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Dickman and Code Section 7872: The Death Knell to Interest-Free and Below-Market Loans

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DICKMAN AND CODE SECTION 7872: THE DEATH KNELL TO INTEREST-FREE AND BELOW-MARKET LOANS

Until recently the Internal Revenue Service (Service) has been unsuccessful in taxing interest-free and below-market rate interest loan benefits. A taxpayer could circumvent the tax on the interest income from such attractive loans. It was possible to shift loan proceeds to family members, employees, or stockholders without incurring a tax liability on the exchange. Such a transaction was particularly advantageous when the recipient was a child in a low tax bracket. The child could invest the loan proceeds and be taxed at a low rate.[1]

In 1961 the Tax Court frustrated the Commissioner of Internal Revenue (Commissioner) in his attempt to tax the economic benefits of interest-free loans made to controlling stockholders of a family owned corporation in *Dean v. Commissioner.*[2] Twenty years later the Ninth Circuit Court of Appeals again sided with the taxpayer. In this case, *Commissioner v. Greenspun,*[3] the taxpayer received a below-market rate loan with no tax burden because of preferential treatment.

The Service was no more successful in collecting gift tax on interest-free demand loans. *Crown v. Commissioner*[4] was decided in the Seventh Circuit. The court of appeals agreed that the taxpayer had not made a taxable gift of the interest income when he loaned money to his children and relatives.[5]

This privileged tax status was turned upside down by the United States Supreme Court and Congress in 1984. In that year the Supreme Court reversed the long accepted *Crown* theory in its *Dickman v. Commissioner*[6] decision. The Court held that interest-free demand loans had gift tax consequences.[7] In the same year, Congress recognized the extent of the tax loophole that these loans presented and created Internal Revenue Code Section 7872[8] with the enactment of Section 172(a) of the Tax Reform Act (1984 Tax Act).[9]

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[1] J. FREELAND, S. LIND & R. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 512 (1985) [hereinafter cited as FREELAND]; Adams & Kerworthy, *Tax Planning for the Family: New Rules for Interest Free and Low Interest Family Loans,* 56 OKLA. B.J. 761 (1985) [hereinafter cited as Adams]; Lieber, *Interest-Free Loans,* 23 DUQ. L. REV. 1019 (1985); McCue & Brosterhaus, *Interest-Free and Below-Market Loans After Dickman and The Tax Reform Act of 1984,* 62 TAXES 1010 (1984) [hereinafter cited as McCue]; Note, *Below-Market Intrafamily Loans — The Recognition of Unrealized Earnings and Accumulations of Wealth: I.R.C. Section 7872 and Dickman v. Commissioner,* 16 TEX. TECH L. REV. 599 (1985) [hereinafter cited as *Intrafamily Loans*].

[2] 35 T.C. 1083 (1961).

[3] 670 F.2d 123 (9th Cir. 1982).

[4] 67 T.C. 1060 (1977), *aff'd* 585 F.2d 234 (7th Cir. 1978).

[5] *Id.* at 1065.

[6] 104 S. Ct. 1086, *reh'g denied,* 104 S. Ct. 1932 (1984).

[7] *Id.* at 1094-95.

[8] I.R.C. § 7872 (1984).

[9] The Tax Reform Act is a section of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 172, 1984 U.S. CODE CONG. & AD. NEWS 697 (98 Stat.) 494 (to be codified at I.R.C. § 7872).

This Act imputed interest on tax-free and below-market loans.[10]

This comment will discuss the history of interest-free and below-market rate loans, including recent changes in the law from *Dickman* and the Internal Revenue Code (Code) revision in 1984. In addition, some of the tax planning alternatives to interest-free loans will be briefly examined.

HISTORY

Federal Income Tax — The Dean Rule

The *Dean v. Commissioner* case was one of first impression for the Tax Court.[11] The interest-free loan income issue in *Dean* revolved around corporate non-interest bearing loans to majority shareholders.[12] The Commissioner's premise was that the taxpayers should be taxed on the income attributable to the free use of corporate funds.[13]

Mr. and Mrs. Dean, controlling stockholders of Nemours Corporation, obtained interest-free loans in excess of two million dollars from Nemours.[14] The Service relied on several cases in which stockholders or officers derived taxable income from rent-free personal use of corporate assets.[15] Much to the Service's dismay, the Tax Court held that the *Dean* circumstances presented no taxable income[16] despite the broad scope of the definition of gross income in Section 61 of the Code.[17] The Tax Court stated that the income would be offset by an equal deduction under Code Section 163[18] and, thus, the recognition of the income benefit was unnecessary.[19]

In *Dean,* the dissent was quick to point out that the majority reasoning

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[10] *Id.*

[11] 35 T.C. at 1091 (Opper, J., concurring).

[12] *Id.* at 1087.

[13] The Commissioner determined that the tax deficiency, based on the prime rate, was $65,649 for 1955 and $97,932 for 1956. *Id.* at 1087-89.

[14] *Id.* at 1088.

[15] *Id.* at 1089-90. *See* Dean v. Comm'r, 187 F.2d 1019 (1951); Rodgers Dairy Co. v. Comm'r, 14 T.C. 66 (1950); Dean v. Comm'r, 9 T.C. 256 (1947), *aff'd* 187 F.2d 1019 (3d Cir. 1951); Chandler v. Comm'r, 41 B.T.A. 165 (1940), *aff'd,* 119 F.2d 623 (3d Cir. 1941); Reynard Corp. v. Comm'r, 30 B.T.A. 451 (1934); Frueauff v. Comm'r, 30 B.T.A. 449 (1934).

