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John A. Lynch Jr.

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## TAXATION OF BELOW-MARKET LOANS UNDER § 7872: \* THIS COULD BE A LOT SIMPLER!

*John A. Lynch, Jr. \*\**

There are always going to be some economic benefits that flow between related parties which escape taxation.<sup>1</sup>

### I. INTRODUCTION

Although such a pragmatic outlook might set well with the libertarian, anti-tax outlook of the party that has controlled tax legislation in the House of Representatives for over the last decade,<sup>2</sup> it surely did *not* in the 1980s. Although perhaps many would think of that era as a time of dramatic rate cuts,<sup>3</sup> there was also a great clamor to make the tax code more “fair” to prevent taxpayers from taking unfair advantage of the system.<sup>4</sup> Oddly, this ran against another persistent theme of that era—to make the tax law simpler.<sup>5</sup> This obsession with “fairness” in some instances resulted in the enactment of provisions that

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\* I.R.C. § 7872 (2000).

\*\* Professor of Law, University of Baltimore.

1. *Greenspun v. Commissioner*, 72 T.C. 931, 956 (1979) (Goffe, J., concurring), *affirmed*, 670 F.2d 123 (9th Cir. 1982).

2. See, e.g., Bob Kemper, *Baby Steps on Tax Reform Chafe GOP*, ATLANTA CONST., Nov. 29, 2004, at 1A (indicating that both House Speaker Dennis Hastert and former Majority Leader Tom Delay support proposal to replace income tax with national sales tax).

3. See Julian Block, *Your Guide to the New Tax Laws*, 72 A.B.A.J. 70 (1986).

4. See James A. Baker, *Fundamental Tax Reform: An Analysis of the President's Proposals*, 27 S. TEX. L.R. 1, 6 (1985).

The average taxpayer has become convinced that others benefit from this growing complexity and that he or she does not. He or she understands very well that as long as the tax laws permit others to shelter income and thereby avoid paying a fair share of tax, then he or she must make up the difference by paying a greater share.

*Id.*

5. See Ronald Reagan, *Remarks and Question and Answer Session with Students of John A. Holmes High School of Edenton, N.C.*, 1 PUB. PAPERS 594, 598 (May 13, 1986) (“[The tax code has] been simplified to the place that you won’t need a public accountant to tell you how much you owe. You can figure out your tax yourself.”).

were complex, perhaps absurdly so; these provisions were too complex to be administrable.<sup>6</sup>

A signature 1980s “reform” provision is I.R.C. § 7872, adopted as part of the Deficit Reduction Act of 1984, which regulates below-market loans and placed the nose of the IRS into what had for decades been regarded as the private financial affairs of taxpayers.<sup>7</sup> The IRS provided that in certain settings, taxpayers making loans are treated as having done so at prescribed interest rates—whether or not they so desire.<sup>8</sup>

Essentially, § 7872 decreed that taxpayers are not, at least in certain instances, permitted to give away the use of their money without adverse tax consequences to the donor and the donee, consequences that Congress, perhaps inadvertently, made harsher two years later.<sup>9</sup> Although aimed at transactions within families and between corporations and shareholders and employers and employees, § 7872 contains a provision permitting the IRS to impute interest with respect to “tax avoidance” loans, allowing a recasting of transactions far afield of the circumstances that led to the adoption of § 7872.<sup>10</sup>

Section 7872 was one small part of the 1980s culture of tax reform aimed at restricting tax avoidance. It entails complexity in pursuit of fairness.<sup>11</sup> There is no question that interest-free and other below-market loans were used before the adoption of § 7872 to flout double taxation of corporate income, avoid taxation of compensation and to foster intra-family shifting of income to lower bracket taxpayers.<sup>12</sup> Such problems were significant and intractable in light of judicial unwillingness to

6. Examples of this phenomenon might include the addition to the Code of I.R.C. § 461(h)'s economic performance rule or the passive loss rules of I.R.C. § 501(a) or I.R.C. § 263A accounting monstrosities added to the Code in 1986. This is not an exhaustive list, but it does include the author's subjective “favorites” among onerous Code sections that probably have not made the world a better place.

7. See Pub. L. No. 98-369, 98 Stat. 699 (1984).

8. “Did I hear you say that there must be a catch? Will you walk away from a fool and his money?” *BADFINGER, Come and Get It, on MAGIC CHRISTIAN MUSIC* (Apple Records 1970). When § 7872 is applicable, alas, there must be a catch!

9. The adoption of I.R.C. § 163(h) in 1986, see Pub. L. 99-514, 100 Stat. 2246 (1986), which generally denies deduction of personal interest, significantly skewed this provision in the government's favor. Whether or not this was intended or not in 1986 is unclear since the legislative history of § 163(h) does not mention § 7872. See Brien D. Ward, *The Taxation of Interest-Free Loans*, 61 TUL.L. REV. 849, 887 (1987).

10. See I.R.C. § 7872 (c)(1)(D) and § 7872 (c)(3)(B).

11. See Douglas A. Allison, *Taxation – Deficit Reduction Act of 1984 – Treatment of Loans with Below-Market Interest Rates*, 16 ST. MARY'S L.J. 745, 763 (1985).

12. See generally Lester B. Snyder & Marianne Gallegos, *Redefining the Role of the Federal Income Tax: Taking the Tax Law “Private” Through the Flat Tax and Other Consumption Taxes*, 13 AM. J. TAX POL'Y 1, 41-42 (1996) (discussing various responses to the imposition of double taxation and noting the adoption of I.R.C. § 7872 as a response to interest-free loans).

address the problem.<sup>13</sup> As Professor Cooper stated: “A tax minimization practice is attacked with reform legislation when the unarticulated, ever changing, and rather illogical tax conscience of Congress is shocked.”<sup>14</sup>

But well-intended efforts to control avoidance may themselves exact a price. As stated by Professor McCaffery:

Ad hoc changes in the tax system designed to close particular loopholes in narrow areas only serve to increase the structural and technical complexity of the tax law as a whole. Increased technical and structural complexity, in turn, put additional compliance burdens on the taxpayer and increase incentives to find new loopholes.<sup>15</sup>

This article will explore § 7872: what it is, why it was enacted, how it has developed judicially and administratively since its enactment, and how it might be improved - mostly by reducing its complexity. It shall be contended generally that the “reform” intended with respect to § 7872 in several instances overshot the mark and serves no useful purpose.

## II. STRUCTURE AND WORKINGS OF § 7872

### *A. Applicability of Section and Transfers of Interest*

Section 7872 presumes that if a loan to which the section applies does not specify an interest rate, it then entails two transactions: a transfer by the lender to the borrower of the loan proceeds at the statutorily designated rate, as well as a transfer to the borrower to pay to the lender this designated rate.<sup>16</sup> This is not what really happens — it is a fiction that accommodates the transactions hypothecated alternatively by subsections (a) and (b) of § 7872.

The statutory floor as to loans covered by § 7872 is the applicable

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

14. George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 660 n.243 (1985) (praising § 7872).

15. Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267, 1278 (1990).

16. See Prop. Treas. Reg. § 1.7872-1(a), 50 Fed. Reg. 33553, 33556 (Aug. 20, 1985). Remarkably, while a number of provisions of § 7872 are dependent for implementation on the adoption of regulations by the Treasury Department, few of the proposed regulations have been implemented since they were proposed over 20 years ago. This has occasionally permitted the Service to disavow the proposals when it was expedient. See, e.g., *Frazee v. Commissioner*, 98 T.C. 554 (1992). It has also been suggested that the difference between the proposed regulations and the legislative history offers “a well-advised taxpayer a unique tax arbitrage opportunity.” See Gary Rozenshteyn, *Below-Market Loans Offer Tax Arbitrage Potential*, 64 PRAC. TAX STRATEGIES 260, 266 (2000). If that is correct, it is remarkable that the administration of an enactment aimed at tax avoidance may itself create opportunities for ameliorating the statute’s impact.

federal rate.<sup>17</sup> This rate depends on the duration of the loan.<sup>18</sup> The short-term rate applies if the term of the loan is three years or less, the mid-term rate if the term is over three years but less than nine years, and the long-term rate if the term is over nine years.<sup>19</sup> The applicable federal rate for a demand loan is the short-term rate.<sup>20</sup> This rate is determined monthly<sup>21</sup> on the basis of the average market yields on outstanding marketable obligations of the United States.<sup>22</sup> A loan which does not charge interest of at least the applicable federal rate is a below-market loan.<sup>23</sup> The difference between the actual loan rate and the applicable rate is forgone interest.<sup>24</sup>

Proposed regulations treat a loan as:

[A]ny extension of credit (including, for example, a purchase money mortgage) and any transaction under which the owner of money permits another person to use the money for a period of time after which the money is to be transferred to the owner or applied according to an express or implied agreement with the owner.<sup>25</sup>

The proposed regulation states further that “loan” is to be “interpreted broadly to implement the anti-abuse intent of the statute.”<sup>26</sup> This flexible conception of a loan has enabled the IRS to recharacterize transactions far outside the circumstances that led to the enactment of § 7872, transactions not obviously characterizable as loans.<sup>27</sup>

Section 7872 applies to six types of loans: gift loans,<sup>28</sup> compensation-related loans,<sup>29</sup> corporation-shareholder loans,<sup>30</sup> tax-avoidance loans,<sup>31</sup> “other” below-market loans,<sup>32</sup> and loans to qualified continuing care facilities.<sup>33</sup>

17. I.R.C. § 7872 (e)(1)(A)(B), (f)(1), (2). The applicable federal rate is defined as the rate in effect under I.R.C. § 1274(d).

