Interest-Free Loans and the Gift Tax: *Crown v. Commissioner*

Section 2501(a)(1) of the Internal Revenue Code of 1954 provides that "a tax . . . is hereby imposed on the transfer of property by gift . . . by any individual, resident or nonresident." This gift tax was primarily designed (1) to discourage income-splitting among family members and (2) to ensure the effectiveness of the estate tax by preventing the depletion of the taxable estate before death.[1] In *Crown v. Commissioner*,[2] the Tax Court faced the issue of whether substantial interest-free loans made to trusts for the benefit of children and other relatives of a taxpayer constituted taxable gifts of the use of the funds. The Tax Court held for the taxpayer, from which holding the government has appealed. This Case Comment will examine the background of this decision and suggest various modes of analysis under which a different result might obtain.

I. Facts and Holding

The taxpayer and his two brothers, Robert Crown (now deceased) and John J. Crown, were equal partners in Areljay Company, Not Incorporated, an Illinois general partnership formed in 1944. Separate trusts existed for the benefit of the fifteen children of the Areljay partners and for a first cousin and eleven children of first cousins of the Areljay partners. During 1967, Areljay made various interest-free loans to twenty-four of these trusts,[3] the aggregate sum of the loans being $18,030,024 for the taxable year. The bulk of the amount loaned was in the form of open accounts and was loaned for the purpose of enabling the trusts to acquire an interest in Henry Crown and Company, Not Incorporated. Some of the loans were evidenced by demand notes. These demand notes made no provision for payment of interest before demand, but did provide for interest of 6% per annum after demand. The prime rate of interest on the market averaged 5.63% for the year 1967.

The Internal Revenue Service found the taxpayer's statement of 1967 gifts to be deficient to the extent of $362,135.92. This figure represents one-third[4] of the Service's estimate of the value of the *use*

1. H.R. Rep. No. 708, 72d Cong., 1st Sess. 28 (1932), *reprinted in* 1939-1 C.B. 457, 477; S. Rep. No. 655, 72d Cong., 1st Sess. 40 (1932), *reprinted in* 1939-1 C.B. 496, 525. For further references to legislative intent, see C. Lowndes, R. Kramer & J. McCord, Federal Estate and Gift Taxes 640 n.11 (3d ed. 1974).

2. 67 T.C. 1060, *appeal docketed*, No. 77-1898 (7th Cir. July 1, 1977).

3. Gifts made to a trust are treated as gifts to the beneficiaries of the trust and not as gifts to the trustee or to the trust as a legal entity. Helvering v. Hutchings, 312 U.S. 393 (1941).

4. A gift by a partnership will probably be taxed to the individual members of the partnership in proportion to their interest in the property transferred. This is by analogy to Treas. Reg. § 25.2511-1(h)(1), T.D. 6334, 1958-2 C.B. 643, 645-46 which provides that a gift by a

of the funds transferred by the three partners of Areljay. The valuation of the use of the funds was based on a "reasonable rate of interest"[5] of 6% per annum.

The issue thus presented to the Tax Court (in a reviewed opinion) was whether the making of interest-free loans under these circumstances was a taxable event under the gift tax laws. A divided court[6] found that it was not, following *Johnson v. United States.*[7] The court reasoned (1) that the position of the Service is a new one and that its enforcement would work an unfair surprise on the taxpayer, (2) that the purpose of the gift tax (to prevent depletion of the taxable estate) would not be frustrated, since the principal would be repaid, (3) that "the right to interest must arise from an express or implied contractual obligation or from statute,"[8] (4) that the interpretation sought by the Service was so broad that only Congress, and not the courts, could authorize it, and (5) that, as a matter of policy, the application of gift tax law to "inter-family sharing of use of property" would be "administratively unmanageable."[9]

The dissenters found that "[t]o hold that such a transfer is not a taxable gift . . . ignores economic reality,"[10] and contested the view that the purpose of the gift tax was not being defeated by the majority's holding.[11]

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corporation is taxable as gifts by the individual shareholders in proportion to their holdings in the corporation. There are no cases on point. Thus, although the gift in *Crown* was from a partnership to a trust, it is comparable to cases in which the gift is from one individual to another. *See* note 3 *supra.*

5. Crown v. Commissioner, 67 T.C. 1060, 1061, *appeal docketed*, No. 77-1898 (7th Cir. July 1, 1977).

6. The decision was six to four. Judges Simpson, Raum, Tannenwald, and Wilbur dissented. Judges Drennen, Quealy, and Hale did not participate in the decision.

7. 254 F. Supp. 73 (N.D. Tex. 1966).

8. 67 T.C. at 1064 (quoting Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966)).

9. *Id.*

10. *Id.* at 1065.

11. *Id.* at 1069-70. Judge Simpson, citing no authority, stated that the portion of a note includible in the estate of a decedent is the total amount of the note discounted to present value. Since in the case of an interest-free loan, the only amount to be discounted is the principal itself, the amount includible in the estate will be less than the amount that was transferred out to the borrower. This may be contrasted with the normal interest-bearing instrument, for which a discounting of all future interest and principal payments results in a present value theoretically equal to the original principal amount. Under this line of reasoning, Judge Simpson argues that the interest-free loan results in a depletion of the taxable estate, whereas the normal interest-bearing loan does not. This argument is problematical for three reasons. First, it is not entirely clear that the estate would not also be depleted when interest-bearing notes are discounted, since what is being discounted in either case is *what the creditor has a right to receive.* Thus, discounting in either case produces a figure lower than the amount that the creditor's estate has a right to receive. Second, and more importantly, Judge Simpson appears to have assumed that the depletion of the estate must be shown in order to establish that a taxable gift has been made. But the gift tax is two-pronged. It is designed to prevent not only the depletion of a decedent's estate before death but also to tax transferred gains to the recipient (here, the interest-free use of money) for purposes of income-splitting. *See* text accompanying note 1 *supra.* Third, and most importantly, the method used by Judge Simpson for the valuation of notes held by the estate is not the correct one. Valuation of notes for estate

II. The Legal Milieu: Taxpayer Successes, Service Nonacquiescence

From the broadest perspective, the issue involved in *Crown* can be viewed as an example of a conflict that is a recurring theme in federal tax law: that of form versus substance. This section will examine the form versus substance conflict as it has developed in the context of the specific issue presented in *Crown*. *In form* nothing permanently passes to the debtor when an interest-free loan is made, for the entire principal eventually returns to the creditor; *in substance*, the debtor has received the use of the funds, the value of which is commonly known as interest.