[16] 35 T.C. at 1090.

[17] The Code defines gross income as "*all* income from whatever source derived . . ." (emphasis added). I.R.C. § 61 (1955).

[18] This Code section generally allows a deduction for "interest paid or accrued." I.R.C. § 163 (1955). One important exception to § 163 is for interest expense relating to tax-exempt obligations. This type of interest expense is not allowable as a deduction. I.R.C. § 265 (1954).

Dean was a landmark case for interest-free loan taxability. The theory that the income and deductions would offset each other is now known as the *Dean* rule. IRS Letter Ruling (CCH) 8309002 (Nov. 2, 1982).

[19] 35 T.C. at 1090.

Interest bearing promissory notes do not require that the taxpayer report taxable income on the accrued interest unless, and until, the taxpayer has a right to receive a fixed amount of interest. Society Brand Clothes, Inc. v. Comm'r, 18 T.C. 304, 321 (1952).

made "too broad a generalization."[20] The dissent specified that an interest expense deduction would not be available if the loan proceeds were used to invest in tax-exempt indebtedness.[21] Several commentators have since agreed that the two-transaction approach should have been used by the *Dean* court, reporting both income and an allowable deduction.[22] The taxpayer might not even be able to use his interest expense deduction if he did not itemize deductions.[23] It seems only rational that a taxpayer who receives an interest-free corporate loan should have the same tax liability as a shareholder who receives a dividend[24] or an employee who receives compensation and then pays interest on a separate obligation.[25]

Regardless of the rationality of the decision, the Service followed the *Dean* rule without question for 12 years. Then, in 1973, the Commissioner suddenly announced that he would not acquiesce to the *Dean* decision.[26] Thereafter, the Service started an unsuccessful campaign to convince the Tax Court to tax interest-free and low-market rate loan benefits.

Reaffirmation of the Dean Rule

In each subsequent case the Commissioner presented, the Tax Court refused to overrule *Dean*. Instead, it repeatedly ruled for the taxpayer, thus allowing stockholders to reap tax-free benefits from such loans.[27] The Tax

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[20] 35 T.C. 1091 (Bruce, J., dissenting).

[21] *Id.* at 1092 (Bruce, J., dissenting).

[22] Hartigan, *From Dean and Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans*, 60 NOTRE DAME L. REV. 31, 42-49 (1984); Keller, *The Tax Consequences of Interest-Free Loans from Corporations to Shareholders and from Employers to Employees*, 19 B.C.L. REV. 231, 235-55 (1978); O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. L. REV. 1085 (1974).

If the corporation had no earnings and profits, I.R.C. §§ 301(c)(2), 316 (1984) provide that the distribution is a return of capital on which the shareholder will have no taxable income. The taxpayer would still have an interest deduction as with any loan.

An interest-free loan should have the same effect on a stockholder as if the corporation pays a dividend and the recipient then pays interest on a separate obligation. There are flaws in the assumption that interest-free loans are automatically offset by deductible expenses. The receipt of income is the first step transaction and the expense deduction the second. Often these steps will offset each other but it is a fallacy to assume that these transactions always balance out and cause no tax consequences. Several situations exemplify cases in which income and deductions do not balance. Dividends are taxable income to the stockholder under I.R.C. § 61(a)(7) but not a corporate tax deductible expense under I.R.C. §§ 301(c)(1), 316 (1984).

Some itemized deductions might decrease because of a percentage of adjusted gross income limitation. Some examples of such deductions are casualty losses under I.R.C. § 165 (1984), charitable contributions under I.R.C. § 170 (1984) and medical expenses under I.R.C. § 213 (1984). The taxpayer might not even be able to use his interest expense deduction. I.R.C. § 63 (1984) allows a taxpayer to itemize deductions only if they exceed a specific amount. *Id.*

[23] The taxpayer only receives a tax advantage from itemized deductions that exceed the excess of itemized deductions over the zero bracket amount. Therefore, in the case of interest expense, the expense might not result in a deductible expense if the total of all deductions do not exceed the zero bracket amount. I.R.C. § 63(c) (1984).

[24] I.R.C. §§ 301(c)(1), 316 (1984). *See also* Hartigan, *supra* note 22; Keller, *supra* note 22; O'Hare, *supra* note 22.

[25] I.R.C. § 61(a)(1) (1984) includes compensation as an item of gross income. I.R.C. § 163(a) (1984) generally allows deduction for interest payments on indebtedness.

[26] 1973-2 C.B. 4 (1973).

[27] A line of cases followed in which the Service unsuccessfully demanded taxation of loan benefits to

Court did begin to acknowledge the disparities present in the *Dean* doctrine, but the courts were unwilling to overturn a rule that had been followed for so many years.[28] The only requirement seemed to be that the parties execute a formal loan instrument with an intent to repay the principal.[29] The form seems to take precedence over the substance of the transaction.