18. *See id.* at § 1274 (d)(1)(A).

19. *Id.*

20. *Id.* at § 7872 (f)(2).

21. *Id.* at § 1274(d)(1)(B).

22. *Id.* at § 1274(d)(1)(C).

23. *Id.* at § 7872(c)(1).

24. *Id.* at § 7872(e)(2).

25. Prop. Treas. Reg. § 1.7872-2(a)(1), 50 Fed. Reg. 33553, 33557 (Aug. 20, 1985).

26. *Id.*

27. *See* Section IV.F.

28. I.R.C. § 7872(c)(1)(A).

29. *Id.* at § 7872(c)(1)(B).

30. *Id.* at § (c)(1)(C).

31. *Id.* at § 7872(c)(1)(D).

32. *Id.* at § 7872(c)(1)(E). These are loans the interest arrangements of which have a significant effect on any federal tax liability of the lender or borrower.

33. *Id.* at § 7872(c)(1)(F).

Although there are some differences in the exceptions and mechanisms of the application of § 7872 among these types of loans, the primary distinction in the workings of the imputation of interest under § 7872 is that between demand and term loans. A demand loan is “any loan which is payable in full at any time on the demand of the lender.”<sup>34</sup> A term loan is “any loan which is not a demand loan.”<sup>35</sup> Under proposed regulations, a loan is a term loan if the loan agreement specifies a time that may be determined actuarially.<sup>36</sup>

The most important mechanisms of § 7872 are the provisions that carry out the transfer of forgone interest in below-market loans from lender to borrower and back again.<sup>37</sup> There are two such mechanisms: subsection (a) for demand loans and subsection (b) for term loans.

Subsection (a) is simpler. It provides that with respect to a loan,<sup>38</sup> the forgone interest is transferred from the lender to the borrower and retransferred from the borrower to the lender as interest.<sup>39</sup> Although § 7872 does not so state, this transfer is intended to be treated by the lender as: “[A] gift, dividend, contribution to capital, payment of compensation or other payment depending on the substance of the transaction.”<sup>40</sup> Again, although § 7872 itself does not so state, the borrower on retransferring the forgone interest to the lender, is intended to be paying the same amount of interest to the lender as was paid by the lender to the borrower.<sup>41</sup> The transfers effected with respect to demand and gift loans during any calendar year are treated as made on the last day of such calendar year.<sup>42</sup>

The mechanism applicable to term loans is more complicated. The lender of a below-market loan is treated as transferring to the borrower, in cash, on the date the loan is made,<sup>43</sup> an amount equal to the excess of

34. *Id.* at § 7872(f)(5).

35. *Id.* at § 7872(f)(6).

36. Prop. Treas. Reg. § 1.7872-10(a)(2), 50 Fed. Reg. 33553, 33566 (proposed Aug. 20, 1985).

37. See Frederick R. Schneider, *Which Tax Unit for the Federal Income Tax?*, 20 U. DAYTON L. REV. 93, 108 (1994) (referring to income attribution as, “an important aspect of Section 7872” and explaining that topic’s application).

38. Section 7872 treats gift loans as demand loans even when the loan agreement provides for a term. I.R.C. § 7872(a)(1). For purposes of measuring a gift for gift tax purposes, § 7872(b)(1) applies to gift loans that are term loans. *Id.* at § 7872(d)(2).

39. *Id.* at § 7872(a)(1)(A).

40. H.R. Rep. No. 98-861, at 1012 (1984) (Conf. Rep.).

41. *Id.*

42. I.R.C. § 7872(a)(2).

43. *Id.* at § 7872 (b)(1). If later, the lender shall be treated as having transferred on the first day on which this section applies to the loan. *Id.*

the amount loaned over the present value of all payments which are required to be made under the terms of the loan.<sup>44</sup> Stated otherwise, if the present value of all payments under the loan, discounted at the applicable federal rate, is less than the amount loaned, the difference is treated as transferred by the borrower to the lender at the time of the loan. Whatever the consequences of such a transfer for the lender, the borrower has income in the amount of the forgone interest. Depending on the interest rate applicable to the term, the amount may be quite large.<sup>45</sup> The present value of payments due under a loan is determined as of the date of the loan by using a discount rate equal to the applicable federal rate.<sup>46</sup>

The excess of the amount loaned over the present value of payments under terms of the loan is treated as an original issue discount.<sup>47</sup> This requires inclusion by the lender of the daily portions of the original issue discount for each day during the taxable year the debt is outstanding.<sup>48</sup>

Although § 7872 uses the term “original issue discount” and the proposed regulations refer to I.R.C. § 1272,<sup>49</sup> § 7872(b)(1) provides for very different reporting consequences for the “holder” of what § 7872 deems to be an original issue discount obligation: a term loan. While under § 1272(a), the holder of an original issue discount obligation reports the daily portions of such interest for each day in the taxable year in which he or she holds the obligation, the borrower of a term loan is treated as receiving the entire amount of the original issue discount on the date the loan is made.<sup>50</sup> This is a strong deterrent to any borrower from entering into a below-market term loan agreement. It amounts to an unconscionable acceleration or distortion of income. If the interest represented by this original issue discount is deductible, it is deducted by the borrower on a daily basis over the life of the loan.<sup>51</sup>

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44. *Id.* at § 7872(b)(1)(A), (B).

45. Although interest rates in recent years have been quite low by historical standards, *see, e.g.,* Lee Ann Gjertsen, *A Fed Rate Hike is Seen as Eventual Fixed Annuity Boon; Interest Rates, Federal Reserve Board; Industry Overview*; 169 AM. BANKER NO. 125, June 30, 2004, at 7. This has not always been so during the life of I.R.C. § 7872.

46. I.R.C. § 7872(f)(2).

47. *Id.* at § 7872 (b)(2)(B).

48. *See id.* at § 1272(a).

49. *See* Treas. Reg. § 1.7872-7(a)(3), 50 Fed. Reg. 33553, 33563 (proposed Aug. 20, 1985).

50. I.R.C. § 7872(b)(1).

51. *See id.* at § 163(e).

## *B. Exceptions to the Application of § 7872 for Certain Below-Market Loans*

### 1. Gift Loans

Section 7872 does not apply to any gift loan directly between individuals on any day on which the aggregate amount of loans between such individuals is not more than \$10,000.<sup>52</sup> This exception does not apply to the extent that any such loans are used to purchase or carry income producing assets.<sup>53</sup> Under another special rule pertaining to gift loans, there is no retransfer of forgone interest from lender to borrower unless the borrower has net investment interest.<sup>54</sup> This exception does not apply to any loan on any day on which the aggregate amount of loans between borrower and lender exceeds \$100,000.<sup>55</sup> This special rule does not apply where one of the principal purposes of a loan is the avoidance of any federal tax.<sup>56</sup>

### 2. Compensation-Related and Corporation-Shareholder Loans

In the case of compensation-related and corporation-shareholder loans, § 7872 does not apply to any day on which the aggregate outstanding amount of loans do not exceed \$10,000.<sup>57</sup> This exception also is inapplicable to any loan where one of the principal purposes of the interest arrangements is to avoid federal tax.<sup>58</sup>

### 3. Loans to Qualified Continuing Care Facilities

Section 7872 also exempts loans to continuing care facilities.<sup>59</sup> The

52. *Id.* at § 7872(c)(2)(A).

53. *Id.* at § 7872(c)(2)(B).

54. *Id.* at § 7872(d). Net investment income has the same meaning as it does under I.R.C. § 163(d)(4), *viz.*, the excess of investment income over investment expenses.

55. *Id.* at § 7872(d)(1).

56. *Id.* at § 7872(d)(1)(B).

57. *Id.* at § 7872(c)(3)(A).

58. *Id.* at § 7872(c)(3)(B). Under Prop. Treas. Reg. § 1.7872-4(e), 50 Fed. Reg. 33553, 33561, tax avoidance is a principal purpose of the interest arrangements of a loan if: “[A] principal factor in the decision to structure the transaction as a below-market loan (rather than, for example, as a market interest rate loan and a payment by the lender to the borrower) is to reduce the federal tax liability of the borrower or the lender or both.” Prop. Treas. Reg. § 1.7872-4(e), 50 Fed. Reg. 33553, 33561 (Aug. 20, 1985). The purpose for making the loan itself is irrelevant in determining the principal purpose of the interest arrangement and, hence, applicability of the exception. *See id.*

59. I.R.C. § 7872(g).



amount of such an exempted loan, originally fixed at \$90,000,<sup>60</sup> has risen by adjustment for inflation.<sup>61</sup> This exception applies to any loan made to a continuing care facility pursuant to a continuing care contract if the lender or the lender's spouse has attained age sixty-five before the close of the calendar year such loan is outstanding.<sup>62</sup> A continuing care contract is a written agreement between an individual and a continuing care facility under which the individual or his or her spouse may use the facility for their lives.<sup>63</sup> A continuing care facility is a facility designed to provide services under continuing care contracts, substantially all of the residents of which are covered by continuing care contracts.<sup>64</sup>

#### 4. Exceptions Created by Regulation

Temporary<sup>65</sup> and Proposed Regulations<sup>66</sup> contain a list of loans exempted from § 7872. Most of the exemptions in the temporary and proposed regulations are the same.<sup>67</sup> Both the Temporary<sup>68</sup> and the

60. *Id.* at § 7872(g)(2).