Narrowing the perspective, *Crown* can be compared to those cases in which the Service has sought to *impute* interest or rent when no such interest or rent was actually charged or paid. The courts have been reluctant to accept this point of view. In *Tennessee-Arkansas Gravel Co. v. Commissioner*[12] a corporation allowed a company that it controlled to use certain equipment rent-free. Although section 482 of the Internal Revenue Code authorizes the Secretary or his delegate to "distribute, apportion, or allocate" gross income among commonly controlled entities "in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations," the Sixth Circuit refused to allocate or impute rental income to the corporation, declaring that the Commissioner had "set up income where none existed."[13] Eleven years later in *Smith-Bridgman and Co.*,[14] the Tax Court refused to impute interest on $247,774 worth of noninterest-bearing loans made by a parent corporation to a subsidiary. Thus, even armed with section 482, the Service had twice failed to successfully assert an imputation of income.[15] It subsequently nonacquiesced on the issue of the propriety of imputation.[16]

In *J. Simpson Dean*,[17] a case cited by the *Crown* majority, the Tax

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tax purposes is governed by Treas. Reg. § 20.2031-4, T.D. 6296, 1958-2 C.B. 432, 482. That regulation provides that the value of notes shall be presumed to be the unpaid principal amount plus interest accrued to the date of death. Therefore, the estate would not be "depleted" even in the case of an interest-free loan, since the value includible in the estate would be the same principal amount that had previously been transferred out.

12. 112 F.2d 508 (6th Cir. 1940).

13. *Id.* at 510.

14. 16 T.C. 287 (1951), *acq.*, 1951-1 C.B. 3; *accord*, Huber Homes, Inc. v. Commissioner, 55 T.C. 598 (1971); PPG Indus. Inc. v. Commissioner, 55 T.C. 928 (1970).

15. More recent cases have interpreted § 482 and its corresponding regulations to require the imputation of interest in the case of certain interest-free commercial loans. However, these decisions have usually come about only through reversal of the Tax Court position on appeal. For an extensive analysis of these cases consult O'Hare, *The Taxation of Interest-Free Loans*, 27 Vand. L. Rev. 1085, 1096-105 (1974).

16. Rev. Rul. 67-79, 1967-1 C.B. 117. The Service maintains that it acquiesced in *Smith-Bridgman* and *Tennessee-Arkansas Gravel* only because it had misallocated income in those cases. The actual authority to allocate under § 482 was reasserted.

17. 35 T.C. 1083 (1961).

Court applied the *Smith-Bridgman* logic to a situation involving loans to shareholders. A corporation eighty percent controlled by the taxpayers made interest-free loans to the taxpayers in excess of two million dollars. The court reasoned that any imputed income from the use of the funds would be offset by a deduction for the payment of the interest,[18] and so, apparently believing imputation and offset to be a pointless exercise, disallowed the imputation. The fallacy of that argument was pointed out by Judge Bruce in his dissent in *Dean*.[19] It is that not all interest expenses are deductible, the most notable exception being those interest expenses incurred for the purchase of tax-exempt bonds.[20] Yet *Dean* remains law.[21]

Within the gift tax area specifically, *Johnson v. United States*[22] stands as the only case directly on point. Mr. and Mrs. Johnson had made bona fide but noninterest-bearing loans in excess of one half million dollars to their two children. For the four taxable years in question, the Internal Revenue Service claimed that the Johnsons had made gifts of the use of the money to the extent of 3.5% per annum on the average unpaid balance for each year. In language that has been described as "elliptical and conclusionary"[23] the district court found no gift of the use of the funds. The court based its holding on the reasoning that "[t]he right to interest must arise from an express or implied contractual obligation or from statute."[24] From a policy point of view, the court was very concerned about the law's intrusion into family relationships:

> The time has not yet come when a parent must suddenly deal at arm's length with his children when they finish their education and start out in life. There is no legal requirement, express or implied, to charge them interest on money advanced to them at that stage, whether it be to open a law office and hang out a shingle, to go into the oil business on a substantial scale, or to begin life on their own in some other way. The fact that the Johnsons were financially able to make substantial loans to their children does not change the principle involved. It is to the credit of the entire family that children of those wealthy parents had the judg-

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18. I.R.C. § 163.

19. 35 T.C. 1083, 1083-92 (1961) (Bruce, J., dissenting).

20. I.R.C. § 265(2). Furthermore, it would seem more in accord with a logical and harmonious tax procedure to establish the income that had been realized and then make deductions as allowed. Stating that income does not exist because the Code provides a corresponding deduction simply creates a shortcut to the presumed destination it does not reflect the analytical process required by the Code itself in the determination of the tax liability.

21. *Dean* has not been well received by commentators. *See, e.g.*, J. SNEED, THE CONFIGURATIONS OF GROSS INCOME 86-88 (1967); O'Hare, *supra* note 15, at 1094-96; Schlifke, *Taxing as Income the Receipt of Interest-Free Loans*, 44 TAXES 544, 544-47 (1966).

22. 254 F. Supp. 73 (N.D. Tex. 1966).

23. 19 STAN. L. REV. 870, 870 (1967).

24. 254 F. Supp. at 77. The court cited no authority on this point.

ment to use their money in such a way that they were able to repay almost the entire loans during their father's lifetime.[25]

The court further noted, as did the *Crown* majority, that the interpretation sought by the Commissioner should come from Congress and not the courts.

