Volume 23 | Issue 3 Article 10

1978

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Recommended Citation

Lee H. Stein, *Federal Gift and Estate Tax - Interest-Fre Loans - Intrafamily Interest-Free Loans are Not Taxable Transfers for Purposes of I.R.C.*, 23 Vill. L. Rev. 625 (1978).
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affirmative governmental action in protecting and advancing his constitutional rights, will need to be clarified in the future.

Amanda M. Shaw

FEDERAL GIFT AND ESTATE TAX — INTEREST-FREE LOANS — INTRAFAMILY INTEREST-FREE LOANS ARE NOT TAXABLE TRANSFERS FOR PURPOSES OF I.R.C. § 2501. *Crown v. Commissioner,* (T.C. 1977).

A gift tax deficiency[1] was assessed against the taxpayer, Lester Crown, as a result of certain interest-free loans extended by a partnership,[2] in which he had a one-third interest, to twenty-four trusts.[3] The trusts involved were created for the benefit of the children and other relatives of the partners.[4] Loans in excess of eighteen million dollars[5] were executed as either demand notes or as loans with fixed maturity dates.[6] The Internal Revenue Service (Service), relying on an earlier Revenue Ruling,[7] determined that the loans constituted gifts to the borrowers to the extent of the value of the use of the money loaned.[8] In computing this value, the Service utilized an interest rate

1. Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by gift. I.R.C. § 2501. The statute is comprehensive in nature and I.R.C. § 2511 provides:

> Subject to the limitations contained in this chapter, the 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, but in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States.

I.R.C. § 2511(a). The regulations provide:

> The tax applies to all transfers by gift of property, wherever situated, by an individual who is a citizen or resident of the United States, to the extent the value of the transfers exceeds the amount of the exclusions authorized by section 2503 and the deductions authorized by sections 2521, 2522, and 2523.

Treas. Reg. § 25.2501-1(a)(1), T.D. 7296, 1974-1 C.B. 255.

2. Crown v. Commissioner, 67 T.C. 1060, 1061 (1977). The partnership, the Areljay Company, was an Illinois general partnership formed in 1944. *Id.* at 1060. The three equal partners were the petitioner and his two brothers. *Id.*

3. *Id.* at 1060-61.

4. *Id.* at 1061.

5. *Id.* The loans were created at various times. *Id.* Prior to January 3, 1967, the majority of loans recorded were noninterest bearing demand notes aggregating $2,262,574. *Id.* However, on that date, separate open account loans totalling $15,960,000 were made to the 24 trusts. *Id.* The loans outstanding at the end of 1967 consisted of $2,073,649 in demand notes and $15,956,375 on open account. *Id.* While the open account loans had no provision with respect to interest, all of the demand notes provided for interest at six percent per annum *after* demand. *Id.*

6. *Id.* A demand obligation is the use of capital at the will of the lender, which may be recalled at any point in time. BLACK'S LAW DICTIONARY 517 (4th ed. 1951).

7. Rev. Rul. 73-61, 1973-1 C.B. 408. *See* notes 29 & 30 and accompanying text *infra*.

8. 67 T.C. at 1062.

of six percent per annum.[9] The Tax Court entered a decision for the taxpayer, *holding* that since the principal of the loan would not escape taxation in the taxpayer's estate at the time of his death and since the subjection of intrafamily sharing of property to the gift tax laws would create severe administrative problems, the gift tax would not be applied to intrafamily interest-free loans. *Crown v. Commissioner,* 67 T.C. 1060 (1977).

The congressional purpose underlying the imposition of the gift tax provisions was to tax all inter vivos transactions which operated to pass property for less than an adequate and full consideration.[10] The Supreme Court has emphasized that the congressional intent was to control the passage of the economic benefits in property for which full value had not been received.[11] Under the Internal Revenue Code (Code), the three requirements for imposition of the gift tax[12] are simply a transfer[13] of property[14]

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9. *Id.* at 1061. The Service calculated the rate of interest at six percent, based upon market factors involving arm's-length transactions. *Id.* The interest computed on the total indebtedness amounted to $1,086,407.75 and one-third of this amount ($362,135.92) was attributed to the petitioner as a result of his interest in the partnership. *Id.* at 1061-62. The Service presented no evidence as to why it deemed a six percent interest rate proper, though it was presumably used because it is the rate utilized by the regulations for valuing annuities and life estates created during 1971 or afterwards. Treas. Reg. § 25.2512-9 (1977). One commentator has stated that in certain situations it is unrealistic to value demand notes and fixed maturity indebtedness in the same manner. *See* E. HELFERT, TECHNIQUES OF FINANCIAL ANALYSIS 127-45 (1972). Market analysis indicates that the value of the right to use money on a demand basis is less than the right to use the same amount of money for a fixed time period. *Id.* at 137-38. This difference results from the inability to calculate the present value of demand obligations since it is not known how long the debt will be outstanding; the amount of such discount will increase in proportion to the amount of time the demand loans remain unpaid. *Id.* at 129-30.

10. *See* H.R. REP. No. 708, 72d Cong., 1st Sess. 27-28 (1932).

