing loan a deduction from income for interest the borrower paid or accrued on the loan during the taxable year,[129] whether a taxpayer receives a loan interest free or is required to make an interest payment should make no taxable difference.[130] In an attempt to give effect to the economic reality of the two transactions, the *Dean* court refused to treat the use value of the interest-free loan as income to the borrower.[131] To hold otherwise would cause a disparity because the interest-paying borrower would have a deduction from income for interest paid while the interest-free borrower would realize additional income to the extent of interest not paid or accrued.[132]

Unlike *Dean*, the *Hardee* court equated interest-free loans to the rent-free use of property.[133] Under the Code, ordinary rental payments are not deductible[134] and the rent-free use of property results in a taxable gain to the recipient.[135] When an interest-free loan is equated to the rent-free use of property, any attempt to equalize the tax treatment of the two transactions requires the borrower of the interest-free loan to recognize income as measured by the interest value of the funds borrowed.[136]

In reasoning that interest-free borrowers are entitled to the same tax

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free use of corporate property) *with* 35 T.C. at 1090 (*Dean* court equates interest-free loans to interest-bearing loans).

[128] *See* 35 T.C. at 1090 (same tax results should apply to borrower of interest-free loan or borrower of interest-bearing loan); *supra* text accompanying notes 30-35 (*Dean* court's rationale).

[129] *See* I.R.C. § 163 (West 1983) (interest expense deduction).

[130] *See* 35 T.C. at 1090 (same tax results should apply to borrower of interest-free loan as borrower of interest-bearing loan); *supra* text accompanying notes 30-35 (*Dean* court's rationale).

[131] *See* 35 T.C. at 1089-90 (no taxable gain to borrower of interest-free loan).

[132] *See id.* at 1090 (*Dean* court's rationale for holding borrower of an interest-free loan realizes no taxable gain); *supra* text accompanying notes 30-35 (same). *See generally supra* note 52 (Judge Goldberg's explanation in *Martin v. Commissioner* of how treating as income the use value of interest-free demand loan would cause disparity between interest-free loan recipient and interest-bearing loan recipient).

[133] *See* 50 A.F.T.R.2d at 82-5255 (same result should apply to taxpayer who uses corporate property rent-free as taxpayer who borrows corporate money interest-free).

[134] *See* I.R.C. § 162(a) (3) (West 1983) (rent expense deduction allowed only when rented property relates to carrying on of trade or business).

[135] *See, e.g.*, Gardner v. Commissioner, 613 F.2d 160, 162 (6th Cir. 1980) (free use of company-owned car held to result in taxable gain); Chandler v. Commissioner, 119 F.2d 623, 626-28 (3d Cir. 1941) (rent-free use of corporate residence held to result in taxable gain); Challenge Mfg. Co. v Commissioner, 37 T.C. 650, 663 (1962) (rent-free use of company owned boat held to result in taxable gain); Frueauff v. Commissioner, 30 B.T.A. 449, 451 (1934) (rent-free use of corporate apartment held to result in taxable gain); I.R.C. § 61 (West 1983) (gross income includes income from whatever source derived).

[136] *See* 50 A.F.T.R.2d at 82-5255 (*Hardee* court's holding that use of corporate asset without corresponding rent obligation and use of corporate money without interest expense obligation are economically indistinguishable and should result in same tax consequences).

consequences as interest paying borrowers, the *Dean* majority overlooked the fact that not all interest payments are deductible.[137] The *Dean* majority also overlooked the fact that the Code entitles the interest paying borrower to an interest deduction by virtue of a previously paid or accrued interest expense.[138] The Code provides direct authority for the *Hardee* court's conclusion that a taxpayer may deduct only interest expenses paid or accrued.[139] Section 163 of the Code allows an interest deduction for all interest paid or accrued during the taxable year on indebtedness.[140] Because the holder of an interest-free loan neither pays nor accrues an interest expense, the holder may not take a deduction under section 163 of the Code.[141] The taxpayers in *Dean* neither paid nor accrued an interest expense.[142] The *Dean* majority presumed the availability of the deduction.[143] To the extent the *Dean* majority granted the taxpayers a deduction without first requiring an interest expense, the *Dean* decision conflicts with section 163 of the Code.[144] The *Dean* decision is also at variance with other cases which have denied an interest deduction upon failure to prove an interest expense.[145]

Presently the tax consequences of interest-free loans to family members is uncertain.[146] The Tax Court has refused to impose a gift tax on the making of interest-free loans to relatives.[147] The recent reversal of the Tax Court's *Dickman* decision, however, reveals that unlike the

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[137] 35 T.C. at 1091 (Opper, J., dissenting); *see, e.g.*, I.R.C. § 265(2) (West 1983). Section 265(2) of the Code does not allow the taxpayer to deduct interest expense on indebtedness when the taxpayer incurs the indebtedness in the purchase of assets which pay tax exempt interest. *Id. See generally supra* note 19 (nondeductible interest expenses).