61. *Id.* at § 7872(g)(5)(B). For 2005 the amount is \$158,100. *See* Rev. Rul. 2004-108, 2004-47 I.R.B. 853.

62. *Id.* at § 7872 (g)(1).

63. *Id.* at § 7872(g)(3). The contract must provide that the individual or his or her spouse will first reside in a separate, independent unit and then will be provided with such long term and skilled nursing care as the health of either requires and that there be no additional substantial payment if either require increased personal care services or long-term and skilled nursing care. *Id.*

64. *Id.* at § 7872(g)(4). It does not include any facility of a type which is traditionally considered a nursing home. *Id.* at § 7872 (g)(4)(C).

65. Temp. Treas. Reg. § 1.7872-5T (1985).

66. Prop. Treas. Reg. § 1.7872-5, 50 Fed. Reg. 33553, 33561 (Aug. 20, 1985).

67. Prop. Treas. Reg. § 1-7872-5(b) lists as exempt:

- (1) loans made available by the lender to the general public on the same terms and conditions and which are consistent with the lender's customary business practices;
- (2) accounts or withdrawable shares with a bank or credit union made in the ordinary course of business;
- (3) acquisitions of publicly traded debt obligations for an amount equal to the public trading price at the time of acquisition;
- (4) loans by a life insurance company in the ordinary course of its business to its insured, under a loan right contained in a life insurance policy and in which the case surrender values are used as collateral;
- (5) loans subsidized by federal, state, or municipal governments which are made available under a program of general application to the public;
- (6) employer relocation loans that meet the requirements of Prop. Treas. Reg. § 7872-5(c)(1);
- (7) obligations as to which interest is exempt under § 103;
- (8) obligations of the United States government;
- (9) loans to a charitable organization unless the aggregate of the lender's loans to such organizations during the taxable year exceeds \$10,000;
- (10) certain loans to or from foreign persons meeting the requirements of Prop. Treas. Reg. § 1.7872-5(c)(2);
- (11) loans made by a private foundation the primary purpose of which is to accomplish one or more of the charitable purposes described in § 170(c)(2)(B);
- (12) intercorporate loans made prior to July 1, 1986, under former § 1.482-2 of the regulations (superseded by T.D. 8204, 1988-2 C.B. 246);
- (13) for periods prior to July 1, 1986, all money, securities, and property received by a futures commissioner merchant or by a clearing organization to margin,

Proposed Regulations<sup>69</sup> sternly provide that if a taxpayer structures a transaction to fit within one of the regulation exemptions and one of the principal purposes of structuring the transaction is the avoidance of federal tax, then the transaction will be characterized as a tax avoidance loan under § 7872(c)(1)(D), thereby vitiating the exemption. Of the regulation exemptions, three receive fuller explanation in both the Temporary<sup>70</sup> and Proposed Regulations.<sup>71</sup>

Both the Temporary and Proposed Regulations exempt mortgage or bridge<sup>72</sup> loans for employees relocated by the needs of the employer.<sup>73</sup> Under the Proposed Regulations, a mortgage loan must be a demand loan or a term loan, the benefits of which are not transferable by the employee and which are conditioned on the future performance of substantial services by the employee. Further, the employee must certify that he or she expects to be entitled to and will itemize deductions for each year the loan is outstanding, and the loan agreement must require that the proceeds be used only to purchase the new residence of the employee.<sup>74</sup> With respect to bridge loans, the loan agreement must meet the above conditions and the agreement must provide that the loan is payable in full within fifteen days of the sale of employee's former principal residence, the principal amount of all such loans may not exceed the employer's reasonable estimate of the amount of the employee's equity in his or her former residence, and such residence is not converted to business or investment use.<sup>75</sup>

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guarantee or secure contracts for future delivery on or subject to the rules of a qualified board or exchange or to purchase, margin, guarantee or secure options contracts traded on or subject to the rules of a qualified board or exchange, and all money accruing to account holders as the result of such futures and options contracts; (14) loans where the taxpayer can show that the below-the-market interest arrangements have no significant effect on any federal tax liability of the lender or the borrower, as described in Prop. Treas. Regs. § 1-7872-5(c)(3); and (15) loans described in regulations promulgated under what is now § 7872(h)(1)(C) pertaining to any class of transactions the interest arrangements of which have no significant effect on any federal tax liability of the lender or borrower.

*Id.*

68. Temp. Treas. Reg. § 1.7872-5T(a)(2) (1985).

69. Prop. Treas. Reg. § 1.7872-5(a)(2), 50 Fed. Reg. 33553, 33561 (Aug. 20, 1985).

70. Temp. Treas. Reg. § 1.7872-5T(c) (1985).

71. Prop. Treas. Reg. § 1.7872-5(c), 50 Fed. Reg. 33553, 33562 (Aug. 20, 1985).

72. See *id.* at § 1.7872-5(c)(1)(ii). Bridge loans refer to loans that enable a relocated employee to purchase a new residence before selling his or her previous residence. *Id.*

73. The necessary relationship to employment is indicated by reference in the regulations to I.R.C. § 217. See Temp. Treas. Reg. § 1.7872-5T(c)(1)(i), (ii) (1985) and Prop. Treas. Reg. § 1.7872-5(c)(i), (ii), 50 Fed. Reg. 33553, 33562 (Aug. 20, 1985).

74. Prop. Treas. Reg. § 1.7872-5(c)(1), 50 Fed. Reg. 33553, 33562 (Aug. 20, 1985).

75. *Id.* at § 1.7872-5(c)(ii).

The Temporary<sup>76</sup> and Proposed<sup>77</sup> Regulations provide that certain loans involving foreign persons may be exempt from § 7872. Loans between foreign persons are exempt except to the extent that the interest income imputed to the foreign lender would be effectively connected with the conduct of a United States trade or business.<sup>78</sup> A loan, other than a compensation-related or a corporation-shareholder loan, by a foreign lender to a U.S. citizen who is not a C Corporation is exempt to the extent the interest income imputed to the foreign lender would not be effectively connected with the conduct of a United States trade or business.<sup>79</sup>

Finally, the Temporary<sup>80</sup> and Proposed<sup>81</sup> Regulations elaborate on the exemption for loans without significant tax effect on the lender or the borrower. The factors that give rise to this exemption are: whether the items of income and deduction generated offset each other; the amount of such items; the cost to the taxpayer of complying with the provisions of § 7872 and any non-tax reasons to structure the transaction as a below-market loan rather than a loan with an interest rate equal to or greater than the applicable federal rate; and a payment by the lender to the borrower.<sup>82</sup> The Temporary and Proposed Regulations contain no guidance for weighing these factors.<sup>83</sup>

### C. Retroactive Application of § 7872

If the interest provided with respect to a loan is subsequently waived, cancelled, or forgiven, and such loan is one to which § 7872 would have been applied had it been made without interest, the waiver does not include in substantial part the loan principal and a principal part of the waiver is to confer a benefit on the borrower such as to pay compensation or make a gift or corporate distribution, such waiver, cancellation, or forgiveness is treated as if the interest had been paid to the lender and then retransferred by the lender to the borrower.<sup>84</sup> This reversal of the scheme of transferring the forgone interest falls under §

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76. Temp. Treas. Reg. § 1.7872-5T(c)(2) (1985).

77. Prop. Treas. Reg. § 1.7872-5(c)(2), 50 Fed. Reg. 33553, 33562 (Aug. 20, 1985).

78. See *id.* at § 1.7872-5(c)(2)(ii) and I.R.C. § 864(c).

79. See Prop. Treas. Reg. § 1.7872-5(c)(2)(i), 50 Fed. Reg. 33553, 33562 (Aug. 20, 1985) and I.R.C. § 864(c). See also Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 9, 228 (1986).

80. Temp. Treas. Reg. § 1.7872-5T(c)(3) (1985).

81. Prop. Treas. Reg. § 1.7872-5(c)(3), 50 Fed. Reg. 33553, 33562 (Aug. 20, 1985).

82. *Id.*

83. See Lokken, *supra* note 79, at 220.

84. Prop. Treas. Reg. § 1.7872-11(a), 50 Fed. Reg. 33553, 33566 (Aug. 20, 1985).

7872(a). It would appear that the transfer of *accrued* interest would in any case be made on the day of waiver or cancellation. The further transfer of interest from that time would depend on whether the loan is a demand or a term loan.

#### *D. Reporting Requirements of Borrower and Lender*

The Proposed Regulations prescribe reporting rules for the parties to below-market loans under § 7872.<sup>85</sup> The lender must attach a statement to his or her return listing the name, address, and taxpayer identification number of each borrower, the amount of imputed interest income and the amount and character of any item deductible by reason of § 7872 attributable to each borrower, and the mathematical assumptions used for computing the amounts imputed under § 7872.<sup>86</sup>

The borrower also must attach a statement to his or her return providing information that parallels the information the lender must provide.<sup>87</sup> In the case of the employee-recipient of a compensation-related loan or an individual recipient of a gift loan, the requirement that the recipient provide the mathematical assumptions for the imputation of interest would often be a surreal imposition.<sup>88</sup>

### III. WHY CONGRESS ENACTED § 7872: THE *DEAN* ERA

#### *A. Dean and Income Taxes*

The enactment of § 7872 marked a legislative victory for the IRS that it had been unable to win in the courts.<sup>89</sup> No doubt the struggle with respect to below-market loans fared so badly for the government because it took up the cudgel fairly late in the history of the tax law. In 1955, the

85. *See id.* at § 1.7872-11(g).