11. *See, e.g.,* Commissioner v. Wemyss, 324 U.S. 303 (1945); Merrill v. Fahs, 324 U.S. 308 (1945); Robinette v. Helvering, 318 U.S. 184 (1943); Estate of Sanford v. Commissioner, 308 U.S. 39 (1939). The Supreme Court has addressed the purposes underlying the gift tax and stated that the tax is *in pari materia* with the estate tax. Burnet v. Guggenheim, 288 U.S. 280, 286 (1933). Additionally, it has been stated that "the purpose of the gift tax is to complement the estate tax by preventing tax-free depletion of the transferor's estate during his lifetime." Harris v. Commissioner, 340 U.S. 106, 107 (1950). By use of the gift tax, Congress intended "to hit all the protean arrangements which the wit of man can devise that are not business transactions." Commissioner v. Wemyss, 324 U.S. at 306.

12. *See* I.R.C. § 2501; note 1 *supra. See also* Note, *The Value of the Use of Money Loaned by Taxpayers to Their Children Without Interest Does Not Constitute a Gift,* 5 HOUS. L. REV. 138 (1967).

13. *See* Treas. Regs. § 25.2511-1 to 3, T.D. 7296, 1974-1 C.B. 255. A transfer is complete as to "any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another." Treas. Reg. 25.2511-2(b), T.D. 7238, 1973-1 C.B. 544.

14. It has been stated that "any object is property, and . . . the right to use an object is property." Note, *supra* note 12, at 139. Property has been defined "to denote everything which is the subject of ownership, corporael or incorporael, tangible or intangible, visible or invisible, real or personal; everything that has an exchangeable value or which goes to make up wealth or estate. It extends to every species of valuable right and interest . . . ." BLACK'S LAW DICTIONARY 1382 (4th ed. 1951). The committee reports relating to § 2511 of the Code stated that "[t]he terms 'property', 'transfer', 'gift' and 'indirectly' are used in the broadest and most comprehensive

for less than adequate monetary consideration.[15] In *Commissioner v. Wemyss,*[16] the Supreme Court determined that absence of donative intent did not preclude a finding that the transfer of stock by an individual to his prospective wife for less than adequate monetary consideration was a gift for purposes of the gift tax.[17]

In the 1953 case of *Gertrude H. Blackburn,*[18] the Commissioner of Internal Revenue (Commissioner) successfully maintained that between family members, the right to the use of money at less than a fair market rate of return constituted a gift for gift tax purposes.[19] In *Blackburn,* the taxpayer transferred a building to her children, taking in return a note bearing interest well below the market rate.[20] The Tax Court determined a portion of the transaction to be a gift and a portion to be a sale and concluded that a taxable gift[21] existed to the extent of the difference between the fair market value of the property and the fair market value of the note at time of transfer.[22]

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sense; the term 'property' reaching every species of right or interest protected by law and having an exchangeable value." H.R. REP. No. 708, 72d Cong., 1st Sess. 27 (1932); S. REP. No. 665, 72d Cong., 1st Sess. 39 (1932). *See* I.R.C. § 2511.

15. While the estate and gift tax laws are not always correlated, the phrase "adequate and full consideration in money or money's worth" has been held to have the same interpretation under both subtitles. Merrill v. Fahs, 324 U.S. 308 (1945). The Treasury Regulations under § 2043 provide that "[t]o constitute a bona fide sale for an adequate and full consideration in money or money's worth, the transfer must have been made in good faith, and the price must have been an adequate and full equivalent reducible to a money value." Treas. Reg. § 20.2043-1(a) (1977). In addition, another regulation provides:

> Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor.

Treas. Reg. § 25.2512-8 (1977). *See also* Note, *supra* note 12, at 140.

16. 324 U.S. 303 (1945).

17. *Id.* at 306, 308. Common law criteria of consideration, such as a promise to marry, were found equally irrelevant to the imposition of the gift tax. *Id.* at 305-06. Donative intent may be relevant in a bona fide business transaction where one party has made a bad bargain. Treas. Reg. § 25.2511-1(g)(1), T.D. 7296, 1974-1 C.B. 255. However, no genuine business transaction in which a party receives less than adequate consideration comes within the purview of gift tax. *Id.* § 25.2512-8, T.D. 6334, 1958-2 C.B. 627.

18. 20 T.C. 204 (1952).

19. *Id.* at 207.

20. *Id.* The parties stipulated the value of the real estate transferred to be $245,000 on the open market. *Id.* at 204. The record indicated that, while the note involved bore interest at the rate of 2.25% per annum, the market rate of interest on a similarly secured note would be 4% per annum. *Id.* at 207.

21. A "taxable gift" is defined under the regulations as the total amount of gifts made by the donor during a calendar quarter less certain deductions. Treas. Reg. § 25.2503-1, T.D. 7238, 1973-1 C.B. 544. The "total amount of gifts" is also defined by the regulations as "the sum of the values of the gifts made during the calendar quarter." *Id.*

22. 20 T.C. at 207.