Aside from its assertion in 1967[26] (following *Smith-Bridgman*) that it would continue to impute interest under section 482, the Internal Revenue Service remained silent on this issue until 1973. In that year the Service issued Revenue Ruling 73-61,[27] the essence of which provides that "[t]he right to use property, in this case money, is itself an interest in property, the transfer of which is a gift within the purview of section 2501 of the Code unless full and adequate consideration in money or money's worth is received."[28] The ruling specifically stated that *Johnson* would not be followed.[29] This position was amplified later in 1973 when the Service issued its nonacquiescence to *Dean*.[30]

Thus were the lines of conflict drawn when the Internal Revenue Service sent Lester Crown his notice of a gift tax deficiency in 1974. Against this background of taxpayer successes and Service nonacquiescence the issue in *Crown* was once again argued and, with a strong admixture of stare decisis, once again resolved in favor of the taxpayer.

III. Finding the Gift: A Roundtable Analysis

The conclusion that the making of an interest-free loan should be viewed as a gift of the use of the funds can be arrived at by a variety of means. The purpose of the discussion that follows is to provide a brief introduction to some of the modes of analysis that might be

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25. *Id.*

26. It is surprising that the Service did not appeal *Johnson*. *See* 5 Hous. L. Rev. 138, 142 n.28 (1967) in which the author suggests that the decision not to appeal may have been the result of an inadequate development of the facts in the trial court.

27. 1973-1 C.B. 408.

28. *Id.* at 409. The facts underlying the ruling are as follows: a father advanced $250,000 to a corporation wholly owned by his son, for which the son gave his father two promissory notes from the corporation; the first note, payable in ten years, was for $50,000; the second note was a demand note for the amount of $200,000; both notes provided that the principal sum was to be repaid without interest.

As to the term note, the ruling found that "the value of the right to use of the money loaned is ascertainable by accepted actuarial methods." *Id.* As to the demand note, the ruling found the value of the use to be properly ascertainable only on a quarter-by-quarter basis, according to the actual period of use allowed.

29. Cited in favor of the Service's position was the anomalous but eminently reasonable Gertrude H. Blackburn, 20 T.C. 204 (1953). In that case the taxpayer sold a building to her children and accepted in payment a note carrying a very low interest rate. She was held to have made a gift to her children of the difference between the interest charged and the local market rate of interest.

30. 1973-2 C.B. 4.

employed by the Service in its effort to move the substance of Revenue Ruling 73-61, a bone of contention in *Johnson* and *Crown*, into the peaceful repose of settled law. *Crown* is now on appeal to the Seventh Circuit.[31]

A. *"Property" By Definition*

The proposition that the use of money is an item subject to transfer under section 2511, and thus taxable, can be accomplished directly through a process of statutory interpretation. Note first the broad language of section 2511(a) as it defines a taxable transfer: "[t]he tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." The legislative history of the gift tax provisions demonstrates further that "property" was to be broadly interpreted to include "every species of right or interest protected by law and having exchangeable value."[32] That the use of money has an "exchangeable value" is commonly known, and the value of this use is commonly known as interest. It would indeed be difficult to refute the idea that such a value exists when the total credit market debt in the United States exceeded $2.5 trillion in 1975.[33] The more philosophical, less statistically-minded lawyer might prefer the approach of the sage New Hampshire court which found simply that "[i]n the final analysis, the property in anything consists in its use."[34]

A similar position has been taken by the Service. Revenue Ruling 73-61 states that "[t]he right to use property, *in this case money*,"[35] shall be deemed to be property in itself, and thus subject to transfer for purposes of the gift tax. This wording would place money in the same category as such familiar items of property as houses, cars, and yachts, the use of which as a form of compensation has consistently been held to generate income to the user.[36] It is difficult to distinguish between the use of ordinary property and the use of money; the consumption of either results in a gain to the individual. Thus, an

31. No. 77-1898 (7th Cir. July 1, 1977).

32. H.R. REP. No. 708, 72d Cong., 1st Sess. 27 (1932), *reprinted in* 1939-1 C.B. 457, 477; S. REP. No. 566, 72d Cong., 1st Sess. 39 (1932), *reprinted in* 1939-1 C.B. 496, 524.

33. U.S. BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1976, at 749 (97th ed. 1976).

34. Barker v. Publishers Paper Co., 78 N.H. 571, 573, 103 A. 757, 758 (1918).

35. 1973-1 C.B. 408-09 (emphasis added).

36. *See* United Aniline Co. v. Commissioner, 316 F.2d 701 (1st Cir. 1963) (use of corporate-owned yacht by president and principal stockholder); International Artists, Ltd. v. Commissioner, 55 T.C. 94 (1970) (use of corporate-owned mansion by employee Liberace); O'Neill v. Patterson, 65-1 U.S. Tax Cas. ¶9436 (N.D. Ala. Mar. 25, 1964) (use of employer-owned autos).

equal application of basic concepts of value in the income and gift tax areas would seem to require that the use of money be recognized in administration of the gift tax as an item of property subject to transfer. The argument of the *Crown* majority that the application of the gift tax law to intra-family sharing of the use of property would be "administratively unmanageable"[37] is substantially refuted by the generous annual and lifetime exemptions provided by the Code.[38]

B. *The Revocable or Short-Term Trust*

Suppose a taxpayer sought to confer a benefit on a family member or other person in a way that would ensure a steady income for that person and yet not tie up a large sum of money indefinitely. The most ordinary means to achieve this end would be to establish a revocable or short-term trust. The intended beneficiary will receive payments from the income of the corpus, while the corpus remains available either at the will of the grantor or within a term established by the grantor.[39]

Suppose, however, that the taxpayer in the above situation had opted for the making of an interest-free loan instead of a trust. Functionally, the situations are the same:[40] the intended beneficiary has the use of the funds for producing income, while the taxpayer has the funds immediately available (on a demand note, analogous to the revocable trust) or available at a time of his choosing (on a term note, analogous to the short-term trust). The tax effect, however, will be quite different. In the trust situation, the taxpayer must pay gift taxes on any payments made to the beneficiary before revocation or termination;[41] by the *Johnson/Crown* rule, on the other hand, no gift is recognized in the interest-free loan arrangement.