86. *See id.* at § 1.7872-11(g)(1).

87. *See id.* at § 1.7872-11(g)(2).

88. For example, Prop. Treas. Reg. § 1.7872-12 provides an “approximate” method for the “convenience” of the taxpayer, for calculating the amount of interest that must be provided for a \$100,000 loan for four months in order to meet the assumed applicable federal rate of ten percent. It is expressed as:  $\$100,000 \times [(.1012) \times (4/6)] = \$3,333.33$ . *See id.* at § 1.7872-12(d), Example 2. Requiring familiarity with such regulations on the part of unsophisticated taxpayers appears to stretch the familiar maxim “ignorantia legis neminem excusat” (ignorance of the law is no excuse) as far as it can be stretched. Indeed, it appears intended simply to discourage taxpayers from resorting to such loans.

89. *See* Phillip J. Closius & Douglas K. Chapman, *Below Market Loans: From Abuse to Misuse—A Sports Illustration*, 37 CASE W. RES. L. REV. 484, 496-98 (1987) (discussing the passage of § 7872 as a legislative response to courts’ unwillingness to apply income tax liability to below-market loans).

IRS ruled: “The mere making available of money does not result in realized income to the payee or a deduction to the payor.”<sup>90</sup> This was the position of the government, at least concerning income taxes, “[f]rom the inception of the tax law in 1913. . . .”<sup>91</sup> That position changed in *Dean v. Commissioner*.<sup>92</sup> The controversy in *Dean*, the Tax Court’s resolution thereof in favor of the taxpayers, and the government’s struggle to have *Dean* overturned provide insight into the problem that Congress must necessarily have understood that it was redressing in enacting § 7872.

In *Dean*, the original dispute between taxpayers and the IRS concerned whether the taxpayers were permitted to deduct interest on loans on insurance policies that they had irrevocably assigned to their children.<sup>93</sup> By way of amended answer, the government asserted another deficiency concerning the tax years involved.

The taxpayers had received large interest-free loans in the tax years at issue from a corporation in which they were the sole shareholders.<sup>94</sup> In its amended answer, the government asserted that the taxpayers owed tax on “interest” for the loan balances at what it contended was the Delaware legal interest rate of six percent.<sup>95</sup>

The government’s assertion was at odds with its earlier position concerning the tax consequences of interest-free loans.<sup>96</sup> According to the Tax Court in *Dean*, this change in position was instigated by a suggestion in dictum by the Tax Court in unrelated litigation between the IRS and the same taxpayers.<sup>97</sup> Although the suggestion had little bearing on the outcome of the earlier litigation, it had a momentous

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90. Rev. Rul. 55-713, 1955-2 C.B. 23.

91. *Hardee v. U.S.*, 708 F.2d 661, 663 (Fed. Cir. 1983).

92. 35 T.C. 1083 (1961).

93. The court held that such interest was not deductible. *Id.* at 1085.

94. For example, from January 11, 1955 to December 31, 1955, the amount of such loans held by taxpayer J. Simpson Dean was \$223,861.56. *Id.* at 1088. From January 1, 1956 to December 31, 1956 it was \$357,293.41. *Id.* For the period January 1, 1955 to December 31, 1955, the amount of such loans to taxpayer Pauline du Pont Dean was \$1,832,764.71. *Id.* For the period January 1, 1956 to December 31, 1956, it was \$2,205,804.66. *Id.*

95. *Id.* at 1087. This amounted to total deficiencies for both taxpayers of \$224,978.28. *Id.* at 1083.

96. *See id.* at 1089.

97. *Id.* The other case was also *Dean v. Commissioner*, 19 T.C.M. (CCH) 281 (1960). The issue in that case was the value of closely held stock that had been given by taxpayers to trusts for their children. *Dean*, 19 T.C.M. (CCH) 281. With respect to the stock’s dividend paying capabilities, an issue in its valuation, the court stated: “Viewed realistically, the lending of over two million dollars to petitioners without interest might be looked upon as a means of passing on earnings (certainly potential earnings) of [the lender corporation] in lieu of dividends, to the extent of a reasonable interest on such loans.” *Id.* at 288.

impact on tax jurisprudence for nearly twenty-five years, and beyond.

In changing its position concerning the tax consequences of interest-free loans, the government focused on cases that held rent-free uses of corporate property constituted dividend income to taxpayer-shareholders.<sup>98</sup> Under I.R.C. § 316, a distribution to a shareholder is a dividend to the extent of earnings and profits.<sup>99</sup> In citing these decisions concerning gratuitous use of property other than money, the government essentially asserted that a corporation's money should be treated the same as any other property of a corporation made available to a shareholder at less than market value.

On the face of things, the IRS's argument has merit. Allowing a taxpayer who controls a corporation with undistributed earnings and profits to have the use of such profits without the intervening taxable event of a dividend frustrates, or at least permits the delay, of the Code's scheme of taxing corporate income to corporation and the shareholder.<sup>100</sup>

The Commissioner's contention did not convince the Tax Court, which identified only a "superficial resemblance" to cited cases.<sup>101</sup> The court distinguished money from property other than money for this purpose on the basis that if the shareholders had to borrow the money from a lender who charged interest, the interest would be deductible.<sup>102</sup> The deductibility of interest to borrow money in other settings made all the difference to the Tax Court's majority opinion: "We think this circumstance differentiates the various cases relied upon by the Commissioner, and perhaps explains why he has never taken this position in any prior case."<sup>103</sup> Noting that the court had denied an interest deduction for interest-free loans, the court thought it equally true that an interest-free loan should result in no gain to the borrower.<sup>104</sup>

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98. *Dean*, 35 T.C. at 1090. See, e.g., *Dean v. Commissioner*, 187 F.2d 1019 (3rd Cir. 1951) (rent-free use of corporation's house by shareholder); *Silverman v. Commissioner*, 28 T.C. 1061, *aff'd*, 253 F.2d 849 (8th Cir. 1985) (payment of spouse's travel expenses by corporation), and *Frueauff v. Commissioner*, 30 B.T.A. 449 (1934) (rent-free use of corporation's apartment).

99. I.R.C. § 316 (a).

100. It must be noted that the ability of corporations to retain earnings and profits, which are not reduced by loans to shareholders is not unlimited. Sections 531 and 541 impose respectively accumulated earnings and personal holding company taxes on undistributed earnings in certain circumstances. *Id.* at §§ 531, 541.

101. *Dean*, 35 T.C. at 1090.

102. See I.R.C. § 163(a). Prior to the enactment of § 163(h) in 1986, Pub. L. 99-514, 100 Stat. 2246, which sharply restricts deduction of "personal" interest for individuals, interest in most contexts was deductible for individuals.

103. *Dean*, 35 T.C. at 1090.

104. *Id.* (citing *D. Loveman & Son Export Corp. v. Commissioner*, 34 T.C. 776 (1960); *Brantjen & Kluge, Inc. v. Commissioner*, 34 T.C. 416 (1960); *Society Brand Clothes, Inc. v. Commissioner*, 18 T.C. 304 (1952); *Howell Turpentine Co. v. Commissioner*, 6 T.C. 364 (1946),

There were two other opinions in *Dean*. A concurring opinion by Judge Opper agreed that no deficiency should have been found, but stated that “[c]ertainly the statement that ‘an interest-free loan results in no taxable gain to the borrower is much too broad a generalization to make here.’”<sup>105</sup> If he did not accept that proposition, it is difficult to fathom why he would find no income under the circumstances.

Judge Opper’s opinion did introduce a suggestion that if the borrower used the loan proceeds to purchase or carry tax-exempt obligations, the result would have been different.<sup>106</sup> This viewpoint, which was also the basis of Judge Bruce’s dissent,<sup>107</sup> was embodied in § 7872,<sup>108</sup> but it never allowed the IRS to carry the day – to require a taxpayer to report income in consequence of an interest-free or below-market loan<sup>109</sup> – until the adoption of § 7872.

For a significant amount of time after *Dean*, it appeared that the government’s assertion that the borrower in an interest-free or below-market loan had income was a dead letter. The IRS did not “non-acquiesce” in *Dean* until 1973.<sup>110</sup>

Following its non-acquiescence in *Dean*, the Service carried on an extensive campaign to have *Dean* overruled. In this campaign, the Commissioner enjoyed “a notable lack of success.”<sup>111</sup> Most of the cases the Commissioner lost involved taxpayer shareholders who received interest-free loans from closely held corporations.<sup>112</sup> On at least one

*rev’d on other grounds*, 162 F.2d 316 (5th Cir. 1947); *Combs Lumber Co. v. Commissioner*, 41 B.T.A. 339 (1940); *A. Backus, Jr. & Sons v. Commissioner*, 6 B.T.A. 590 (1927)).

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

106. Under I.R.C. § 265(a)(2), interest to purchase or carry such obligations is not deductible on the basis that allowing a deduction for expenses to produce tax-exempt income would amount to a double benefit. See MICHAEL D. ROSE & JOHN C. CHOMMIE, *FEDERAL INCOME TAXATION* § 3.33 (3d ed. 1988).