Thirteen years later, in *Johnson v. United States,*[23] the United States District Court for the Northern District of Texas apparently disagreed with the Tax Court in *Blackburn* by holding that no gift tax should be imposed upon intrafamily interest-free demand loans.[24] In *Johnson,* substantial interest-free loans had been made by taxpayer parents to their children[25] over a period of eleven years.[26] At all relevant times the records and books of the parents indicated that a few gifts had been made, but the postings showed that the advances in question were bona fide interest-free loans, payable upon demand.[27] The *Johnson* court based its holding on the rationale that the principal of an interest-free loan would be included in the lender's gross estate and that, unlike a gift, the loan would not operate to reduce the estate tax realizable at death.[28] The Commissioner never appealed the decision in *Johnson* and never indicated his nonacquiescence to the holding. However, in Revenue Ruling 73-61,[29] commenting on an interest-free loan from a father to his son's closely held corporation, the Service took a position detrimental to the taxpayer and reiterated its assertion that the making of noninterest bearing loans constituted a taxable event.[30]

In contrast to the small number of cases that focus on the gift tax consequences flowing from the grant of interest-free loans,[31] the income tax consequences resulting from such loans have been widely litigated.[32] In *J. Simpson Dean,*[33] the Tax Court was confronted with a case in which a closely held corporation had made substantial loans to its shareholders on

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23. 254 F. Supp. 73 (N.D. Tex. 1966).
24. *Id.* at 77.
25. *Id.* at 73.
26. *Id.* at 74.
27. *Id.*
28. *Id.* at 77. The *Johnson* court relied heavily upon Harris v. Commissioner, 340 U.S. 106 (1950), and viewed the gift tax as a measure to prevent the evasion of estate taxes. 254 F. Supp. at 77. *See* note 11 *supra.*
29. Rev. Rul. 73-61, 1973-1 C.B. 408.
30. *Id.* at 409. In this ruling, the father had loaned $250,000 to his son's closely held corporation. *Id.* at 408. The Service adopted the following position:

> The 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. The tax in the instant case would be imposed on the value of the right to use the money. Such value is usually stated in terms of interest or some other equivalent in money or money's worth. The rate of interest that would represent full and adequate consideration may vary, depending upon the actual circumstances pertaining to the transaction.

Id. at 409 (citation omitted). The ruling was limited however, by the Service's statement that it would not be applicable in cases involving transfers falling within the purview of the annual exclusion. *Id.*
31. *See* notes 18-30 and accompanying text *supra.*
32. *See* notes 33-45 and accompanying text *infra.*
33. 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4. It is interesting to note that the Government did not appeal the decision and that it waited 12 years to indicate it's nonacquiescence. 1973-2 C.B. 4. For additional commentary on *Dean, see* Wilkes, *Tax Court Holds Interest-Free Loans to Shareholder Creates No Taxable Income,* 14 J. Tax. 351 (1961).

an interest-free basis.[34] The Commissioner argued that the value of the use of such funds was equal to the interest that could have been earned at the prime rate and that the shareholder taxpayers had realized income to the extent of that interest.[35] The *Dean* court ruled against the Commissioner, holding that the borrowers did not realize income from the interest-free corporate loans because the imputed interest would have entitled the taxpayers to a corresponding income tax deduction,[36] thus cancelling out any income.[37] The court never addressed the argument presented by the dissent which suggested placing the burden on *taxpayers* to prove that if they did in fact have an obligation to pay interest, they would have been entitled to deduct the interest from their gross income.[38] The principle that income will not be imputed to parties who do not actually receive it was upheld in the income tax case of *Combs Lumber Co. v. Commissioner.*[39] In that case, the court held that no interest income could be imputed to a borrower/shareholder lent money by a closely held corporation since the parties intended that no interest was to be charged.[40] In dealing with loans transacted between a parent corporation and a subsidiary, the Tax Court in *Smith-Bridgeman & Co.*[41] held that no improper shifting of funds existed because the statute involved[42] did not authorize the creation of income where neither party, in fact, had realized income.[43] This position has recently undergone reevaluation by the Second Circuit in *B. Foreman Co. v. Commissioner.*[44] In *Foreman,* the court held that the transaction of an interest-free loan between related entities was subject to section 482.[45]

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34. 35 T.C. at 1083.
35. *Id.* at 1087.
36. I.R.C. § 163.
37. 35 T.C. at 1090.
38. *Id.* at 1092 (Simpson, J., dissenting).
39. 41 B.T.A. 339, 343 (1940).
40. *Id.* at 343. The lack of intent to charge interest was evidenced by the failure of the lender corporation to accrue interest and the failure of the borrower shareholders to deduct interest on their respective books. *Id.*
41. 16 T.C. 287 (1951).
42. I.R.C. § 45.
43. 16 T.C. at 294. *See, e.g.,* Kahler Corp. v. Commissioner, 58 T.C. 496 (1972), *nonacq.* 1972-2 C.B. 3, 5; Kerry Inv. Co. v. Commissioner, 58 T.C. 479 (1972), *nonacq.* 1972-2 C.B. 3, 5; PPG Indus., Inc. 55 T.C. 928 (1970). *See also* Seghers, *The Recent PPG Case: Is it a Blueprint to Balance the IRS's 482 Allocation Powers?,* 34 J. OF TAX. 370 (1971).
44. 453 F.2d 1144 (2d Cir.), *cert. denied,* 407 U.S. 934 (1972).
45. *Id.* at 1147. *See* note 87 *infra. See also* Crawford, *Are the Courts Expanding the Scope of Code Section 482?,* 36 J. OF TAX. 150 (1972); Nauheim, *B. Foreman & Co., Inc. — A Crucial Test of the Future of Section 482,* 26 TAX LAW. 107 (1972).