The Ninth Circuit Court of Appeals strongly declined to overrule the Tax Court's *Dean* position in 1984 with *Commissioner v. Greenspun.*[30] The appellate court stated that "[w]here . . . the Government seeks to modify a principle of taxation so firmly entrenched in our jurisprudence, it should turn to Congress, not to the courts."[31]

Mr. Greenspun received a four million dollar below-market interest loan from Howard Hughes.[32] The Commissioner assessed a tax deficiency based on the present value of the interest that the taxpayer would have paid in an arm's length transaction less the interest specified in the actual term loan contract.[33] The Tax Court agreed that the loan was compensation in exchange for indirect control of Mr. Greenspun's newspaper and favorable publicity for the Hughes operation.[34] Nevertheless, the Court relied upon the *Dean* rationale and found no taxable benefits to Mr. Greenspun from the loan.[35] While the opinion admitted that the income would not offset the deduction in every case, it was enough that the interest deduction in the present case would offset the economic benefit.[36]

The following year an appeals court extended the *Dean* rule to the limit and perhaps beyond.[37] This time an appeals court was reviewing a United

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stockholders. Baker v. Comm'r, 75 T.C. 166 (1980), *aff'd*, 677 F.2d 11 (2d Cir. 1982); Creel v. Comm'r, 72 T.C. 1173 (1979), *aff'd* 649 F.2d 1133 (5th Cir. 1981); Zager v. Comm'r, 72 T.C. 1009 (1979), *aff'd sub nom.* Martin v. Comm'r, 649 F.2d 1133 (5th Cir. 1981); Trowbridge v. Comm'r, 50 T.C.M. (P-H) ¶ 81,190 (1981); Beaton v. Comm'r, 49 T.C.M. (P-H) ¶ 80,413 (1980), *aff'd*, 664 F.2d 315 (1st Cir. 1981); Parks v. Comm'r, 49 T.C.M. (P-H) ¶ 80,382 (1980), *aff'd*, 686 F.2d 408 (6th Cir. 1982); Estate of Liechtung v. Comm'r, 49 T.C.M. (P-H) ¶ 80,352 (1980); Martin v. Comm'r, 48 T.C.M. (P-H) ¶ 79,469 (1979), *aff'd*, 649 F.2d 1133 (5th Cir. 1981); Suttle v. Comm'r, 47 T.C.M. (P-H) ¶ 78,393 (1978); Lisle v. Comm'r, 45 T.C.M. (P-H) ¶ 76,140 (1976).

[28]Greenspun v. Comm'r, 72 T.C. 931, 950 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982).

Had the Service pressed its position earlier, the courts might have been willing to overturn *Dean*. However, *Dean* was the rule for so long that deviation by the courts would only now cause uncertainty for taxpayers. Greenspun v. Comm'r, 670 F.2d 123, 126 (9th Cir. 1982); *Martin*, 649 F.2d at 1133. *See also* Hartigan, *supra* note 22.

[29]Parfrey v. Comm'r, 52 T.C.M. (P-H) ¶ 83,756 (1983). The most important criteria distinguishing a corporate loan from a corporate dividend seems to be the intent to repay the loan. Although the existence of a loan can be proved without a formal agreement, a written note provides strong evidence of the intention of a bona fide loan. 7 MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 38B.19 (1985).

[30]670 F.2d 133 (9th Cir. 1982).

[31]*Id.*

[32]*Id.* at 124.

[33]The Service asserted a deficiency of $469,614 for 1967 and $1,157,956 for 1969. *Id.*

[34]*Id.* at 124-25.

[35]*Id.* at 125-26.

[36]*Id.* at 125.

[37]*See* Doll and Cox, *Interest-Free Loans and the Impact of Hardee v. United States*, 10 W. ST. U.L. REV. 187 (1983).

States Claims Court decision instead of a Tax Court judgment.[38] At the trial level, in *Hardee v. United States*, the United States Claims Court declined to follow *Dean*.[39]

In *Hardee* a closely-held corporation had made interest-free demand loans to controlling stockholders. The loan principal fluctuated between $595,000 and $474,000.[40] Concurrently, the stockholders, Mr. and Mrs. Hardee, held over $500,000 in tax-exempt municipal bonds.[41] The United States Claims Court ruled that the foregone interest constituted taxable gain to the Hardees.[42]

Even the *Dean* Court had not gone as far as this appellate court reversal. The *Dean* rationale relied on the fact that the borrower's implied interest payments would have been fully deductible.[43] By contrast, the Hardees would not have had an interest deduction because the loan proceeds were presumably used to purchase tax-free bonds.[44]

Nevertheless, the appeals court refused to oppose twenty years of case law, leaving any change up to Congress.[45] The appeal ruling stated that interest-free loan benefits were not taxable regardless of the loan purpose.[46]

After almost seventy years, fifty years of government inaction and twenty years of case law precedent,[47] businessmen had come to rely on the nontaxability of interest-free and below-market loans.[48] Change would soon come from Congress, not the courts.

Gift Tax — Crown Loans

In the meantime the Service had attempted to attack interest-free loans on a different front. In 1973 Revenue Ruling 73-61[49] proposed a gift tax for the present value of the foregone interest on family-related, interest-free loans. The Service based its position on the undisputed fact that the notes were not worth face value at redemption.[50] The donor would receive interest plus return of

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[38] Hardee v. United States, 708 F.2d 661 (Fed. Cir. 1983).

[39] *Id.* at 662.

[40] *Id.* at 663.

[41] *Id.* at 663-64.

[42] *Id.* at 662.

[43] *Dean*, 35 T.C. at 1090.

[44] *See* Doti and Cox, *supra* note 37.
Expenses that relate to tax-exempt income are not tax deductible. I.R.C. § 265 (1973).

[45] *Hardee*, 708 F.2d at 664. *See Martin*, 649 F.2d at 1133; Hartigan, *supra* note 22.

[46] *Hardee*, 708 F.2d at 664.

[47] *Id.* at 668.