107. Judge Bruce lamented that the burden should have been placed on the taxpayers to show that they would have been entitled to deduct interest on the loans had they been required to pay it. *Dean*, 35 T.C. at 1092 (Bruce, J., dissenting).

108. Under § 7872(a)(1)(B), the borrower retransfers interest to the lender. I.R.C. § 7872. This is deductible “to the same extent as interest actually due on the loan from the borrower.” See H.R. Rep. No. 98-861, at 1012 (1984) (Conf. Rep.), reprinted in 1984-3 C.B. vol. 2 at 267. Under § 7872(b)(2), the excess of the amount loaned over the present value of all payments due under the loan is treated as original issue discount. I.R.C. § 7872. Under I.R.C. § 163(e), original issue discount is allocable to a taxable year of an issuer (borrower) if “allowable a deduction” to the issuer. *Id.* at § 163.

109. See *Hardee v. U.S.*, 708 F.2d 661 (Fed. Cir. 1983), discussed *infra* notes 151-63, and *Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981), discussed *infra* notes 117-25.

110. See 1973-2 C.B. 4.

111. *Parks v. Commissioner*, 686 F.2d 408, 409 (6th Cir. 1982).

112. See *id.*; *Baker v. Commissioner*, 677 F.2d 11 (2nd Cir. 1982); *Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981); *Beaton v. Commissioner*, 664 F.2d 315 (1st Cir. 1981); *Suttle v.*

occasion, the Tax Court did concede the incongruity of treating the free use of corporate money by shareholders differently from free use of other corporate property.<sup>113</sup> In a few cases, the Service's argument appeared to be based on treating the interest-free loan as compensation, rather than a corporate dividend.<sup>114</sup>

In *Marsh v. Commissioner*, the court confronted a situation that appears unique in *Dean*-era jurisprudence.<sup>115</sup> The taxpayer was a member of a group that was exploring for natural gas. A company that wished to acquire natural gas advanced funds to the taxpayer's group for the purpose of financing the exploration. These funds were advanced interest-free. The IRS contended that this created income to the taxpayer. The unique aspect of the case was that there was no employer/employee or corporation/shareholder relationship between lender and borrower.

Notwithstanding absence of any such relationship between lender and borrower, the government rather boldly asserted that "having cash readily available is an economic benefit because the owner is entitled to demand and receive interest as a condition of lending such capital to another."<sup>116</sup> The court rejected this IRS attempt to impute interest to the taxpayer on account of the opportunity cost to the lender. Agreeing with the taxpayer, the court stated:

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Commissioner, 625 F.2d 1127 (4th Cir. 1980); *Trowbridge v. Commissioner*, 41 T.C.M. (CCH) 1302 (1981); *Estate of Leichtung*, 40 T.C.M. 1118 (1980); *Zager v. Commissioner*, 72 T.C. 1009 (1979), *aff'd sub nom. Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981).

113. In *Zager*, the court stated concerning the *Dean* rule:

[T]here appear[s] to be but little difference between the interest-free use of corporate funds and the rent-free [occupancy of corporate property by a stockholder or officer] that had been held to constitute a tax benefit the fair value of which was includable in gross income. Conceptually it [ ] seem[s] that the same result should be reached in both types of cases. Yet the fact that the Treasury had not theretofore – for some 48 years – attempted to treat as income the benefits attributable to such interest-free loans was highly troublesome. We searched for a distinction that would support the administrative practice which had endured for so long a period. And we found a difference in that if the taxpayer had undertaken to pay interest or rent, he would generally have been entitled to a deduction for the payment of interest but not for rent.

*Zager*, 72 T.C. at 1011.

114. See *Greenspun v. Commissioner*, 670 F.2d 123 (9th Cir. 1982), discussed *infra* notes 125-49; *Creel v. Commissioner*, 72 T.C. 1173 (1979), *aff'd sub nom. Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981); *Lisle v. Commissioner*, 35 T.C.M. (CCH) 627 (1976). In *Creel*, since the taxpayers' employer, which had made an interest-free loan to the taxpayer, had borrowed money at interest in order to make the loan to the tax payment the court concluded that the employer paid interest as the taxpayers' agent, discharging taxpayers' obligation. *Creel*, 72 T.C. 1173. While this resulted in income to the taxpayers, they had offsetting interest deductions. *Id.* at 1180.

115. *Marsh v. Commissioner*, 73 T.C. 317 (1979).

116. *Id.* at 327.



[T]he fact that the owner of capital is entitled to interest on a loan does not mean that he must or actually does receive interest on money loaned. The business transaction here involved was arrived at by arm's length bargaining between two entirely related parties, each of whom had something the other wanted.<sup>117</sup>

The government's attempt to impute income in *Marsh* went beyond what would be permitted even under § 7872. It is not surprising that the court chose to adhere to its *Dean* ruling, but the Tax Court and other courts repeatedly did so, simply on the basis that *Dean* was so well-entrenched.<sup>118</sup> Some courts invoked *United States v. Byrum*<sup>119</sup> for the proposition that courts are reluctant to disturb accepted interpretations of tax law when it could have far-reaching consequences.<sup>120</sup>

The dam protecting the *Dean* rule with respect to income taxation of below-market loans never did break before the enactment of § 7872. Three decisions near the end of the *Dean* regime that involved spirited arguments within courts about the cogency of *Dean*, demonstrated the futility of overturning it judicially and underscored the opportunity for abuse through below-market loans. These decisions – *Martin v. Commissioner*,<sup>121</sup> *Commissioner v. Greenspun*,<sup>122</sup> and *Hardee v. Commissioner*<sup>123</sup> – brought into focus both the urgency of the need for change as well as the difficulties in making such change judicially.

In *Greenspun*, the facts of which appear below,<sup>124</sup> the Tax Court refined *Dean*, acknowledging the obvious IRS contention that there could be no deduction for interest under § 163 unless such interest was paid.<sup>125</sup> In a case where a taxpayer must report as income the economic benefit associated with a low- or no-interest loan, “an exception to the general rule of deductibility is both appropriate and necessary to give recognition to the economic realities of the transaction.”<sup>126</sup>

Before the Ninth Circuit affirmed this decision, the Fifth Circuit endorsed *Greenspun* in *Martin v. Commissioner*, while reviewing three

117. *Id.*

118. See *Parks*, 686 F.2d 408 (defer to Congress); *Baker*, 677 F.2d 11; *Beaton*, 664 F.2d 315; *Martin*, 649 F.2d 1133; *Trowbridge*, 41 T.C.M. (CCH) 1302.

119. 408 U.S. 125 (1972).

120. See, e.g., *Parks*, 686 F.2d at 409; *Beaton*, 664 F.2d at 317.

121. 649 F.2d 1133 (5th Cir. 1981).

122. 670 F.2d 123 (9th Cir. 1982).

123. 708 F.2d 661 (Fed. Cir. 1983).

124. See *infra* notes 127-135 and accompanying text.

125. *Greenspun*, 72 T.C. at 951.

126. *Id.*

other Tax Court cases.<sup>127</sup> All three involved interest-free loans by corporations to principal shareholders who were also directors and salaried employees of the corporations. The court rejected the government's attempt to overrule *Dean* in a cryptic opinion. It described the *Dean* rule as a fiction, entailing an assumption: "[T]hat the interest-free loan ipso facto does not produce benefits that under normal tax regulation result in taxable income because the alleged benefit is equalled by a comparable interest 'deduction.'"<sup>128</sup>

*Martin* is better known for the vigorous and colorful dissent of Judge Goldberg, who castigated the majority's acquiescence in *Dean* as a solution that "abdicates responsibility and begrudgingly accepts error."<sup>129</sup> Judge Goldberg viewed the *Dean* approach, in putting interest-free loans outside the scope of § 61, as doing great damage to that section.<sup>130</sup> On the other hand, he found unjust the government's position of charging the taxpayer with income in all cases on account of failure of the technical requirements for a deduction.<sup>131</sup>

While the government's unjust position was predicated on failure to allow a deduction in any circumstance, the taxpayer's position was predicated on two flaws: (1) that the taxpayer would always have an offsetting deduction,<sup>132</sup> and thus, (2) that there is no reason for the taxpayer to include the loan benefit in income, forcing him or her to report the offsetting benefit under § 163.<sup>133</sup> Judge Goldberg listed the circumstances in which a taxpayer would *not* receive a deduction from the payment of interest.<sup>134</sup>

127. *Martin*, 649 F.2d 1133.

128. *Id.* at 1133-34.

129. *Id.* at 1144 (Goldberg, J., dissenting).

130. Judge Goldberg saw the evolving design of § 61 as taxing "any valuable economic benefit which serves as a form of compensation to an employee or as a dividend to a shareholder." *Id.* at 1142. He felt that there could be little doubt that the free use of money provided by a corporation should fall within the broad construction afforded by § 61. *Id.* at 1136.

131. *Martin*, 649 F.2d at 1139. Judge Goldberg viewed the government's argument with respect to "the deduction side of the ledger" as based on the contention that interest must be "paid or accrued" for a taxpayer to enjoy a deduction under § 163(a). *Id.* at 1142. The IRS argued that a taxpayer who receives an interest-free loan neither pays nor accrues interest. *Id.* at 1136.

132. *Id.* at 1140-41.

133. *Id.* at 1141.