In other contexts, courts have taken conflicting viewpoints as to the taxable effect of certain transactions. In Mason v. Commissioner, 513 F.2d 25 (7th Cir. 1975), the Seventh Circuit held that the value forgone by a taxpayer in a transaction with a charity was allowable as an income tax deduction. *Id.* at 29. For a discussion of *Mason* and the probable impact thereof, *see* Duhl & Fine, *New Case Allowing Interest Deduction Calls for Reappraisal of No-Interest Loans,* 44 J. OF TAX. 34 (1976). *See also* Linett, *Tax Trends — Sec. 482: Interest Income "created" on Interest-Free Loans — CA-5 joins CA-2, CA-8, CA-9 v. TC,* 6 TAX ADIVSOR 380 (1975).

An interest-free loan has been held not to constitute additional compensation for income tax purposes in a real estate transaction amongst partners. Saunders v.

In evaluating the taxability of interest-free loans, the Tax Court[46] in *Crown* noted that only recently had the Service asserted that the existence of these loans created a taxable event,[47] even though "the statutory authorities offered in support of [the Service's] position have been in existence since the creation of our income and gift tax laws."[48] Since the issue *sub judice* was being considered by the Tax Court for the first time, the court referred to income tax as well as gift tax precedents.[49]

The *Crown* court determined that the gift tax need not be applied in the instant situation because the transaction involved herein would not act as a vehicle to avoid the estate tax.[50] In so doing, the court applied the rationale articulated in *Johnson* — since the outstanding indebtedness would be included in the lender's gross estate at death, the taxpayer would not circumvent the estate tax provisions.[51] Furthermore, addressing the argument that the lender's gross estate was effectively diminished as a result of the foregone interest, the court stated that no affirmative obligation exists which requires a taxpayer to invest his money.[52]

In the absence of express congressional mandate, the Tax Court refused to subject intrafamily interest-free loans to the gift tax.[53] The court, referring to the promulgation of regulations under section 482 of the Code,[54] noted the

United States, 294 F. Supp. 1276, 1282 (D. Haw. 1968), *rev'd on other grounds,* 450 F.2d 1047 (9th Cir. 1971). Recently, the decision in Joseph Lupowitz Sons v. Commissioner, 497 F.2d 862 (3d Cir. 1974), upheld the doctrine that interest-free transfers betwen two related corporations will not result in a constructive dividend being taxed to the shareholders solely by the existence of common ownership between the transacting corporations. *Id.* at 868.

46. Chief Judge Dawson wrote the majority opinion. Judge Simpson, joined by Judge Raum, Judge Tannenwald and Judge Wilber, wrote the dissenting opinion. Judges Drennen, Quealy and Hall did not participate.

47. 67 T.C. at 1063.

48. *Id.* at 1067. It is interesting to note that the majority made this assertion without discussing the 1953 Tax Court decision in Gertrude H. Blackburn, 20 T.C. 204 (1953). In that case, the Service assessed a gift tax deficiency against the taxpayer as the result of a sale of property to her children secured by a note well below market interest rates. *Id.* at 207. For a discussion of *Blackburn, see* notes 18-22 and accompanying text *supra.*

49. 67 T.C. at 1062, 1064. *See also* note 45 *supra.*

50. 67 T.C. at 1063-64. The court's position is apparently premised on the fact that the outstanding note, held by the lender, would be classified as § 2033 property and therefore included within the lender's gross estate at its fair market value on date of death or on the alternate valuation date. *See* I.R.C. § 2033. In general, "[t]he gross estate of a decedent . . . includes . . . the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death." Treas. Reg. § 20.2033-1(a), T.D. 6684, 1963-2 C.B. 411.

51. 67 T.C. at 1063. *See* notes 23-28 and accompanying text *supra.* One commentator has stated that *Johnson* was an important decision in "its realization that since the principal of the loans would remain in the lender's estate at death, nothing . . . permitted the lender to avoid future estate taxes by reducing his current estate by means of inter vivos gifts of principal." Linett, *Interest-Free Loans to Relatives Not Subject to Gift Tax,* 8 TAX ADVISOR 371, 372 (1977).

52. 67 T.C. at 1063-64.

53. *Id.* at 1064.