This disparate tax treatment of two substantially similar relationships raises questions about the wisdom of *Johnson* and *Crown*.[42]

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37. 67 T.C. at 1064.

38. *See* note 91 *infra*.

39. The trust hypothesized here has been included as an aid to the analysis, and not as a representation of a "typical" trust arrangement. An actual taxpayer would be more likely to create a trust which satisfied the "no strings" requirements of I.R.C. §§ 673-677 thereby ensuring that the income of the trust would be taxable to the trust, and not to himself. Thus, a taxpayer would ordinarily prefer not to retain a reversion, I.R.C. § 673(a), or a power to revoke, I.R.C. § 676, that would be effective or exercisable within 10 years. For an introduction to the problems facing the settlor who wishes to avoid taxation of the trust income to himself without relinquishing all semblance of control over the trust, see Westfall, *Trust Grantors and Section 674: Adventures in Income Tax Avoidance*, 60 COLUM. L. REV. 326 (1960). Note how the absence of the above-mentioned restriction makes the interest-free loan a comparatively more attractive means of conferring a benefit even before any consideration of the tax advantage.

40. There are many situations, of course, in which the settlor/donor requires that the funds be professionally or at least objectively managed. In those instances, the interest-free loan would not be a feasible alternative to the trust.

41. Treas. Reg. § 25.2511-2(f), T.D. 6334, 1958-2 C.B. 643, 648-49.

42. *See* O'Hare, *supra* note 15, at 1091-93; 65 MICH. L. REV. 1014, 1017-18 (1967); 19 STAN. L. REV. 870, 875-76 (1967).

At the least, this apparent inconsistency would seem to place a burden on a court to either distinguish the two situations factually or, alternatively, to declare the justifying policy. Conservative estate planners may therefore choose not to rely on *Crown* in spite of the obvious tax advantage that can be obtained through the interest-free loan.[43]

C. *Forgiveness of Indebtedness*

The Internal Revenue Code[44] has long provided that the forgiveness of a debt may result in income to the debtor,[45] at least in those situations in which the forgiveness did not qualify as a gift for the purposes of section 102.[46] In the gift tax area, taxable transfers have been found when a part of the principal of a loan has been forgiven,[47] and, more recently, when only the previously stated interest charge has been forgiven.[48] This latter development casts doubt upon the *Johnson/Crown* logic. Suppose Areljay, Co., instead of making interest-free loans from the start, had simply made conventional loans to the twenty-four trusts and had later *forgiven* the interest on these conventional loans. Although the transactions would be in substance the same as in *Crown*, the tax result is different; that is, under existing law a taxable transfer would have been made. Estate planners, though perhaps hard put to explain such anomalies, must learn to recognize those situations in which form seems to prevail over substance. This situation has led at least one estate planner to warn that

43. R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION § 2511, at 9-7 (3d ed. 1974) (the logic of Rev. Rul. 73-61 is "a difficult proposition to refute. . . . [I]t seems that the Service might be entitled to a legislative assist in support of its basically reasonable position"). *But see* Horvitz, *Planning an Effective Gift-Giving Program*, 10 INST. EST. PLAN. ¶ 1700 at 17-1, ¶ 1706.2 at 17-31 (1976) (Service position is "harsh" and "not supported by case law"); Snyder, *Leading a Tax-Sheltered Life*, 25 N.Y.U. INST. FED. TAX. 765, 786 n.49 (1967) (*Johnson* was "correctly decided").

44. I.R.C. § 61(a)(12).

45. *See* Commissioner v. Jacobson, 336 U.S. 28 (1949).

46. *See* Helvering v. American Dental Co., 318 U.S. 322 (1943).

47. Janie Braddock Ogle, 36 B.T.A. 1329 (1937). The forgiveness of indebtedness may not result in income to the debtor in certain other well-defined situations. For example, when the relationship between the debtor and creditor is that of buyer and seller, the forgiveness may be treated simply as a reduction in the purchase price. Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940). Furthermore, when the debtor remains insolvent after the forgiveness of indebtedness, he may be deemed to have realized no income on the theory that "gain" begins at the point of solvency. Lakeland Grocery Co., 36 B.T.A. 289 (1937). Of similar import are the regulations under § 61, which provide that no income is realized by a debtor whose debts have been discharged under the Bankruptcy Act or under a common-law proceeding for debtor relief, provided that the debtor's liabilities continue to exceed his assets immediately after the discharge. Treas. Reg. § 1.61-12(b), 26 C.F.R. § 1.61-12(b) (1977).

48. Republic Petroleum Corp. v. United States, 397 F. Supp. 900 (E.D. La. 1975). The regulations strongly suggest this result. *See* Treas. Reg. § 25.2511-1(a), T.D. 6334, 1958-2 C.B. 627, 643 ("a taxable transfer may be effected by . . . the forgiving of a debt").

if an interest-free loan is intended, it should be executed as such from the start.[49]

It should be noted before leaving this topic that a conceptual distinction can be made, and was made at trial,[50] between the interest-free loan and the forgiveness of indebtedness. The interest-free loan arguably does nothing to diminish the lender's estate, since there was never any legal right in the estate to receive interest. Following this line of reasoning, the forgiveness of indebtedness, however, does result in a diminution of the lender's estate since the estate's legal right to interest has been extinguished. The fallacy of this argument as applied to the gift tax can be shown by an examination of the dual purpose of the gift tax. Its purpose was not only to prevent depletion of the estate before death (and thereby assure the efficacy of the estate tax), but also to prevent income-splitting among family members (to assure the efficacy of the income tax).[51] Therefore, since both the interest-free loan and the forgiveness of indebtedness result in a gain to the debtor, the effect of either transaction should, in a family context, be taxable under the second "prong" of the gift tax irrespective of any gain or loss to the estate of the lender.