[48] *Id.*

[49] Rev. Rul. 73-61, 1973-1 C.B. 408.

[50] *Id.*

principal in an arm's length transaction and, therefore, should be taxed on the transfer of "the value of the right to use money."[51] The Service stated the value should be determined by an accepted rate of return as found in the Internal Revenue Code Regulations (Regulations).[52]

A year later the Service sent a deficiency notice to Lester Crown for delinquent gift taxes.[53] The gift tax was based on foregone interest from interest-free demand and open account loans to trusts for the benefit of the taxpayer's children and close relatives.[54]

The Tax Court heard the *Crown* case in 1977.[55] This was the Tax Court's initial hearing of this issue.[56] Chief Judge Dawson's opinion voiced the Tax Court's opposition to obligating a taxpayer to make a profit on his investment.[57]

The Tax Court relied heavily on a federal court case, *Johnson v. United States.*[58] *Johnson* had held that the foregone interest on demand interest-free loans from parents to their children was not a taxable gift.[59] The *Johnson* opinion noted that "[t]he time has not yet come when a parent must suddenly deal at arm's length with his children."[60]

The *Crown* dissent stated that the majority had disregarded gift tax statutes and legislative history.[61] The committee reports concerning the gift tax Code sections indicate the law was meant to be comprehensive and to include all transfers of property or property rights that were donated to another.[62] Code § 2512(b)[63] states that a gift occurs when "property is transferred for less

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[51] *Id.*

[52] *Id.* The ruling leaves uncertainty in determining the gift portion of the loan. O'Hare, *supra* note 22, at 1088-89.

The Regulations give rules for present value determinations of annuities, life estates, terms of years, remainders, and reversions. Treas. Reg. § 25.2512-9 (1973).

[53] Crown v. Comm'r, 67 T.C. 1060-61 (1977).

[54] The loans were through a partnership in which the taxpayer was a 1/3 partner. By December, 1967, the loans totaled over $18 million. The Service computed the interest based on a 6% rate on the daily outstanding balance as if the loans were arm's length transactions. Mr. Crown's share of 1967 alleged deficiency was $46,000 in federal gift tax. *Id.*

[55] *Id.* at 1060.

[56] *Id.* at 1062.

[57] *Id.* at 1063-64.

[58] 254 F. Supp. 73 (N.D. Tex. 1966).

[59] *Id.* at 77.

[60] *Id.*

[61] *Crown,* 67 T.C. at 1066 (Simpson, J., dissenting).

[62] *Id.* The type of devise used to directly or indirectly transfer a gift was not important. The substance of the transfer should rule. "The terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense; . . ." H.R. Rep. No. 708, 72d Cong., 1st Sess. 27-28 (1932), *reprinted in* 1939-1 C.B. 457, 476 (hereinafter cited as H.R. Rep. No. 708); S. Rep. No. 665, 72d Cong., 1st Sess. 3 (1932), *reprinted in* 1939-1 C.B. 496, 524 (hereinafter cited as S. Rep. No. 665).

[63] I.R.C. § 2512(b) (1984).

than an adequate and full consideration in money or money's worth, . . ."[64] while § 2511[65] gives a wide encompassing definition for a gift transfer.

Regardless of the dissent reasoning, the *Crown* demand loan became an easy way to shift high bracket parental income to a child's lower bracket rate.[66] It seems all that was needed was good record-keeping and an intent to repay the loan principal.[67]

THE BEGINNING OF THE END — DICKMAN REPLACES CROWN

The Service was unsuccessful in obtaining judicial approval of gift tax consequences for a non-interest bearing loan transfer until *Dickman v. Commissioner*.[68] *Dickman* brought an end to *Crown* loans as a tax planning tool.[69]

The Tax Court originally determined that Mr. and Mrs. Dickman did not owe gift tax on the use of the money loaned without interest to the Dickmans' son and their corporation.[70] For the first time a court of appeals took the position that such loan benefits were taxable for gift tax purposes.[71] The U.S. Supreme Court granted certiorari to resolve the *Crown* versus *Dickman* conflict.[72]

The Supreme Court affirmed the appellate reversal.[73] The Court relied on the broad intent of the gift tax statutes and the original committee reports when those statutes were first proposed.[74] Those were the same authorities referred to in the *Crown* dissent seven years before.[75] The *Dickman* decision acknowledged the value received from use of the loan proceeds, as well as the income shifting benefits to the lender.[76] It seems that, finally, the judiciary was ready to accept the economic realities of interest-free loan transfers and benefits.

With the *Dickman* "common sense approach" to interest-free loan taxa-

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[64] *Id.*

[65] I.R.C. § 2511(a) (1984) in relevant part: "the tax imposed . . . 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; . . ."

[66] Avery, *The Lester Crown Case: Its Implications and Applications*, 38 N.Y.U. INST. ON FED. TAX'N § 36, § 36.04(3) (1980); Comment, *Dickman v. Commissioner: Turning Crown on Its Head*, 37 TAX LAW. No. 1, 223 (1983) [hereinafter cited as Comment, *Turning Crown on Its Head*].

[67] Avery, *supra* note 66, at § 36.04(2).

[68] 104 S. Ct. 1086, *reh'g denied*, 104 S. Ct. 1932 (1984).

[69] Avery, *supra* note 66; Comment, *Turning Crown on Its Head*, *supra* note 66.

[70] The aggregate loan balances reached sums of nearly $700,000 during a five year period. 104 S. Ct. at 1089.

[71] *Id.*

[72] *Id.* at 1088.