54. *Id. See* note 87 *infra.* The court made reference to this section to support its position that the legislature, not the courts, should cause the making of a noninterest-bearing loan to be a taxable event. 67 T.C. at 1064.

traditional position of the judiciary not to subject noninterest bearing instruments to the income tax or gift tax provisions.[55] Finally, the court recognized that without adequate congressional guidelines, the taxing of intrafamily sharing of property would be administratively unmanageable.[56]

In a dissenting opinion, Judge Simpson strongly disagreed with the majority's holding.[57] The dissent evaluated the congressional intentions behind the enactment of section 2511 and determined that, although no specific mention was made of interest-free loans within the statute or committee reports, the expansive language of the statute and regulations implicitly incorporated the right to use money as a property interest.[58] Accordingly, since a property interest was transferred for "less than an adequate and full consideration in money or money's worth,"[59] Judge Simpson believed that a gift tax should be imposed.[60] Additionally, the dissent asserted that an application of the *Wemyss* interpretation of "gift" mandated a result contrary to that reached by the majority.[61] Judge Simpson, relying on *Blackburn,* then valued the gift as the difference between the face value of the notes and their discounted values at the prevailing rate of interest.[62]

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55. 67 T.C. at 1064.

56. *Id.* at 1065. The court appeard to be considerably swayed by the administrative practicalities of imposing the gift tax and the majority implied that a strictly academic interpretation of the gift tax provisions would produce a contrary result. *Id.* The court stated: "Thus, we are inclined to follow in this area Justice Holmes' admonition that 'a page of history is worth a volume of logic.' " *Id.* (citations omitted).

57. *Id.* at 1065-70 (Simpson, J., dissenting).

58. *Id.* at 1066 (Simpson, J., dissenting). In discussing the valuation of transfers, the regulations speak in terms of valuing property:

> Transfers for insufficient consideration. Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth. A consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift.

Treas. Reg. § 25.2512-8 (1977). It is suggested that the attempt by the Treasury to reduce "sales, exchanges, and other dispositions of property" to a specific monetary value may reflect an implicit understanding that property equals money or money's worth. *See* note 15 *supra.*

59. 67 T.C. at 1061. *See* I.R.C. § 2512(b).

60. 67 T.C. at 1066-67 (Simpson, J., dissenting).

61. 67 T.C. at 1067 (Simpson, J., dissenting). *See* notes 16 & 17 and accompanying text *supra.*

62. 67 T.C. at 1068 (Simpson, J., dissenting) (citation omitted). It is suggested that the technique asserted by the dissent as the proper method of valuation of property exchanged is consistent with congressional intent as well as in accordance with the applicable provisions of the Treasury Regulations. The regulations provided that "[t]he value of the property [transferred] is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Treas. Reg. § 25.2512-1, T.D. 6826, 1965-2 C.B. 367. The rate of return utilized

As an alternative argument, the dissent analogized to the charitable deduction permitted in the income tax area for the free use of property.[63] Judge Simpson reasoned that if such use of property rights can provide a foundation for charitable deductions under the income tax, it must also constitute the foundation for a taxable gift.[64] Furthermore, the dissent disagreed with the district court decision in *Johnson*,[65] and determined that an interest-free loan might well deplete the taxpayer's taxable estate at death.[66] In support of this argument, Judge Simpson noted the situation in which the taxpayer/creditor dies before the date specified for repayment of principal.[67] Under such circumstances, the amount includable in his estate becomes not the face value of the note, but its value discounted to date of death.[68]

Although the majority analysis in *Crown* is subject to criticism,[69] it is submitted that the policy considerations involved provide a viable basis for supporting the instant decision. In this regard, the ramifications of a decision holding intrafamily transfers subject to gift tax would create

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in *Blackburn* was determined in relation to real estate loans executed in the locality of the transfer. G. H. Blackburn, 20 T.C. 204, 207 (1952). *See* notes 18-22 and accompanying text *supra*. The dissent noted that *Blackburn* permitted valuation at a figure of four percent per annum. 67 T.C. at 1068 (Simpson, J., dissenting). However, the dissent failed to mention that the *Blackburn* court determined such value to be the fair market rate of real estate loans as compared to the average prime rate calculated over the period of time involved. 20 T.C. at 207. The *Crown* court made reference to the average prime rate over the period of time involved when it evaluated the position of the Commissioner. 67 T.C. at 1061. In addition, the other authorities cited by the dissent involved the valuation of an annuity interest where the applicable rate to be imposed upon such transfers is set forth by the regulations. 67 T.C. at 1068-69, *citing* Estate of Koert Bartman, 10 T.C. 1075 (1949); Estate of Sarah A. Bergan, 1 T.C. 543 (1943). Accordingly, it is submitted that as the regulations fail to provide a uniform rate for other types of transfers, the dissent should have set forth a uniform standard to be utilized, rather than leave the determination of interest rates to the Commissioner without having provided any guidelines. A similar position was enunciated by one commentator in reviewing Revenue Ruling 73-61, 1973-1 C.B. 408. Note, *Gift Tax: Parent's Interest Free Loan to Son's Corporation Held Taxable Gift*, 4 TAX ADVISOR 175, 176 (1973). The commentator considered deficiencies to exist in the ruling's failure to cover understated interest, failure to provide a safe-haven, and failure to specify an interest-imputing rate. *Id.* at 176.

63. 67 T.C. at 1069 (Simpson, J., dissenting). *See* note 45 *supra*. *See also* Duhl & Fine, *supra* note 45, at 34.

64. 67 T.C. at 1069 (Simpson, J., dissenting).