D. *The "Split-Dollar" Insurance Plans*

Under the typical "split-dollar" insurance plan, the employer and the employee will share the costs of a whole-life policy on the life of the employee. The employer pays a part of the premium equal to the increase in the cash surrender value of the policy; the employee pays the remainder. Upon the death of the employee or the surrender of the policy (usually when employment is terminated), the employer receives that part of the proceeds equal to the cash surrender value; the beneficiary designated by the employee then receives the remainder of the proceeds.

This arrangement proved to be very popular.[52] After the first few years, the employee's portion of the premiums has diminished

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49. Horvitz, *supra* note 43, ¶ 1700, at 17-32. The same warning is found in 46 J. TAX. 375, 376 (1977).

50. Brief for Petitioner at 20-23, Crown v. Commissioner, 67 T.C. 1060, *appeal docketed*, No. 77-1898 (7th Cir. July 1, 1977).

51. *See* text accompanying note 1 *supra*.

52. It also proved to be susceptible to abuse. *See* H.R. REP. No. 749, 88th Cong., 2d Sess. 61 (1963), *reprinted in* 1964-1 (part 2) C.B. 125, 186:

> The attention of your committee has been called to instances where life, or other, insurance policies have been sold to individuals on the basis that they cost the individual little or nothing, and in some cases on the grounds that they actually result in a net profit for him. In such cases, the taxpayer each year borrows all, or a substantial part, of the funds necessary to pay the premium on the policy. If he is in a 50% (or higher) tax bracket, since the interest payments on such loans are presently deductible, the net interest cost to him is one-half or less of the interest payments he makes. The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal

considerably—perhaps even to nothing—[53] while policy coverage remains in force. In this way employers could provide an attractive fringe benefit, foregoing only the potential investment income of the "cash value" funds.

Much impetus was given to such plans by Revenue Ruling 55-713.[54] This ruling treated the insurance arrangement as though the employer had made annual loans without interest in an amount equal to the annual increases in the cash surrender value.[55] This analysis would seem to comport with the substance of the transaction, since a whole-life insurance policy is essentially nothing more than an investment of principal, the interest from which goes to pay for insurance protection. Thus, the cash value of the policy was "loaned" to the employee while he lived without any interest charge; the employee then used the investment income from these funds to provide insurance protection for his beneficiaries. Since the arrangement is essentially an interest-free loan, the employee realizes no income under the ruling.

The Treasury became concerned with the proliferation of the split-dollar plans following Revenue Ruling 55-713. When Congress was asked for assistance in 1962, its response was to suggest that a problem that was administratively created, *i.e.*, by Revenue Ruling 55-713, could be administratively solved.[56] The result was Revenue Ruling 64-328, which effectively plugged the income tax "loophole" of Revenue Ruling 55-713. To accomplish this end, however, the Service employed some rather oblique reasoning. It purported to discard the analysis of Revenue Ruling 55-713 described above, yet recognized that, in essence, "[t]he effect of the arrangement . . . is that the earnings on the investment element in the contract are applied to provide current life insurance protection to the employee from year to year, without cost to the employee."[57] The Service thus took the position that the employer is providing a benefit to the employee for which the

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> or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured. Because of this, some insurance companies have sold insurance policies under plans which provide for the taxpayer borrowing the premiums either directly from the insurer, or from a bank or otherwise, primarily on the grounds that the policies are tax-saving devices. Your committee doubts that the sale of insurance on such a basis is either desirable or fair to taxpayers generally.

This language is repeated in S. REP. No. 830, 88th Cong., 2d Sess. 77-78 (1963), *reprinted in* 1964-1 (Part 2) C.B. 505, 582.

53. *See* the chart in Rev. Rul. 64-328, 1964-2 C.B. 11, at 14.

54. 1955-2 C.B. 23.

55. Thus, the employee received no income as a result of the employer's payments and the employer received no deduction.

56. *See* H.R. REP. No. 749, *supra* note 52, at 62.

57. 1964-2 C.B. 11, at 13.

employee is paying either very little or perhaps nothing. It proceeded to value this benefit on the basis of what the employee would have had to pay for one year of term insurance at the same level of coverage, minus the payment actually made by the employee. Under the ruling, this difference represents the income realized by the employee.

The Service is, of course, right that the employee has realized income. However, its job would have been much easier had it not been faced with the judicial resistance to the taxation of interest-free loans. This resistance compelled the Service to characterize the split-dollar plan in such a way that it would not appear to be merely the use of funds (for insurance purposes), which in fact it is. Stated another way, the illogical refusal of the courts to tax the use of money while at the same time recognizing the concept of compensation in kind has induced the Service, in Revenue Ruling 64-328, to make a distinction where there is no difference.[58]

Revenue Ruling 64-328 has not been judicially tested.[59] The ruling taxes split-dollar insurance, which is indistinguishable in substance from an interest-free loan. If the Service succeeds in obtaining judicial approval for this ruling, its argument for taxing all forms of interest-free loans, including those between family members, will be strengthened.[60]

E. *Section 483's Imputation of Interest*

Section 483 of the Internal Revenue Code imputes interest[61] as a component of certain deferred payments[62] made in the sale or exchange of property. The purpose of section 483 was to equalize the tax treatment of the seller who charged interest on deferred payments and the seller who made no provision for interest but would simply fix a higher selling price for the property. Absent section 483, this hiding of the interest payments in the selling price would enable the seller to have interest payments, usually taxed as ordinary income, taxed at capital gains rates.[63]

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58. *See* Schlifke, *supra* note 21, at 548.

59. Genschaft v. Commissioner, 64 T.C. 282 (1975), would appear to support Revenue Ruling 64-328, but in fact never reached the issue of the interest-free loan.