[73] *Id.* at 1089.

[74] *Id.* at 1089-90. *See* H.R. Rep. No. 708, *supra* note 62; S. Rep. No. 665, *supra* note 62.

[75] *Crown*, 67 T.C. at 1066 (Simpson, J., dissenting).

[76] *Dickman*, 104 S. Ct. at 1090-91.

tion,[77] the economic benefits of demand interest-free and low-market rate term loans lost some of their glamour.[78]

CONGRESS REACTS

Congress closed the door on the rest of the interest-free and below-market rate loan tax advantages with the 1984 Tax Act. This resulted in the rather confusing Code § 7872.[79] It appears that the *Dickman* decision encouraged Congress to act at last.[80]

The House Ways and Means Committee report observed that taxpayers were using interest-free loans to avoid taxes.[81] Section 7872 was the Service's long awaited answer to the repeated request for an all-inclusive tax on interest-free and below-market loans.[82] Congress was now ready to reclassify these loans as arm's length transactions.[83] With § 7872 Congress created the fiction that the foregone interest benefits are transferred from the lender to the borrower and then paid back as interest by the borrower to the lender.[84]

The section applies to gift loans, compensation-related loans, corporation-shareholder loans, tax avoidance loans and other below-market loans that would significantly affect the lender or borrower's federal tax liability.[85] Certain loans to qualified continuing care facilities are also affected.[86]

It is evident that the inclusion of tax avoidance loans and those that significantly affect the taxpayers tax liability are vague enough terms to allow the Treasury broad interpretation. The Proposed Regulations to § 7872 (Proposed Regulations)[87] reinforce this view. The Proposed Regulations broadly define "loan" in order to "implement the anti-abuse intent of the statute,"[88] but bona fide prepayments for services, property or property use are not con-

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[77] Note, *Dickman v. Commissioner: The Supreme Court Applies the Gift Tax to Interest-Free Loans*, 35 ALA. L. REV. 553 (1984).

[78] The reasoning inherent in the gift tax laws discourages income shifting. It seemed only logical that Congress would eventually give in to the Service's persistent attacks on the nontaxability of interest-free loans. Mandelman & Heber, *Interest-Free Loans: The Gift and Estate Tax Planner's Dream — Are We About to be Awakened?*, 65 MARQ. L. REV. 367, 369, 387 (1982).

Dickman did not completely eliminate gift loans. Taxpayers could still transfer large sums to low bracket taxpayers, thus, shifting the taxable income. The gift tax would have to be paid at the time of the transfer, but the annual gift tax exclusion allowable under I.R.C. § 2503(b) of $10,000 could be applied. Note, *Dickman v. Commissioner: Gift of Interest-Free Loans*, ARK. L. REV. 400, 411 (1982).

[79] I.R.C. § 7872 (1984).

[80] FREELAND, *supra* note 1, at 513.

[81] H.R. No. 98-432, 1373-74, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1021.

[82] Adams, *supra* note 1 at 761.

[83] I.R.C. § 7872(a)(1) (1984); Lieber, *supra* note 1 at 1019.

[84] Adams & Kenworthy, *supra* note 1.

[85] I.R.C. § 7872(c)(1) (1984).

[86] *Id.*

[87] Prop. Treas. Reg. § 1.7872 (1985).

[88] Prop. Treas. Reg. § 1.7872-2(a)(1) (1985).

sidered loans.[89]

EXCEPTIONS

Section 7872 and the Proposed Regulations do have some exceptions. De minimus gift, compensation-related or corporate-shareholder loans without a tax avoidance purpose are exempt from the statute for any day the aggregate amount of loans between the parties does not exceed $10,000.[90] This exemption loses much of its usefulness when, in the case of gift loans, the de minimus exception only applies to proceeds that are not used to acquire income-producing assets.[91]

Another exception is for loans of $100,000 or less between individuals. The exception limits income tax on imputed income equal to the borrower's net investment interest income.[92] Loans subject to § 483 "interest on certain deferred payments on the sale or exchange of property"[93] or § 1274 "determination of issue price in the case of certain debt instruments issued for property"[94] are also not taxable under § 7872.[95] Neither are loans taxable if they are from a qualified pension, profit-sharing or stock bonus plan.[96]

The Proposed Regulations specifically list several other exempted loans. These exempted loans include: 1) loans to the general public in the ordinary course of business, 2) bank, savings and loan or credit union interest accounts, 3) publicly traded debt obligations acquired at market price, 4) life insurance loans to a policyholder, 5) government subsidized loans, 6) certain employee relocation loans, 7) tax-exempt obligations, 8) United States government obligations, 9) certain loans to or from a foreign person, 10) private charitable foundation loans up to ten thousand dollars, 11) loans the Commissioner may describe in revenue rulings or procedures, and 12) loans with no significant effect on federal tax liability.[97] The last exception gives the Secretary of the Treasury broad interpretive latitude.[98]

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[89] *Id.*

[90] I.R.C. § 7872(c)(2), (3) (1984).

[91] I.R.C. § 7872(c)(2)(B) (1984).

[92] I.R.C. § 7872(d)(1) (1984). This income tax exception does not exempt the lender from gift tax consequences. Investment income is attributed to "gross income from interest, dividends, rents, and royalties" and "net short-term capital gain attributable to the disposition of property held for investment." I.R.C. § 163(h)(3)(B) (1984).

Under Section 7872 investment income of $1,000 or less is treated as if the taxpayer received no investment income. I.R.C. § 7872(d)(1)(E)(ii) (1984).