65. *Id.* For a discussion of *Johnson*, *see* notes 23-30 and accompanying text *supra*.

66. 67 T.C. at 1069-70 (Simpson, J., dissenting).

67. *Id.*

68. 67 T.C. at 1069-70 (Simpson, J., dissenting). This argument may be demonstrated by reference to the value assigned to such property for estate tax purposes. The regulations provide:

> The value of every item of property includible in a decedent's gross estate . . . is its fair market value at the time of the decedent's death. . . . The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

Treas. Reg. §20.2031-1(b), T.D. 6826, 1965-2 C.B. 367. Accordingly, if the notes involved were outstanding at date of death, a considerably lower value would be placed on them than if they included a provision for accrued interest.

69. *See* notes 77-90 and accompanying text *infra*.

enormous problems of valuation and administration.[70] Moreover, specific guidelines and regulations would need to be promulgated in order to prevent increased litigation.[71] In addition, such a holding could possibly be interpreted as creating an obligation upon taxpayers to credit each use of the family car, television, or summer home to a gift account for a value equal to the fair market rental value of the item.[72] Then, at the end of the first calendar quarter when the account exceeded the section 2503(b) exclusion,[73] if available,[74] a gift tax return would be due.[75] Since it is not the function of the judiciary to enact regulations,[76] it is accordingly submitted that from a policy standpoint the court's action was sound.

The most serious objection to the majority's opinion is its failure to recognize the distinctions between the treatment of interest-free loans under the gift tax provisions of the Code and their treatment under the income tax provisions. Chapter twelve of subtitle B of the Code provides the specific statutory authority for the calculation and imposition of the gift tax.[77] In

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70. Linett, *supra* note 51, at 372. In discussing valuation and the process involved it has been stated:

> Valuation questions are primarily factual. Undoubtedly, most such controversies are settled in the administrative process, although litigation involving valuation is certainly common. As may be expected, the final determination of value often represents a compromise between the figure asserted by the taxpayer and that of the Commissioner. In general, any factor that reasonably would be considered in determining whether property should be purchased or sold is relevant in determining fair market value for estate tax purposes. Such factors include income yield, appraisals, sales prices of similar property near the time of death, bids made for the property and general economic conditions.

R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 4-4 (3d ed. 1974) (footnotes omitted). If each such family transfer were to be subjected to the above procedures, it is questionable whether the courts or the Service would be able to absorb the additional workloads. *See also* Bosland, *Tax Valuation by Compromise,* 19 TAX L. REV. 77 (1963).

71. 67 T.C. at 1065-66.

72. *See* Note, *supra* note 62, at 176. The regulations provide for valuing an item at the price at which that item would be sold at retail. Treas. Reg. § 25.2512-1, T.D. 6826, 1965-2 C.B. 369.

73. *See* I.R.C. § 2503(b). The annual exclusion provides that "the first $3,000 of gifts made to any one donee . . . except gifts of future interests in property . . . is excluded in determining the total amount of gifts for a calendar quarter." Treas. Reg. § 25.2503-2(a), T.D. 7238, 1973-1 C.B. 544. The $3,000 is an aggregate exclusion which is applied until such time as the total amount of gifts exceeds the excludible amount. I.R.C. § 2503(b).

74. It should be noted that the exclusion is not applied to transfers of future interests. I.R.C. § 2503(b). Additionally, while the exclusion is available in the intrafamily transfer between husband and wife, *id.*, § 2523(a) of the Code provides a deduction for certain intraspousal transfers. *Id.* at § 2523(a). Subject to certain limitations, that section provides in relevant part:

> Where a donor who is a citizen or resident transfers during the calendar quarter by gift an interest in property to a donee who at the time of the gift is the donor's spouse, there shall be allowed as a deduction in computing taxable gifts for the calendar quarter an amount with respect to such interest equal to its value.

Id.

75. Treas. Reg. § 25.6019-1, T.D. 7238, 1973-1 C.B. 544.

76. *See, e.g.,* Quinn v. United States, 349 U.S. 155 (1955); Lewis v. United States, 92 U.S. 618 (1875); Hepburn v. Griswold, 75 U.S. 603 (1869).

77. *See generally* I.R.C. §§ 2501-2622.

contrast, subtitle A provides the authority for the taxing of income in its most general sense, with no provisions therein that permit the taxing of transfers for less than adequate consideration in money or money's worth.[78] Although it is possible for a single transaction to be subject to more than one tax under multiple subtitles, it is suggested that the court's failure to recognize the limited applicability of each subtitle is a shortcoming of the majority opinion.[79]

It is submitted that the court's summary incorporation of the *Johnson* rationale presents another basis for criticism of the *Crown* decision.[80] The majority in the instant case, as the *Johnson* court before it, failed to address the threshold inquiry of the gift tax statute: was there a "transfer of property"?[81] Congress intended that the term "property" reach "every species of right or interest protected by law and having exchangeable value."[82] Accordingly, since the right to use money is susceptible of present value calculation,[83] the loans in the case *sub judice* should have been classified as property by the *Crown* court.