60. Indeed, many family arrangements are more directly suggestive of gift than income tax problems. For examples of split-dollar arrangements within the family, see Snyder, *supra* note 43, at 785 n.46.

61. Interest is currently imputed on payments to which § 483 applies at the rate of 7% per annum, compounded semi-annually. Treas. Reg. § 1.483(c)(2)(ii)(B), T.D. 7394, 1976-1 C.B. 135, 137. Imputed interest rates under §§ 482 and 483 were raised in 1976 to "better reflect prevailing interest rates." T.D. 7394, 1976-1 C.B. 135, 135.

62. Generally, interest is imputed in the case of payments that are made more than six months from the date of sale and that total more than $3000. *See* I.R.C. § 483(c)(1), (f)(1). Thus, through the operation of a kind of de minimis rule, the familiar "90 days same as cash" retail sales agreement escapes the imputation of interest.

63. The legislative history discloses Congress' disapproval of the interest-free loan as a means of tax avoidance:

The *Johnson* court made the assertion, repeated in *Crown*,[64] that "[t]he right to interest must arise from an express or implied contractual obligation or from statute."[65] Section 483, however, imputes interest in situations in which interest is neither provided for by the contract or required by state law. It is a "substance over form" provision. In combination with section 482, which authorizes the Service to reallocate income and deductions between related companies "in order to prevent evasion of taxes or clearly to reflect the income" of such companies, section 483 pronounces clearly the legislative policy in favor of recognizing the interest component of a transaction, even where no interest is expressly stated.

The majority in *Crown* apparently found the issue of imputed interest broad enough to embrace both the income and gift tax laws. It cited failures[66] of the Service to enforce section 482 in support of its decision not to find a gift of interest on the facts presented.[67] It would seem to follow that in future cases the Tax Court might be

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> Your committee sees no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments. In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. . . . Your committee believes that manipulation of the tax laws in such a manner is undesirable and that corrective action is needed.

H.R. REP. No. 749, 88th Cong., 2d Sess. 72 (1973), *reprinted in* 1964-1 (Part 2) C.B. 1251, 1961. This language is repeated verbatim in the Senate Report. S. REP. No. 830, 88th Cong., 2d Sess. 102 (1973), *reprinted in* 1974-1 (Part 2) C.B. 505, 606.

64. 67 T.C. 1060, 1064, *appeal docketed*, No. 77-1898 (7th Cir. July 1, 1977).

65. 254 F. Supp. 73, 77 (N.D. Tex. 1966). The court's rejection of the rationale of B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972), seems especially questionable since that case specifically requires the imputation of interest in the case of an interest-free loan and is the first of a line of cases taking that view. *See* Kerry Investment Co. v. Commissioner, 500 F.2d 108 (9th Cir. 1974); Kahler Corp. v. Commissioner, 486 F.2d 1 (8th Cir. 1973); Latham Park Manor, Inc. v. Commissioner, 69 T.C. No. 15 (Nov. 9, 1977); Collins Electrical Co. v. Commissioner, 67 T.C. 911 (1977). These cases allocate income or deductions between parents and subsidiaries in order to properly account for the benefit conferred by the interest-free loans. Their relevance to the general issue in *Crown* is indicated by the following statement from *Kerry Investment Co.*:

> When a taxpayer lends $500,000 to a wholly-owned subsidiary without interest, it is obvious that the lender is likely divesting itself of interest income that it could have earned by making interest-bearing loans in a competitive market. When such an interest-free loan is made, we see no reason why an allocation of some income on the loan should not be made to taxpayer even if the interest-free loan did not result in the production of gross income.

500 F.2d at 109-10.

66. *E.g.*, Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940); Smith-Bridgman & Co., 16 T.C. 287 (1951), *acq.* 1951-1 C.B. 3.

67. The court noted the more recent success of the Service in B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir.), *cert. denied* 407 U.S. 934 (1972), but apparently found this case unconvincing precedent in light of a Tax Court case, Fitzgerald Motor Co. v. Commissioner, 60 T.C. 957 (1973), *aff'd on other grounds*, 508 F.2d 1096 (5th Cir. 1975). The court's reasoning here is unclear, since *Fitzgerald* upholds the allocation of interest under § 482 and cites *B. Forman* as authority.

persuaded to take cognizance of the policy expressed by section 483, and, in doing so, reverse *Crown.*[68]

F. *The Charitable Deduction for Interest-Free Loans*

A relatively recent development in the area of deductions casts some doubt on the holding in *Crown.* In *Mason v. United States,*[69] a 1975 decision from the Seventh Circuit, a taxpayer was allowed a charitable deduction[70] for his failure to charge the market rate of interest on a loan to a charitable organization.[71] "Although," as co-counsel for the taxpayer later noted, "this decision was favorable to the taxpayer because it involved the question of a charitable deduction, it may provide support for the position of the IRS that interest-free loans . . . from one family member to another result in a taxable gift for gift tax purposes."[72] The taxpayer in *Crown* questioned the applicability of an income tax precedent in a gift tax context.[73] A "strong congressional policy in favor of public philanthrophy," it was argued, could justify the holding in *Mason* that a low-interest loan resulted in a deductible charitable contribution without affecting the gift tax status of a similar loan made to a family member.[74] However, there is no reason to believe that the underlying rationale of *Mason,* a case decided by the same court to which *Crown* has been appealed, might not be carried over into the gift tax area in the interest of conceptual consistency. Furthermore, it can be persuasively argued that if the failure to charge interest is a sufficient donation to qualify for the income tax deduction, it surely ought to qualify as a gift for purposes of section 2511, which does not even require donative intent.[75]

Of similar import to the problem of determining whether a gift

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68. Section 482 has been construed by commentators to apply *directly* to the intra-family loan situation. Under this analysis, members of the same family could be "controlled taxpayers" for the purposes of § 482 and the regulations thereunder. *See* Feinschreiber & Granwell, *IRS Imputes Interest on Loans Between Family Members,* 51 TAXES 294, 299 (1973).