134. He noted that a taxpayer would receive no benefit with respect to interest unless he or she itemizes deductions. *Id.* See also I.R.C. § 63. A taxpayer receives no deduction for interest incurred to purchase or carry obligations the interest on which is wholly exempt from taxes, see *id.* at § 265(a)(2), or a single premium life insurance, endowment or annuity contract. See *id.* at § 264. He noted that deductions for interest are limited with respect to investment property, see *id.* at § 163(d), and may be denied with respect to sham transactions. *Martin*, 649 F.2d at 1141.

Judge Goldberg also noted that not including the economic benefit in gross income distorted the availability of deductions dependent upon a percentage of adjusted gross income, such

Judge Goldberg's middle ground, that a taxpayer-borrower of a below-market loan incurs tax liability only to the extent interest income exceeds a correlative deduction, was the view adopted by § 7872, at least initially. The legislative history of § 7872 indicates a similar list of circumstances in which interest would not be deductible for a taxpayer.<sup>135</sup> The balance struck by Judge Goldberg and then Congress in 1984 was greatly skewed by the enactment of § 163(h) which sharply restricts deduction of personal interest.

Although *Greenspun* at the appellate level did not involve the same spirited debate about the *Dean* rule as *Martin*, such a discussion did occur in the Tax Court.<sup>136</sup> The facts of *Greenspun* which, unlike most of the other *Dean* progeny did not involve below-market loans from a corporation to its shareholders, presented the most alarming "abuse" of the *Dean* rule.<sup>137</sup>

The taxpayer, Mr. Greenspun, owned a newspaper and television station in Las Vegas. In 1966, Howard Hughes moved to Las Vegas and met Greenspun, where they became friends. Hughes had a telephone installed in taxpayer's home so that Hughes' "alter ego," Robert Maheu, could seek Greenspun's advice on Hughes' behalf.<sup>138</sup> In connection with his acquisition of substantial assets in Las Vegas, Hughes sought to acquire local radio, television, and newspaper interests.<sup>139</sup> Greenspun refused to sell Hughes his newspaper but he did sell Hughes the television station.<sup>140</sup> Hughes knew that Greenspun needed money because of a disastrous fire that had occurred at Greenspun's newspaper a few years before.<sup>141</sup>

At about the same time as the sale of the television station in 1967, Hughes' corporate "alter ego" agreed to loan Greenspun \$4 million.<sup>142</sup> Initially, this loan was for a term of eight years at three percent interest.<sup>143</sup> The rate of interest charged by banks for mortgages, etc. at

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as medical deductions under § 213. *Id.* at 1142.

135. The Conference Report to I.R.C. § 7872, H.R. Rep. No. 98-861, lists § 163(d) and § 268 as denying deductions for interest in some circumstances. H.R. Rep. No. 98-861, at 1012 (1984) (Conf. Rep.), reprinted in 1984-3 C.B. vol. 2 at 267.

136. *Greenspun*, 72 T.C. 931.

137. *See id.* at 952, n. 22.

138. *Id.* at 933.

139. *Greenspun*, 670 F.2d at 124.

140. *Greenspun*, 72 T.C. at 935.

141. *Id.* at 933.

142. *Id.* at 935.

143. *Id.* at 935-36. In 1969 a note for 35 years was renegotiated between the parties. *Id.* at 943.

the time of the loan would have been not less than six percent.<sup>144</sup>

Although Greenspun contended that he did not believe that the loan from Hughes was in compensation for past services or services to be rendered in the future,<sup>145</sup> Hughes received a great deal of favorable coverage in Greenspun's newspaper in its wake.<sup>146</sup> This editorial support appears consistent with Hughes' plan, which Maheu described as keeping Greenspun "perpetually beholden."<sup>147</sup>

The government determined deficiencies in Greenspun's taxes of \$469,613.77 and \$1,152,956.16 in 1967 and 1969 respectively, the years in which the original and renegotiated notes were executed.<sup>148</sup> This represented a totaling of the present values of the expected annual savings over the terms of the loans.<sup>149</sup> Making the taxpayer account for the economic benefit for the life of the loan on the date he or she executes the loan is similar to the treatment of term loans under § 7872(b).<sup>150</sup> Dissenting in *Martin*, Judge Goldberg had brushed aside the majority's concern about computing taxable income if *Dean* were abandoned by asserting that "[h]aving determined the proper interest rate, the cited difficulties of computation are reduced to a grade school exercise in multiplication."<sup>151</sup> As demonstrated by the computations under the proposed regulations adverted to above, calculation of whether a loan is below-market and the amount of imputed interest is not simply a matter of grade school multiplication.<sup>152</sup> The Tax Court majority also rejected the present value approach stating that the benefit to the taxpayer occurred ratably over the life of the loan.<sup>153</sup>

The Tax Court agreed with the IRS that the loan and its favorable terms were intended to compensate Greenspun for services and as an

144. *Id.* at 940.

145. *Greenspun*, 72 T.C. at 936.

146. In editorials, Greenspun called Hughes "a legend in his own time," an "exceptional man," and "the world's greatest industrialist." *Id.* at 938. Greenspun contended that Hughes' presence in Las Vegas had created a new favorable image of Las Vegas around the country. *Id.* at 939. Greenspun, reversing an earlier position he had taken, testified before the Nevada Gaming Policy Board supporting Hughes acquisition of two Las Vegas strip resorts. *Id.*

147. *Id.* at 935.

148. *Greenspun*, 670 F.2d at 124. According to the Tax Court, the amounts of the deficiencies were \$701,211 and \$1,536,156 for 1967 and 1969 respectively. *Greenspun*, 72 T.C. at 940-41.

149. *Greenspun*, 72 T.C. at 941.

150. Even Judge Nims, who dissented from the court's adherence to the *Dean* rule, would not endorse the government's "present value" method of calculating the deficiencies. *Id.* at 958 (Nims, J., dissenting).

151. *Martin*, 649 F.2d at 1144 (Goldberg, J., dissenting).

152. See *supra* note 81 and accompanying text. See also Prop. Treas. Reg. § 1.7272-12, -13, and -14, 50 Fed. Reg. 33553, 33567-33570 (Aug. 20, 1985).

153. *Greenspun*, 72 T.C. at 950-51.

inducement concerning certain property transactions.<sup>154</sup> Nevertheless, even though the court conceded that the *Dean* rule was “laden with some potential for abuse,”<sup>155</sup> it not only applied *Dean*, it rejected the need of a taxpayer to comply literally with the requirements of § 163(a) in order to make the economic benefit of the loan proceeds excludable.<sup>156</sup> The result appeared based, in part, on the notion that the IRS should sleep in the bed it had made.<sup>157</sup>

In a concurring opinion, Judge Goffe envisioned that overruling *Dean* to the extent of requiring that the taxpayer demonstrate specifically the applicability of an interest deduction in order not to have income would require that the lender be deemed to have interest income.<sup>158</sup> This, of course, is precisely the regime Congress adopted in § 7872, except with respect to gift loans below a certain level.<sup>159</sup>

*Greenspun* presented a troubling application of the *Dean* rule.<sup>160</sup> Hughes and Greenspun found a way to compensate the latter without a tax impact to Greenspun. Hughes, of course, did not receive a tax deduction in conferring this benefit, although he received the rough equivalent. To the extent he shifted funds from himself to Greenspun, Hughes shifted any interest income pertaining to such funds away from himself. With that cost, he purchased Greenspun’s valuable services, eliminating the tax for both parties. As such, it would probably be regarded as either a tax-avoidance loan<sup>161</sup> or a loan the interest arrangements of which have a significant effect on the tax liability of the lender or borrower<sup>162</sup> and subject to § 7872.

The last truly unsettling decision under the *Dean* regime was *Hardee v. United States*.<sup>163</sup> In this case, despite a promising beginning in what was then the United States Court of Claims,<sup>164</sup> the government’s

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154. *Id.* at 942. A sale of real property owned by Greenspun to Hughes for over \$5,000,000, the proceeds of which Greenspun wanted to use to repay Hughes’ loan, apparently was never consummated. *Id.* at 937.

155. *Id.* at 952, n.22.

156. *Id.* at 951.

157. *Id.* at 952, n.22. The court stated: “[W]e think it is important to point out that respondent has not aided his position by waiting approximately 13 years to publicly announce his disagreement with the decision.” *Id.*

158. *Id.* at 954 (Goffe, J., concurring).

159. See I.R.C. § 7872(d)(1)(A).

160. See *Greenspun*, 72 T.C. at 957 (Nims, J., dissenting).

161. See I.R.C. § 7872(c)(1)(D).

162. See *id.* at § 7872(c)(1)(E).

163. 708 F.2d 661 (Fed. Cir. 1983).

164. *Hardee v. United States*, 82-2 USTC P9459 (Ct. Cl. 1982), *rev’d*, 708 F.2d 661 (Fed. Cir. 1983).

effort to overturn *Dean* in income tax cases reached its nadir.