The regulations provide that a transfer occurs when the "donor has so parted with dominion and control as to leave in him no power to change [the property's] disposition."[84] Arguably, it could be maintained that as a portion of the loans involved were executed on a demand basis,[85] the grantor never parted with the statutorily required dominion and control.[86] It is suggested, however, that a grantor may be deemed, at the end of each calendar quarter, to have parted with dominion and control of the loans which are then outstanding.[87] It is therefore submitted that the result in *Crown* appears to be contrary to the result obtained by a strict statutory interpretation.

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78. *See generally* I.R.C. §§ 1-1564. *See also* Hooton, *Gift Tax Analysis of non-Interest Bearing Loans,* 54 TAXES 635 (1976).

79. Despite such an interpretation, it may be argued that the majority did recognize the distinction when it stated: "The courts have uniformly rejected every attempt by the Internal Revenue Service to subject the making of non-interest bearing loans to income or gift taxes." 67 T.C. at 1064. Notwithstanding such a possibility, it is submitted that such an inference seems unwarranted since the majority, after making this statement, referred solely to income tax cases in support of its holding. *Id.* at 1064-65. For a discussion of the income tax cases relied on by the majority, *see* notes 33-45 *supra.*

80. *See* 67 T.C. at 1062-64.

81. *See* I.R.C. § 2501; note 13 and accompanying text *supra.*

82. H.R. REP. No. 708, 72d Cong., 1st Sess. 27 (1932); S. REP. No. 665, 72d Cong., 1st Sess. 39 (1932); *reprinted* in 1939-1 C.B. 496, 524. *See* note 14 *supra.*

83. *E. Helfert, supra* note 9, at 126-36. It is submitted that the ability to reduce a negotiable instrument to a present value figure is evidence that an ascertainable value in money or money's worth does exist.

84. Treas. Reg. § 25.2511-2(b), T.D. 7296, 1974-1 C.B. 255.

85. *See* note 6 and accompanying text *supra.*

86. Treas. Reg. 25.2511-2(a), T.D. 7238, 1973-1 C.B. 544. *See* notes 13 & 14 and accompanying text *supra.*

87. *See* Treas. Reg. § 1.482-2(a), T.D. 7394, 1976-1 C.B. 135. The Treasury Regulations under § 482 provide that the Service is authorized to make allocations that reflect an arm's-length interest rate in transactions between entities owned or controlled directly or indirectly by the same interests. Treas. Reg. § 1.482-1(b)(1), T.D. 6952, 1968-1 C.B. 224. *See also* Jenks, *Treasury Regulations Under Section 482,* 23 TAX LAW. 279 (1970).

Moreover, it appears that the majority's reliance on section 482 income tax cases was inappropriate.[88] Section 482 is an income tax, rather than a gift tax, provision prohibiting certain manipulations of funds among related entities. Furthermore, the *Crown* court ignored the fact that section 482 was *enacted* as a result of the courts' failure to inhibit such manipulations.[89] It is accordingly submitted that the failure of the judiciary to address an income tax question does not constitute sufficient authority for judicial avoidance of a gift tax problem, particularly with the problems corrected by section 482 demanded rectification through congressional intervention.[90]

In contravention of the purposes behind the income tax and gift tax provisions, the holding in *Crown* permitted the transfer of the taxpayer's right to earn income on his capital to his children, with no value in "money or money's worth" exchanged in receipt of that right[91] and without any gift tax consequences.[92] In addition, *Crown* fails to indicate the taxable outcome in the event that a family member/borrower makes an investment that goes sour. Whether a parent would force a child into bankruptcy, or forgive the indebtedness and cause a realization of the entire principal of the loan by "both" the income and gift tax laws, is worthy of consideration.[93]

For the estate planner, the *Crown* decision may stimulate reevaluation of the desirability of grantor trusts.[94] Both the borrower of the interest-free

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88. *See* 67 T.C. at 1064-65. *See also* B. Foreman Co. v. Commissioner, 453 F.2d 1144 (2d Cir.), *cert. denied,* 407 U.S. 934 (1972); Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940); Smith-Bridgeman & Co. v. Commissioner, 16 T.C. 287 (1951); Text accompanying notes 33-45 *supra.*

89. *See* 67 T.C. at 1064. Section 482 was enacted in response to the practice engaged in by related organizations of transferring assets for unrealistically high sales prices and extending installment credit without charging interest. Nauheim, *supra* note 45, at 108.

90. *See* notes 87-89 and accompanying text *supra.*

91. While the transfer was made to the various trusts, the children were the beneficiaries of such trusts and accordingly received any benefits from such transfers. 67 T.C. at 1060.

92. *Id.* at 1065.

93. In this hypothetical situation, if the parent discharges the indebtedness, the doctrine of forgiveness of indebtedness would cause the entire amount due and owing to be included within the gross income of the child. I.R.C. § 61(a)(12). This doctrine was first enunciated by the Supreme Court in United States v. Kirby Lumber Co., 284 U.S. 1 (1931). Additionally, since the note receivable may be considered property and the discharge of the indebtedness may be a transfer, § 2501 would require the imposition of a gift tax (for purposes of this hypothetical the section 2503(b) exclusion is disregarded). I.R.C. § 2501(a).