69. 513 F.2d 25 (7th Cir. 1975).

70. I.R.C. § 170 allows a deduction for certain charitable contributions.

71. The facts stated in the text have been simplified. The taxpayer was one of three stockholders of a corporation operating a blood bank. At the time this business was sold to a charity, his interest in the corporation had a fair market value of $117,000. In exchange for his interest in the corporation, the taxpayer received $4,507.50 in cash and a note for $112,689.42, payable in 20 annual installments at 4% interest. Discounted to the time of the transaction, the 4% note had a fair market value of only $81,000. Therefore, the taxpayer had transferred to a charity property worth $117,000 and received in exchange cash and a note worth a total of $85,507.50. The difference of $31,492.50 was the amount claimed as a charitable deduction.

72. Duhl & Fine, *New Case Allowing Interest Deduction Calls for Reappraisal of Interest-Free Loans,* 44 J. TAX. 34, 34 (1976).

73. Brief for Petitioner at 7-8, Crown v. Commissioner, 67 T.C. 1060, *appeal docketed,* No. 77-1898 (7th Cir. July 1, 1977).

74. *Id.* at 7.

75. *See* Treas. Reg. § 25.2511-1(g)(1), T.D. 6334, 1958-2 C.B. 627, 645.

has been made is Revenue Ruling 64-274.[76] The relevance of this ruling stems from the similarity between charitable activity and the making of an interest-free loan, namely, that both involve the transfer of a benefit without consideration or *quid pro quo*. In the ruling, a nonprofit organization supplied housing, books, and instructional materials or loans without interest for the purchase of those items to needy but deserving students. Advice was requested regarding whether the organization was "organized and operated exclusively for . . . charitable . . . purposes" and thus exempt from federal income taxes under section 501(c)(3). The ruling found that the organization qualified for the exemption. It is not clear from the ruling whether the making of interest-free loans alone would have qualified the organization. However, since the language of the ruling included the loan-making in the same category as other clearly charitable activities, it would not be unreasonable to make this inference.

G. *Congressional Hostility Toward Interest-Free Loans*

One curious note may be added[77] in evaluating the future of the interest-free loan as a nontaxable transfer. This is, that whatever Congress may think of interest-free loans between family members, it apparently has no desire whatever to itself make such "loans" to individual American taxpayers. In looking at the legislative histories of some recent tax measures, one can find evidence of hostility to income tax techniques that result in the equivalent of an interest-free loan from the government. The 1969 Tax Reform Act, for example, imposed an interest charge on certain payments from accumulation trusts.[78] The lawmakers reasoned that

> this interest charge is necessary because, otherwise, the deferral of the payment of the additional tax (*i.e.*, from the time the income is taxed to the trust until the time when the remainder of the tax is paid on the ac-

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76. 1964-2 C.B. 141.

77. A section dealing with the imputation of interest in equity might also have been included in the discussion. It is not difficult to find judicial generalizations to the effect that "in practice a court should charge and allow interest in accordance with principles of equity in order to accomplish justice in each particular case." Small v. Schuncke, 42 N.J. 407, 415-16, 201 A.2d 56, 60 (1954). The problem of whether interest should be charged as an equitable matter frequently arises in the assessment of damages. *See* 22 AM. JUR. 2d *Damages* §§ 179-94 (1965). For a citation to cases going both ways on the issue of imputing interest as an element of damages, see 5 HOUS. L. REV. 138, 141 n.25 (1967). However, the application of equitable principles in federal tax law is an uncertain matter at best. Perhaps the closest approximation of "tax chancery" to be found in the cases is the occasional tendency of courts to invoke the vague notion of "taxpayer equity" in support of a particular statutory construction. *See* Haft Trust v. Commissioner, 510 F.2d 43, 48 (1st Cir. 1975) (increase in administrative inconvenience is tolerable when "taxpayer equity" is at stake).

78. Act of Dec. 30, 1969, Pub. L. No. 91-172, §§ 331-32, 83 Stat. 487. An accumulation trust is a trust which may accumulate income, there being no requirement to distribute all current income. *See* Treas. Reg. §§ 1.651(a)-1, 1.661(a)-1 (1960).

> cumulation distribution by the beneficiary) amounts, in effect, to an *interest-free loan* to the beneficiary by the government.[79]

The legislative histories of the 1969 changes on deductions for real estate depreciation[80] and the 1976 changes on tax shelters[81] included the same complaint. These oblique references to the interest-free loan do not bear directly upon any of the gift tax provisions. They do, however, provide some indication of how Congress might respond to the issue in *Crown* in that they are founded on the assumption that an interest-free loan does in fact confer a benefit of some kind that is free of taxation to the recipient. Both the *Johnson* and the *Crown* courts stated that the initiative on the gift tax issue rested with Congress and not the courts. The indirect application of the legislative histories referred to above, while certainly representing no "initiative" on the specific gift tax issue, might, in combination with the administrative opinion expressed in Revenue Ruling 73-61,[82] work to convice some courts that the legislative intent behind the gift tax supports the interpretation sought by the Internal Revenue Service in *Johnson* and *Crown.*

IV. THE VALUATION PROBLEM

Should a gift be found, the next task is to value it. This section will examine the rationale behind and the problems attending some of the possible approaches to valuation.

Revenue Ruling 73-61 states that "[t]he rate of interest that would represent full and adequate consideration may vary, depending on the actual circumstances pertaining to the transaction."[83] Further, on the facts of the ruling (a term note from a son to his father) it was found that "the value of the right to the use of the money loaned is ascertainable by accepted actuarial methods, as of the date the money and the note were exchanged, and is, therefore, subject to the gift tax at that time."[84] Thus, the ruling suggests a variable "fair market value" approach at the outset, but then ambiguously refers to the regulations,[85] which provide for a flat 6% rate.[86] A number of approaches

79. S. REP. No. 91-552, 91st Cong., 1st Sess. 326 (1969), *reprinted in* 1969-3 C.B. 505 (emphasis added).

80. *Id.* at 326, 1969-3 C.B. 628.