In *Hardee* the taxpayer, who held a majority of the stock in a close corporation that engaged in several business, borrowed money from the corporation as he needed. He repaid it as he was able to do so.<sup>165</sup> At the end of the two years at issue, 1972 and 1973, taxpayer's debt to the corporation was over \$500,000.<sup>166</sup> To make matters worse, taxpayer held tax-exempt municipal bonds valued at more than \$500,000 in the same years.<sup>167</sup> This permitted an inference that the taxpayer used his borrowings to purchase or carry tax-exempt bonds. *Dean* had predicated exclusion of the economic benefit of an interest-free loan to the borrower on the availability of a deduction. No deduction is allowed for borrowings to purchase or carry tax-free bonds.<sup>168</sup>

The IRS asserted deficiencies against the taxpayer for 1973 and 1974 based on this borrowing, setting an interest rate at seven percent.<sup>169</sup> The Trial Division of the Court of Claims sweepingly rejected *Dean* and its progeny determining itself "not bound to honor existing views that it considers to be wrong."<sup>170</sup>

The trial court held that the taxpayer had income on the basis of tax hornbook principles.<sup>171</sup> The court rejected the theoretical availability of an interest deduction as offsetting the economic benefit of the interest-free loan on the basis that deductions do not turn on "equitable considerations," but rather depend upon "legislative grace" and thus obtain only where there is "clear provision therefor."<sup>172</sup>

The familiar principles upon which the trial court based its refusal to follow *Dean* might have been as obvious to the *Dean* court and those other courts that followed *Dean*. The victory of the government in

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165. The Federal Circuit noted that the taxpayer deferred his salary until the end of the corporation's fiscal year and then credited it to his account and gave a note to the corporation for the balance due. *Hardee*, 708 F.2d at 662.

166. *Id.* at 663.

167. *Hardee*, 82-2 USTC at 84,656.

168. See I.R.C. § 265(2). Indeed, Judge Opper's concurring opinion in *Dean* referred to I.R.C. § 265(2). *Dean*, 35 T.C. at 1091 (Opper, J., concurring).

169. *Hardee*, 708 F.2d at 663. This interest rate was not contested by the taxpayer. *Id.*

170. *Hardee*, 82-2 USTC at 84,658.

171. See *id.* For example, the court relied on *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955) for the notion that gross income is to be broadly construed to tax all gains except those specifically exempted. *Id.* It noted that the value of in-kind benefits are taxable to an employee or shareholder to the same extent or cash, *id.* (citing *Commissioner v. Smith*, 324 U.S. 177 (1945)), and that the economic benefit realized through free use of corporate assets compels recognition of income to the extent of the market value of that use. *Id.*

172. *Id.* at 84,659 (quoting *Commissioner v. National Alfalfa Dehydrating*, 417 U.S. 134, 148-49 (1974)).

*Hardee* was short-lived, however, as the Federal Circuit reversed.<sup>173</sup> The court was strongly influenced by the failure of the government to take the position prior to *Dean* that an interest-free loan resulted in income to the borrower<sup>174</sup> and by the failure of the Service to non-acquiesce in the result in *Dean* until 1973, during one of the tax years for the taxpayer involved.<sup>175</sup>

The court side-stepped the problem of possible taxpayer use of loan proceeds to purchase or carry tax-exempt bonds by ignoring *Greenspun* and perhaps even *Dean* in stating:

[T]he accepted interpretation of the definition of taxable income does not encompass the benefit of such an interest-free loan in the first place. Thus, it is immaterial that no statutory authority exists for imputing a deduction for imputed interest payments, or that no statutory authority authorizes equal treatment for economically equivalent transactions when one of those transactions depends on the ability to deduct interest payments.<sup>176</sup>

Even the two dissenting judges did not question the continued application of *Dean*. Both opined that a taxpayer who used loan proceeds to carry tax-exempt bonds should realize income.<sup>177</sup> Thus, by the time of *Hardee*, the last circuit court opinion pertaining to the *Dean* rule before the enactment of § 7872, even the theoretical requirement of a deduction appeared in question.

The most obvious consequence of this state of affairs, at least in the case law, was the ability of close corporations to bail out earnings to employee/shareholders. This had at least the temporary effect of sidestepping corporate taxation at the shareholder level, and the uncertainty, in the informality endemic to close corporations, that “loans” would ever be repaid. *Greenspun* suggested the possibility of tax-avoidance that involved a favorable interest rate as a *quid pro quo* for some service.<sup>178</sup> For example, professional sports teams used below-market loans extensively to compensate highly paid athletes.<sup>179</sup> *Hardee* left the IRS in full retreat and legislative relief was inevitable.

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173. *Hardee*, 708 F.2d 661.

174. *Id.* at 663.

175. *Id.* at 663-64.

176. *Id.* at 665.

177. *Id.* at 668 (Markey, C.J., dissenting) and 669 (Kashiwa, J., dissenting).

178. Even in the absence of an employment relationship between borrower and lender, payment in return for some service would ordinarily result in income for the person who provided the service. See *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

179. *Closius & Chapman*, *supra* note 89, at 507.

### B. Below-Market Loans and the Gift Tax

Perhaps the most significant impetus for § 7872 was the Service's significant victory in the gift tax arena in *Dickman v. Commissioner*, where the Supreme Court held that the benefit inherent in an interest-free demand loan was a gift taxable to the lender.<sup>180</sup> This victory with respect to the gift tax consequences of below-market loans did not come all at once, at least with respect to demand loans.

The Tax Court held long before *Dickman* that a below-market *term* loan could result in gift tax liability for the lender in *Blackburn v. Commissioner*.<sup>181</sup> The Tax Court's holding in *Blackburn* had the effect of transforming into interest part of the principal on a note given by "buyers" in a transaction that was part sale/part gift and treated the interest component as part of the gift. The court's analysis was quite cryptic. It simply cited the predecessor to the current § 2512(b), to the effect that a transfer of property for less than adequate consideration in money or money's worth entails a gift to the extent the value of the property exceeds that of the consideration.<sup>182</sup> As is true under § 7872 with respect to non-gift term loans<sup>183</sup> and the gift tax consequences of gift loans,<sup>184</sup> *Blackburn* required the taxpayer making the gift to reckon with the interest component at the time of the gift in the amount of the difference between the face amount and the present value of the buyer's obligation. In a sense, this represents a "bunching" into one year of a transfer that in *Blackburn* occurred over thirty-four years and six months.<sup>185</sup> Perhaps that is a practical necessity with a gift, since spreading it out over the period over which the donees actually receive the benefit of the transferred interest would have made the multiple transfers eligible for the gift tax exclusion.<sup>186</sup>

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180. *Dickman v. Commissioner*, 465 U.S. 330 (1984). One commentator has contended that I.R.C. § 7872 essentially codified *Dickman*. See Michael D. Hartigan, *From Dean to Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans*, 60 N.D. L. REV. 31, 58 (1984).

181. 20 T.C. 204 (1953). In that case, the taxpayer deeded land she contended was worth \$225,000 to her adult children in return for a promissory note in the amount of \$172,517.65, the taxpayer's basis in the land. *Id.* at 205. She reported a gift in the amount of \$52,482.35. *Id.* The government argued that the present value of the note, at four percent, the market rate on such loans, was only \$134,538.30. *Id.* at 206. The court upheld, adding the difference between the present value and the face amount of the note to the amount subject to the gift tax as a consequence of the transaction. *Id.* at 207.

182. Internal Revenue Code of 1939, § 1002.

183. I.R.C. § 7872(b).

184. *Id.* at § 7872(d)(2).

185. *Blackburn*, 20 T.C. at 206.

186. See I.R.C. § 2503(b) (excluding from gift tax the first \$10,000 transferred from donor to donee).



The government's attempts to extend the rule of *Blackburn* to interest free *demand* loans were rejected in *Johnson v. United States*<sup>187</sup> by the United States District Court for the Northern District of Texas, and in *Crown v. Commissioner* by both the Tax Court and the Seventh Circuit.<sup>188</sup>

In *Johnson*, the taxpayers made large demand loans to their children.<sup>189</sup> The government contended that the taxpayers had made gifts to their children in the amount of the average annual unpaid balances multiplied by three and a half percent.<sup>190</sup> The court treated the case as one of first impression and rejected the government's attempt to impute interest to agreements between taxpayers and their children that did not provide for interest.<sup>191</sup> The court appeared to view the government's assertion of tax on the interest component as the imposition of tax upon an opportunity cost of the loans by taxpayers to their children. The court stridently rejected the legitimacy of such an impost:

The time has not yet come when a parent must suddenly deal at arm's length with his children when they finish their education and start out in life. There is no legal requirement, express or implied, to charge them interest on money advanced to them at that stage, whether it be to open a law office and hang out a shingle, or to go into the oil business on a substantial scale, or to begin life on their own in some other way.<sup>192</sup>

In this era of pervasive discontent with the tax code and radical proposals to overhaul it,<sup>193</sup> the *Johnson* court's sentiment resonates perhaps more strongly than at the time it was uttered. Nevertheless, the refusal to impose gift or income tax consequences on gift loans allowed them to serve as a means of income tax avoidance.<sup>194</sup>

*Johnson* did not refer to *Dean*, but the latter's spill-over effect may

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187. *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966).

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

189. *Johnson*, 254 F. Supp. at 73.

190. *Id.* at 73.

191. *Id.* at 77. The court did not view the taxpayers as using the interest-free nature of the loans to deplete their taxable estate since the principal amounts of the loans remained includable in the estate. See *Harris v. Commissioner*, 340 U.S. 106 (1950).

192. *Johnson*, 254 F. Supp. at 77.