One commentator has enumerated the essential attributes which are necessary to effectuate a proper interest-free intrāfamily loan. *See* Burke, *Interest-Free Loans — A Valuable Family Tax Planning Tool?* 48 TAXES 137 (1970). First, the lender must retain no control, either implicit or explicit, over the principal. *Id.* at 138. A failure to incorporate this feature may cause the Commissioner to succeed in an attempt to apply the assignment of income rule. *Id.* Second, the loan must be 1) evidenced in writing, and 2) contain adequate provisions for repayment. *Id.* at 139. The incorporation of these factors will help to overcome the presumption that transfers without consideration between parents and children are gifts. *Id.* Third, there must be an explicit provision evidencing the intent of the parties that no interest is to exist on the debt. *Id.*

94. A grantor trust is defined, for purposes of this note, as a trust which contains implicit or explicit provisions in the governing instrument that cause the grantor or

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loan and the beneficiary of the grantor trust are entitled to the income generated by the respective principal or corpus.[95] However, sections 671-678 of the Code contain provisions that tax the income generated by a trust to the grantor or another person in certain circumstances although he does not receive the distribution of such income.[96] The use of an interest-free loan, on the other hand, causes the *borrower* to be taxed on the income generated by such funds without reference to the technical conditions imposed under the grantor trust provisions.[97]

An additional benefit in making an interest-free loan after *Crown* is that no taxable transfer exists at the inception of the loan.[98] In contrast, the Service may impose a gift tax under certain circumstances on the initial transfer funding a grantor trust.[99] The gift tax consequences after the instant case definitely favor the interest-free loan since it is possible to have a shifting of the income generated by such funds to a lower income tax bracketed taxpayer,[100] and the initial transfer will not constitute a taxable

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another person to be treated as owner of all or a portion of the trust. When the grantor or such other person is treated as owner, the income generated by the trust is taxed to such person even though he does not receive a distribution from the trust. I.R.C. §§ 671-678.

Some of the circumstances which may cause the grantor to be treated as owner of a portion of the trust are:

(1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

(2) If the grantor or a non-adverse party has certain powers over the beneficial interests under the trust (section 674);

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675);

(4) If the grantor or a non-adverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

(5) If the grantor or a non-adverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse (section 677).

Treas. Reg. 1.671-1(a), T.D. 7148, 1971-2 C.B. 251.

95. For the beneficiary of a trust, this would necessarily depend upon the terms of the trust instrument and the classification of the beneficiary under the normal rules of trust taxation. *See* I.R.C. §§ 651-656.

96. *See* I.R.C. §§ 671-678; note 94 *supra*. *See also* Treas. Regs. 1.671-1.678, T.D. 6217, 1956-2 C.B. 336.

97. *See* Treas. Regs. 1.671-1.678, T.D. 6217, 1956-2 C.B. 336. The conditions referred to consist of whatever limitations the grantor has incorporated into the instrument at its inception. For a discussion of these limitations, *see* L. Van Geffen, *Tax Clinic — Interest Free Loans*, 120 J. OF ACCOUNTANCY 75 (1965).

98. *See* notes 91 & 92 and accompanying text *supra*.

99. I.R.C. § 2501. In addition, § 2511 imposes a gift tax on the initial transfer into a grantor trust. *Id.* § 2511. *See also* Treas. Reg. § 25.2511-1(e), T.D. 7296, 1974-1 C.B. 255. The other conditions for imposition of the gift tax are that the property is transferred and that the transfer is complete within the terms of the statute. *Id.* *See* notes 11-15, 81 & 82 and accompanying text *supra*.

100. By structuring a transaction as an interest-free loan, the lender avoids the risk of being characterized as the owner of the interest income. Compare this with I.R.C. § 673 which provides that a grantor will be treated as the owner of the trust unless such power may not be exercised prior to the expiration of one of the three relevant time frames. *Id.* Section 673(a) provides:

> The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be

event.[101] Recognizing that the Treasury and Congress sought to impose a taxable result when a transfer falls within sections 671-678,[102] it is submitted that the judiciary should not permit an interest-free loan to be a method to circumvent such taxes. Accordingly, it is anticipated that Congress will act to impose a tax on such gratuitous transfers of property.[103]

As a result of the approach taken by the *Crown* court, it will be the responsibility of Congress to enact legislation that prevents the manipulation of funds within a family from being a tax-avoidance technique. Until that time, however, the interest-free, intrafamily loan remains a viable vehicle for the practitioner to best serve the needs of his client.

Lee H. Stein

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expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

I.R.C. § 673(a).

101. *See* I.R.C. § 2511. As the lender has a legal right to the borrowed funds, he would not be considered to have parted with dominion and control. Treas. Reg. § 25.2511-2(a), T.D. 7238, 1973-1 C.B. 565.

102. *See* I.R.C. §§ 671-678.

103. For a discussion of some of the possible solutions to the taxation of interest-free loans, *see* Schlifke, *Taxing as Income the Receipt of Interest Free Loans,* 33 U. CHI. L. REV. 346 (1966); Note, *Intra-Family Income Splitting: The Luxury of Nonsupport Trust,* 47 S. CAL. L. REV. 166 (1973).