[93] I.R.C. § 483 (1984).

[94] I.R.C. § 1274 (1984).

[95] Prop. Treas. Reg. § 1.7872-2(a)(2)(ii) (1985).

[96] Prop. Treas. Reg. § 1.7872-4(c)(iii) (1985). Although pension, profit-sharing and stock bonus loans are not subject to Section 7872, the taxpayer must remember that such loans are subject to limitations and rules under I.R.C. § 72 (1984).

[97] Temp. Treas. Reg. § 1.7872-5T(b) (1985).

[98] McCue, *supra* note 1, at 1017.

Demand versus Term Loans

Demand and term loans are treated differently under § 7872. A demand loan is one which is payable on the lender's demand while a term loan agreement states an ascertainable time for payment.[99] Acceleration clauses are disregarded in distinguishing a loan as demand or term.[100]

Both type of loans are below-market if the interest is below the appropriate applicable federal rate (AFR).[101] A below-market or interest-free demand loan is taxable if the interest rate is lower than the AFR.[102] A term loan is subject to § 7872, using the appropriate AFR, if the present value of all payments is less than the amount loaned.[103] In both cases, the tax is based on the difference between an AFR interest amount and the rate actually charged for the loan.

In practice the demand and term loan taxation results are quite different. The timing of the transfer tax events depends on the type of loan. The demand loan computation is made at the end of each calendar year over the life of the loan for both gift and income tax purposes.[104] The lender pays the tax for the gift transfer yearly, as well as on the imputed interest income.[105] If an interest expense is deductible for the borrower, the deduction is also available yearly.[106] The computation for term loan transfers is generally made at the inception of the loan. The entire present value of the loan benefits is deemed given and received at this one time.[107]

In addition, term loans, other than gift loans, are subject to original issue discount treatment on an amount equal to the excess of the loan proceeds over the present value of the total payments under the contract.[108] Accordingly, the

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[99] Prop. Treas. Reg. § 1.7872-10 (1985).

[100] *Id.*

[101] I.R.C. § 7872(f)(2) (1984).

The applicable federal rate for term loans is the federal statutory rate effective on the day that the loan is made. This rate is under I.R.C. § 1274(d) (1984) and is compounded semiannually. I.R.C. § 7872(f)(2)(A) (1984).

The Secretary of the Treasury determines the applicable federal rate each year to be applied on January 1 and July 1. I.R.C. § 1274(d)(1) (1984). Loans of three years or under have a rate based on the federal short-term rate, over three years and up to nine years based on the federal mid-term rate, and over nine years on the federal long-term rate. I.R.C. § 1274(d)(1)(A) (1984). The applicable federal rate for demand below-market loans is the federal short-term rate under I.R.C. § 1274(d) (1984). I.R.C. § 7872(f)(2)(B) (1984); H.R. Rep. No. 98-861, 98th Cong., 2d Sess., *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1701-02 (hereinafter cited as H.R. Rep. No. 98-861).

[102] I.R.C. § 7872(e)(1)(A) (1984).

[103] I.R.C. § 7872(e)(1)(B) (1984). The computation method for finding the value of a term loan is explained in Prop. Treas. Reg. § 1.7872-14 (1985).

[104] I.R.C. § 7872(a)(1), (2) (1984); FREELAND, *supra* note 1, at 516.

[105] *Id.*

[106] *Id.*; I.R.C. § 163(a) (1984) (generally allows an interest deduction); I.R.C. § 63(c) (1984) (limits itemizing of deductions).

[107] I.R.C. § 7872(b)(1) (1984).

[108] I.R.C. § 7872(b)(2) (1984).

lender receives and the borrower deducts the original issue discount imputed interest income and expense annually in compliance with § 1272[109] requirements.

Section 7872 rules are effective for term loans made after June 6, 1984, and demand loans outstanding on that date.[110] Demand loans that were repaid or restructured by September 17, 1984, were not subject to the statute.[111]

Gift Loans

Gift loans have been used as a tax planning device ever since the revenue acts were first passed.[112] It was not unusual for a high tax bracket parent to loan money to a low bracket child and, thus, save tax dollars with the income shift.[113] This type of family gift loan is no longer an attractive tax saver. With *Dickman* the Supreme Court ruled that a gift loan is subject to gift tax.[114] Section 7872 quickly followed, not only codifying the gift tax requirement, but, more importantly, imputing the foregone interest payments on interest-free loans as if they were received by the lender and deductible as an expense by the borrower.[115] In most cases this forced transaction puts the income back with the high taxpayer and the deduction with the low bracket taxpayer. It defeats the original purpose of a *Crown* type transfer. Obviously, the Supreme Court and Congress have tolled the death knell for below-market rate gift loans.[116]

Furthermore, the law now looks to the substance of a loan transaction not the form of the loan instrument.[117] A loan from a parent to a child's corporation would be restructured as a gift loan from the parent to the child and another loan from the child to the corporation.[118]

A gift or family loan is viewed as a demand loan for income tax purposes regardless of the agreement terms.[119] Accordingly, the interest income and expense are acknowledged yearly on both gift demand and term loans. The gift tax element of the foregone interest is still dependent upon the demand or term nature of the loan.[120] Therefore, gift demand loans require annual gift tax pay-

[109] I.R.C. § 1272 (1984). Original issue discount is the redemption price over the issue price. I.R.C. § 1273 (1984). A discussion of original issue discount is beyond the scope of this article.