[138] *See* I.R.C. § 163(a) (West 1983). Section 163(a) of the Code provides a deduction only for interest the taxpayer has paid or accrued. *Id.*; *see supra* text accompanying notes 41-53 (*Hardee* court's disagreement with *Dean* court's off-setting deductiblity rationale); *see also supra* text accompanying notes 34-35 (*Dean* court's off-setting deductibility rationale).

[139] *See supra* note 138 (Code § 163(a)).

[140] *See supra* note 138 (Code § 163(a)).

[141] *Cf.* I.R.C. § 163(a) (West 1983). Section 163(a) of the Code provides a deduction only for interest the taxpayer has paid or accrued. *Id. But see supra* note 52 (Judge Goldberg's criticism in *Martin v. Commissioner* of the Service's literal reading of Code § 163(a)).

[142] 35 T.C. at 1083.

[143] *Id.* at 1090.

[144] *Compare id.* (*Dean* court imputes interest deduction) *with* I.R.C. § 163(a) (West 1983) (taxpayer allowed deduction only for interest expense actually paid or accrued).

[145] *See, e.g.*, Woodward v. United States, 106 F. Supp. 14, 27 (N.D. Iowa 1952) (taxpayer claiming interest deduction must prove interest expense), *aff'd*, 208 F.2d 893 (8th Cir. 1953); Hart v. Commissioner, 9 T.C.M. (CCH) 485, 501 (1950) (interest deduction denied when taxpayer could not prove payment represented interest expense); A. Backus Jr. & Sons v. Commissioner, 6 B.T.A. 590, 592 (1927) (taxpayer must make strict proof of deductible expenses).

[146] *Cf. supra* text accompanying notes 30-112 (differing judicial interpretations of reach of income and gift tax provisions of Code).

[147] *See supra* text accompanying notes 54-60 (*Johnson* decision); *supra* text accompanying notes 65-72 (Tax Court's reliance on *Johnson* in *Crown*); *supra* text accompanying note 85 (Tax Court's reliance on *Crown* and *Johnson* in *Dickman*).

Tax Court the Eleventh Circuit is willing to impose a gift tax on the lender of an interest-free loan.[148] The income tax consequences of interest-free loans made outside the family situation are also uncertain.[149] Although *Dean* apparently had resolved the issue,[150] the decision of the Court of Claims in *Hardee* demonstrates that the issue of the income tax consequences to the borrower of an interest-free loan is still open to debate.[151] The conflicting opinions on the issue arise from disagreement over whether to equate the receipt of an interest-free loan to the rent-free use of property or to the receipt of an interest-bearing loan.[152] Solution to the tax consequences of interest-free loans may be achieved through congressional enactment of a specific statutory provision.[153] More probably, because of the diversity of rulings on the issue,[154] the Supreme Court will provide the more immediate resolution to the question of the income and gift tax consequences of interest-free loans.

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[148] *See supra* text accompanying notes 79-112 (*Dickman* decision).

[149] *Cf. supra* text accompanying notes 30-53 (*Dean* and *Hardee* decisions).

[150] *See supra* text accompanying notes 30-35 (*Dean* decision).

[151] *See supra* text accompanying notes 42-53 (*Hardee* decision). After preparation of this note for publication, the United States Court of Appeals for the Federal Circuit reversed the United States Court of Claims in *Hardee v. United States*. *See* 708 F.2d 661 (Fed. Cir. 1983). The Federal Circuit followed the Tax Court's decision in *Dean* in holding that an interest-free loan from a corporation to its principal shareholder posed no income tax consequences. *See id.* at 663-68. The Federal Circuit avoided serious consideration of the *Dean* rationale by holding that interest-free loans fell outside the accepted definition of taxable income. *See id.* at 665. The Federal Circuit concluded that because the definition of taxable income did not include the interest-free use of money, issues such as the lack of statutory authority to support an imputed deduction for an imputed interest payment were immaterial. *See id.* The long standing practice of treating interest-free loans as tax free which the *Dean* decision established formed the basis of the Federal Circuit's refusal to depart from *Dean*. *See id.* at 664. The Federal Circuit found that Congress, not the courts, has the prerogative to change practices which have coalesced over time into rules of law. *See id.*

[152] *See supra* text accompanying notes 127-136 (*Hardee* court's comparison of interest-free loans to rent-free use of property and *Dean* court's comparison of interest-free loans to interest-bearing loans).

[153] *See generally* SECTION 484: INTEREST ON CERTAIN LOANS (ABA Legislative Proposal 1983). The ABA proposes that on the date the borrower repays the principal of the interest-free loan, an amount equal to the unstated interest be deemed paid by the lender to the borrower and then paid by the borrower to the lender as interest on the indebtedness. *Id.* Under this proposal, the borrower would recognize income and also be entitled to an offsetting interest expense deduction. *Id. See also* Comment, *Hardee v. United States: Income Tax Consequences of Interest-Free Loans*, 36 TAX LAWYER 1225 (1983) (tax parity treatment only realistic way to handle economic benefits flowing from interest-free loans).

[154] *See supra* text accompanying notes 30-112 (differing judicial opinions on tax consequences of interest-free loans).