81. H.R. REP. No. 94-658, 94th Cong., 2d Sess. 25 (1975), *reprinted in* 1976-3 C.B. 717.

82. 1973-1 C.B. 408.

83. *Id.* at 409.

84. *Id.*

85. *See* Treas. Reg. § 25.2512-5.

86. The reference here is apparently intended as an example only. Certain of the regulations under § 25.2512 deal with the valuation for gift tax purposes of annuities, life estates, terms for years, remainders and reversions. In the case of interests that are dependent on the continuation or termination of more than one life, or for which there is a term certain concurrent with one or more lives, or in which the retained interest in the donor is conditioned upon

to the problem of valuation might be taken under this nebulous standard.

One approach would be to tax the donor only to the extent that income was actually produced by the funds. This approach is strictly the most logical in that it recognizes only the benefit actually conferred upon the borrower; moreover, it is a much fairer approach when the donor has restricted the uses to which the funds may be put.[87] However, this analysis runs contrary to the general business notion that the use of money is something that has a value whether or not it is wisely invested,[88] and also might prove administratively impractical in cases in which the gift funds have been widely dispersed in a complicated investment program.

A "fair market value" approach seems to be suggested by the references to varying conditions and "actuarial methods." This approach has a certain appeal when the object is to determine what rate *would have been* charged in an arm's-length transaction. For example, in the situation in which a father himself borrowed money to make an interest-free loan to his son, it might seem appropriate to use the interest rate that the father actually paid as the value of the gift. However, this analysis fails to recognize that the true "market" situation would be one in which the son himself had obtained the loan in an arm's-length transaction. Thus, where the son has no substantial assets with which to secure the loan, the loan would have been at a very high rate of interest or perhaps would not have been made at all. The "fair market value" approach therefore presents two problems; first, ascertaining what the market rates of interest were and, second, determining the configurations of a hypothetical debtor-creditor relationship.

Administratively, then, the most attractive alternative is simply to value the gift at a flat rate prescribed by the regulations.[89] As one commentator has noted,[90] this will still permit some degree of gift tax avoidance when the market rates remain above the prescribed rate. Here, the Service must balance the possibility of tax avoidance against the potential savings in administrative costs and the benefits of added predictability.

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survivorship, the regulations apply a flat 6% rate to values determined by reference to actuarial tables. This 6% rate is the rate provided for by Treas. Reg. § 25.2512-9(e) (1970), which is apparently the intended citation. Treas. Reg. § 25.2512-5, T.D. 7077, 1970-2 C.B. 183, 188-92, applies only to transfers after December 31, 1970.

87. *See* Schlifke, *supra* note 21, at 551.

88. *See generally* cases cited note at 65 *supra*.

89. *Cf.* Kahler v. Commissioner, 486 F.2d 1 (8th Cir. 1973) (when parent corporation borrowed money in the marketplace at more than 5% and then re-loaned the money interest-free to a subsidiary, the Commissioner imputed income at a flat 5% rate).

90. O'Hare, *supra* note 15, at 1090-91.

V. Conclusion

Under *Crown* and its earlier incarnations, it is clear that means exist by which the use of an apparently unlimited amount of property can be transferred free of federal gift taxes, at least within a family setting. The vehicle for this transfer is the interest-free loan. In failing to recognize the taxable quality of this transaction, the Tax Court assumed a position contrary to the broad principles of federal taxation, as comparisons with analogous income tax situations demonstrate.

Crown now awaits disposition in the Court of Appeals for the Seventh Circuit. On behalf of the taxpayer it might be argued that the Tax Court holding serves the policy against intrusion into the family unit and the policy in favor of gift-giving in general. However, the impact of these arguments ought to be diminished by the exclusions from the tax that have always been provided by the Code. They permit a great deal of gift-giving[91] before threshold levels of taxation are reached, and thus contribute directly to the recognition of the pro-taxpayer policies just mentioned.

In the future, the courts should carefully scrutinize the interest-free loan in order that they might discern more clearly the economic realities involved.[92] The use of money is a manifestly valuable and highly sought-after commodity in a sophisticated, modern economy. The transfer of this use without full and adequate consideration would appear to have all the characteristics of a taxable gift.[93]

Kimball H. Carey

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91. A taxpayer can give away $3000 in any taxable year to any given donee before incurring any gift tax liability. I.R.C. § 2503. In addition to this annual exclusion, the pre-1977 law provided for a lifetime exemption of $30,000 per donor. Int. Rev. Code of 1954, ch. 736, § 102(c)(1), 68A Stat. 410 (replaced by I.R.C. § 2505). Thus, by splitting their gifts, I.R.C. § 2513, a husband and wife could give away tax-free $6000 in annual installments, divided among as many donees as they wished, plus $60,000 more in excess of these yearly amounts. The $30,000 lifetime exemption has been replaced with a unified gift tax credit of $47,000 to be phased in by 1981. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1849 (codified at I.R.C. § 2505).

92. A change in the regulations might work to effect a shift in judicial thinking on this subject, as appears to have happened in the case of § 482. 46 J. Tax. 375, 376 (1977). *See also* E. Griswold, Cases and Materials on Federal Taxation 165 (6th ed. 1966).

93. For a recent commentary on *Crown* that reaches a different conclusion, see Frazier, *Interest-Free Loans Between Family Members: What Practitioners Can Expect After Crown*, 48 J. Tax 28 (1978). This article, which appeared as this Case Comment was going to print, asserted, *inter alia*, that (1) the benefit conferred upon the recipient of an interest-free loan does not constitute "property" for gift tax purposes, (2) at the instant that a *demand* loan is made, the value of the promise to repay equals the amount of the loan, so that there is no gift at that time, and (3) since the duration of a demand loan is uncertain, it is an "open" transaction that, under prevailing gift tax principles, is not taxable until the loan is called in.