[110] Prop. Treas. Reg. § 1.7872-1(b)(1) (1985).

[111] Prop. Treas. Reg. § 1.7872-1(b)(2) (1985). The taxpayer was still liable for gift tax on gift loans prior to those dates based on the retroactive nature of *Dickman*, 104 S. Ct. at 1086.

[112] McCue, *supra* note 1, at 1011.

[113] FREELAND, *supra* note 1; Adams, *supra* note 1; Lieber, *Loans*, *supra* note 1; McCue, *supra* note 1; Note, *Intrafamily Loans*, *supra* note 1.

[114] *Dickman*, 104 S. Ct. at 1094-95.

[115] H.R. Rep. No. 98-861, *supra* note 101, at 1013.

[116] McCue, *supra* note 1, at 1010.

[117] Prop. Treas. Reg. § 1.7872-2(a)(1) (1985).

[118] Prop. Treas. Reg. § 1.7872-4(g)(1)(ii) (1985).

[119] I.R.C. § 7872(d)(2) (1984).

[120] I.R.C. § 7872(a)(1), (b)(1), (d)(2) (1984).

ments on that year's foregone interest, but the gift taxes for term gift loans are calculated as other term loans.[121] As previously discussed, the present value of all the benefits on term loans is considered to be received at the inception of the loan so the first year gift tax on a term gift obligation covers all the loan benefits.[122]

COMPENSATION-RELATED LOANS

Another type of loan that has lost some of its usefulness is an employer-employee low interest rate loan.[123] Section 7872 now treats the imputed interest on these loans as compensation,[124] deductible by the employer as expense[125] and taxable as income to the employee.[126]

In the case of a demand compensation-related loan, it would seem on the surface that the transactions balance each other. The employer has interest income offset by wage expense, while the employee has wage income offset by an interest deduction. It must be remembered, though, that wages are subject to applicable Social Security[127] and federal unemployment taxes.[128] Also, the employee may not have enough deductions, even with the imputed interest, to take advantage of itemizing deductions.[129]

In a term loan situation, all the wages are considered as paid at the inception of the loan.[130] Consequently, the employee pays income tax on the present value computation of wages in the first year of the loan. Conversely, the employer enjoys the full wage deduction in that first year.

All loans conditioned on future services are treated as demand loans.[131] When the services are performed or the condition lapses, the loan is treated as if it had ended. A new demand or term loan is created using the appropriate rules dependent upon the type of loan.[132]

CORPORATION-SHAREHOLDER LOANS

A below-market loan between a corporation and a shareholder does not

[121] *Id.*

[122] I.R.C. § 7872(b)(1), (d)(2) (1984).

[123] Prop. Treas. Reg. § 1.7872-4(c) (1985). Compensation-related loans also refer to loans in connection with services between an independent contractor and a person to whom the contractor provides the service and, also, partnership-partner loans based on services. I.R.C. § 7872(c)(1)(B) (1984).

[124] Prop. Treas. Reg. § 1.7872-4(c) (1985).

[125] I.R.C. § 162(a)(1) (1984) (salaries are deductible as ordinary and necessary business expense).

[126] I.R.C. § 61(a)(1) (1984) (includes wages as gross income).

[127] I.R.C. §§ 3101(a), 3111(a) (1984) (an employment tax with a portion paid by each the employee and employer).

[128] I.R.C. § 3301 (1984) (an employment tax completely paid by the employer).

[129] I.R.C. § 63 (1984).

[130] I.R.C. § 7872(b)(1) (1984).

[131] Prop. Treas. Reg. § 1.7872-3(b)(5) (1985).

[132] *Id.*

have the same potential balancing results as a compensation-related loan. In a corporation-shareholder loan, the corporation is deemed to have issued a dividend to the stockholder.[133] Since a dividend payment is a non-deductible corporate expense,[134] the corporation would receive imputed income for the interest income without an offsetting expense.

The final tax consequences of a corporation-shareholder loan could be extreme. If the loan were to the shareholder's child, the Service would use the two-transaction approach. The loan would be recharacterized as two separate loans.[135] The shareholder would have to recognize dividends received and then be deemed as having made a below-market gift loan to the child. The end result would be a dividend payment without a recognized expense for the corporation, a gift tax liability and federal income tax due on the constructive interest income for the stockholder, and a possible interest expense deduction for the presumed low tax bracket child.

TAX PLANNING ALTERNATIVES AFTER DICKMAN AND § 7872

Although large interest-free and below-market loans are no longer viable income shifting devices, some tax planning alternatives are available to taxpayers. An outright gift is still a means to transfer income producing assets,[136] but, of course, once a gift is made the donor loses control of the asset and the principal is never repaid.[137] As with a gift loan, the donor of a gift would be liable for gift tax but, in the case of an outright gift, on the entire proceeds.[138] The advantage of an outright gift would be the elimination of yearly income tax on the imputed interest income.[139]

Instead, the donor could put the assets in an irrevocable trust for the benefit of the donee.[140] The grantor would still be liable for gift tax, but the beneficiary would not have immediate control of the assets as in a direct gift.[141]

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[133] Prop. Treas. Reg. § 1.7872-4(d)(1) (1985); *See* I.R.C. § 316(a) (1984) (dividends are generally distributed from earnings and profits or as a return of capital).

[134] I.R.C. § 162(a) (1984) (limits deductible corporate expenses to those ordinary and necessary to carry on a trade or business).

[135] Prop. Treas. Reg. § 1.7872-4(g) (1985).

[136] The donor of an inter vivos gift must have adequate mental capacity, intend to make a present gift, and deliver the property to or on behalf of the donee. An inter vivos gift is irrevocable. RITCHIE, ALFORD & EFFLAND, DECEDENTS' ESTATES AND TRUSTS 752-53 (1982).

[137] *Id.* at 753.

[138] I.R.C. §§ 2501, 2503 (1984).

[139] I.R.C. § 7872(a)(1), (2) (1984).

[140] Treas. Reg. § 301.7701-4(a) (1984) in relevant part:

> Ordinary trusts . . . trust . . . refers to an arrangement . . . whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries . . . an arrangement will be treated as a trust . . . if it can be shown that the purpose . . . is to vest in trustees responsibility for protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility . . ."

See also Johnson, *Interest-free demand loans to trusts after Dickman and the DRA*, 16 TAX ADVISER 66, 67-70 (Feb. 1985) (a discussion of various types of trusts).

[141] Treas. Reg. § 301.7701-4(a) (1984).

However, the transfer of assets would be permanent just as in an outright gift.

There remains a way to temporarily transfer income producing assets without imputing interest income to the donor. The donor can create a short-term Clifford Trust for the benefit of the donee.[142] Gift tax is still a consideration but only on the trust benefits as the principal reverts to the grantor.[143] The main drawback of a Clifford Trust is the length of time that the transferred assets must stay in the trust, at least ten years and one day.[144] At that time the principal could revert to the donor. A Clifford Trust is more complicated to establish than a *Crown* type loan but will successfully shift asset income to a low bracket taxpayer.

Recently, President Reagan has asked Congress to amend the tax laws so that short-term revocable trust income would be taxed to the donor.[145] If Congress makes this tax change, Clifford Trusts will be significantly less popular as tax planning tools.

If the donor is unwilling to tie up assets for over ten years, a spousal remainder trust might be the answer. The term of years for a spousal remainder trust is arbitrary and, therefore, can be substantially less than with a Clifford Trust.[146] The assets are put in trust for the beneficiary with the donor's spouse receiving the remainder at the termination of the trust.[147] The gift tax on the potential trust earnings can be less than with a short-term trust since the term of years can be shorter.[148] Because the remainder passes to a spouse, the donor would not owe gift tax on the remainder portion of the transfer due to the marital gift tax deduction.[149] It is apparent that the stability of the donor's marriage is a major factor in considering a spousal remainder trust.[150] It must be remembered that the assets revert to the spouse and not the donor. The President would also like to see the income from spousal remainder trusts taxed to

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[142]Short-term trusts have been called Clifford Trusts after a taxpayer established an irrevocable trust for the benefit of his wife with the principal returning to the husband upon termination. Helvering v. Clifford, 309 U.S. 331, 332 (1940).

Clifford, the husband, did not avoid tax liability on the trust income, not because of the reversion he retained, but, because the trust duration was too short and Clifford retained too much control. *Id.* at 335. *See* Johnson, *supra* note 140, at 70; Rhine, *Income Shifting under The President's Proposals,* 124 TR. & EST. 16, 17 (Aug. 1985).

[143]Johnson, *supra* note 140, at 70.

The gift tax on Clifford Trusts qualifies for the annual $10,000 exclusion available under I.R.C. § 2503(b) (1984). *Id.*

[144]The grantor of a trust is taxable on the trust income if his reversion is within 10 years. I.R.C. § 673(a) (1984).

[145]Rhine, *supra* note 142, at 18.

[146]Smith, *The Spousal Remainder Trust,* 123 TR. & EST. 32 (Apr. 1984).

[147]*Id.*

[148]*Id.*

[149]*Id.*; I.R.C. § 2523(a) (1984) (allows a deduction from gift tax for the full amount of property donated to a spouse).

[150]Smith, *supra* note 146, at 34.

the donor.[151] If Congress grants his request, these trusts also would lose most of their tax planning usefulness.

CONCLUSION

For many years interest-free and low-interest loans were used as an income shifting device to divert income from a high to a low tax bracket taxpayer. The long history in interest-free and below-market rate loan use was first challenged in 1961 in *Dean*. In that decision, the Tax Court held that such a transfer was not a taxable event. Twelve years later the Commissioner announced nonacquiesence to the *Dean* principle and began a long series of unsuccessful court challenges to *Dean*.

The Service's attack on gift loans, desiring gift tax on the use of the proceeds, was no more successful. The *Crown* decision again put the Tax Court's stamp of approval on the interest-free family loans.

Thus, continued the Tax Court rationale until the United States Supreme Court *Dickman* ruling in 1984. The Supreme Court reversed years of judicial precedent and found the lender liable for gift tax on the loan benefits.

Congress was quick to act on the Court's lead in broadening the tax effect of these below-market rate loans. The Internal Revenue Code Section 7872 codified The 1984 Tax Reform Act, making most interest-free and low-interest loan benefits subject to federal income tax as well as gift tax.

Now that the Court and Congress have recognized the economic realities of low or no interest loan transfers, tax planners must look to other methods of income shifting to satisfy the Code.

Some present alternatives to interest-free transfers are outright gifts, irrevocable trusts, Clifford Trusts and spousal remainder trusts. These alternatives do shift income from a high to a low tax bracket individual, but nothing can replace the prior complete nontaxable status of interest-free and low-market obligations. In 1984 the Supreme Court and Congress closed the loopholes inherent in such transfers.

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[151] Rhine, *supra* note 142, at 18.