193. Jeffrey H. Birnbaum, *Commission Proposes Changes in Tax System*, WASH. POST, Nov. 2, 2005, at A1.

194. See William D. Samson & Brian D. Thorn, *The 1984 Deficit Reduction Act's Impact on Low-Interest Loans: Solving the Mystery of Phantom Interest Payments*, 33 OIL & GAS TAX Q. 681, 681-82 (1985).

be seen in *Crown*.<sup>195</sup> In *Crown*, the taxpayer, in a partnership with his two brothers, made approximately \$18 million in interest-free loans to trusts for the benefit of the partners' children and other close relatives. The Commissioner assessed a deficiency in the amount of \$1,086,407.75, representing six percent interest on the daily balance of outstanding loans for that year.<sup>196</sup> As in *Johnson*, the government's assertion of gift tax was an excise on the opportunity cost of the amount by which income from the principal, had it not been loaned at no interest, might have augmented the estate.<sup>197</sup> The Tax Court rejected the government's rationale in much the same tone as had *Johnson*:

[O]ur income tax system does not recognize unrealized earnings on accumulations of wealth and no taxpayer is under any obligation to continuously invest his money for a profit. The opportunity cost of either letting one's money remain idle or suffering a loss from an unwise investment is not taxable merely because a profit *could have been made* from a wise investment.<sup>198</sup>

Notwithstanding the confidence with which the courts in *Johnson* and then *Crown* asserted this proposition, § 7872 mandates that a donor-taxpayer enjoy the opportunity to receive income with respect to gift loans under certain circumstances.<sup>199</sup>

In a manner characteristic of the income tax cases under *Dean*, the court noted that “[t]he 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.”<sup>200</sup>

The Seventh Circuit addressed the government's argument for inclusion of demand loans within the scope of the gift tax in more detail than the Tax Court. It viewed the government as arguing that the taxpayer's transfer of money for a promise that was worth less than the amount transferred was an unequal exchange within the meaning of § 2512(b).<sup>201</sup> Alternatively, it contended that there was an outright gift of a property right, i.e., the right to use the money for an indefinite

195. *Crown*, 67 T.C. 1060.

196. *Crown*, 585 F.2d at 234.

197. *Id.* at 242. The government relied on Rev. Rul. 73-61, 1973-1 C.B. 408, which had rejected *Johnson*. *Id.*

198. *Crown*, 67 T.C. at 1063-64 (emphasis in original).

199. Under I.R.C. § 7872(d)(1), if loans between lender and borrower are more than \$100,000, there is a retransfer of forgone interest to the lender even if the borrower does not have net investment income. I.R.C. § 7872(d)(1)

200. *Crown*, 67 T.C. at 1064.

201. *Crown*, 585 F.2d at 238-39.

period.<sup>202</sup>

As to the unequal exchange, the court saw anomalies in the calculation of the value of the borrowers' obligations.<sup>203</sup> As to the IRS's argument that the taxpayer had made an outright gift of a property right, the court stated that it saw no authority "that the recipient of a loan payable on demand has a legally protectible interest vis-a-vis the lender."<sup>204</sup>

The court then addressed what it called a "third variant" of the government's argument — that the gift begins at the time the loan is made and continues as long as the lender refrains from demanding repayment.<sup>205</sup> The court stated that the notion that mere use of property can be characterized as a transfer of property "implies a broader concept of what constitutes a property right under the gift tax laws than has heretofore been recognized."<sup>206</sup>

Unlike the sad saga of its struggle to overturn *Dean*, however, the government's battle to impose *gift* tax consequences on interest-free demand loans had a happy ending — at least for the government. In *Dickman v. Commissioner*, the Supreme Court held that interest-free demand loans may constitute taxable gifts of the reasonable value of the use of the money lent.<sup>207</sup>

In that case, the taxpayers lent substantial sums at no interest to their son and a closely held corporation. The IRS determined that the loans resulted in taxable gifts to the extent of the value of the use of the funds lent. In valuing the gifts, the Commissioner multiplied the loan balances at the end of the quarters that loans were outstanding by interest rates from six to nine percent per annum.<sup>208</sup> The Tax Court followed *Crown*,<sup>209</sup> but the Eleventh Circuit reversed.<sup>210</sup> The conflict between the circuits allowed the Supreme Court to resolve the issue of whether demand loans could result in a taxable gift to the lender.

The Court did not share the misgivings of the Tax Court and the

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202. *Id.* at 239.

203. *Id.* at 238-39. The court stated that the government, in valuing the borrowers' obligation, failed to discount the interest of the time subsequent to the loan date so as to determine the value of the exchange at that date as required by § 2512(b). *Id.* at 239. The court also stated that in valuing the obligation, the Commissioner, without basis, assumed that it would be in effect for the entire period for which it sought to impute interest. *Id.*

204. *Crown*, 585 F.2d at 239.

205. *Id.* at 239-40.

206. *Id.* at 240 (footnote omitted).

207. *Dickman*, 465 U.S. 330.

208. *Id.* at 332 n.2.

209. *Dickman v. Commissioner*, 41 T.C.M. (CCH) 620 (1980).

210. *Dickman v. Commissioner*, 690 F.2d 812 (11th Cir. 1982).

Seventh Circuit in *Crown* about whether the benefit entailed in a loan of an indefinite term might be encompassed by § 2511(a). The Court stated: “[T]he gift tax was designed to encompass all transfers of property and property *rights* having significant value.”<sup>211</sup> The Court stated that the uncertain tenure of the interest conveyed to the borrower “may reduce its value, but it does not undermine its status as property.”<sup>212</sup>

In a footnote, the Court acknowledged that the relinquishing of dominion and control over the transferred property required by the regulations under § 2511<sup>213</sup> does not take place at the making of the loan.<sup>214</sup> It insisted, however, that “[a]s time passes without a demand for repayment . . . the transferor allows the use of the principal to pass to the transferee, and the gift becomes complete.”<sup>215</sup>

The Court adverted to the importance of taxing such transfers:

A substantial no-interest loan from parent to child creates significant tax benefits for the lender quite apart from the economic advantages to the borrower. This is especially so when an individual in a high income tax bracket transfers income-producing property to an individual in a lower income tax bracket, thereby reducing the taxable income of the high-bracket taxpayers at the expense, ultimately, of all other taxpayers and the Government.<sup>216</sup>

The Court’s action was thus necessary to prevent tax avoidance.

The Court did not share the concern of the courts in *Crown* and *Johnson* about the inappropriateness of imposing a tax on a taxpayer’s opportunity costs: “The gift tax is an excise tax on *transfers* of property; allowing dollars to be idle involves no transfer. If the taxpayer chooses not to waste the use value of money, however, but instead transfers the use to someone else, a taxable event has occurred.”<sup>217</sup>

This refutation of the corollary of the taxpayer’s right to leave money under the mattress provides an underpinning for treating the forgone interest as a transfer to the borrower. Section 7872 goes a significant step beyond the reasoning of *Dickman* when, in certain

211. *Dickman*, 465 U.S. at 334 (emphasis in original). The Court analogized the scope of the gift tax to that of § 61 under *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), implying that it encompassed any benefit transferred for less than money’s worth unless there is an exemption from the tax. *Dickman*, 465 U.S. at 349 n.4.

212. *Id.* at 337.

213. See Treas. Reg. § 25.2511-2(b) (1983).

214. *Dickman*, 465 U.S. at 338 n.7.

215. *Id.*

216. *Id.* at 339.

217. *Id.* at 340 (emphasis in original).

circumstances, there is a transfer back to the lender from the borrower.<sup>218</sup> Not only can the taxpayer not avoid the gift, he or she cannot avoid income.

The Court recognized the hazards of permitting the IRS to put financial matters among family members on a business-like footing.<sup>219</sup> It stated that if the Service attempted to subject parents allowing their adult children the free use of cars or vacation cottages to taxation, “there will be time enough to deal with such a case.”<sup>220</sup>

The task of creating a method of valuing no or low-interest loans in the absence of statutory guidance would seem to be a tricky one. The Court, though, did not appear to see it that way, stating simply: “[I]t is sufficient for the Commissioner to establish that a certain yield could readily be secured and that the reasonable value of the use of the funds can be reliably ascertained.”<sup>221</sup>

In light of the detailed provisions in the Proposed Regulations for determining whether a loan is subject to § 7872 as a below-market loan and in determining the amount of forgone interest transferred,<sup>222</sup> the Court seemed remarkably unconcerned about the mechanics of calculating taxable gifts in the absence of a statute.

The dissenting opinion of Justice Powell took the Court to task on this account.<sup>223</sup> It noted that in the three cases in which the Commissioner had taken the position with respect to gift tax liability that the Court adopted in *Dickman*, he had posited three different theories for valuing the interest rate to determine the “use-value of the borrowed money.”<sup>224</sup> Of course, the adoption of the applicable federal rate as a benchmark in § 7872 addresses these concerns, although the calculations for term loans may be complex.

218. See I.R.C. § 7872(d)(1).

219. See *Dickman*, 465 U.S. at 340-42.

220. *Id.* at 341.

221. *Id.* at 345 n.14.

222. See Prop. Treas. Reg. § 1.7872-12, -13, -14, 50 Fed. Reg. 33553, 33567-70 (Aug. 20, 1985).

223. See *Dickman*, 465 U.S. at 345 (Powell, J., dissenting).

224. *Id.* at 350 (Powell, J., dissenting). In *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966), the IRS computed the amount of gift specified in regulations for valuing annuities, life estates, etc. See Treas. Reg. § 25.2512-5 (1983). In *Crown v. Commissioner*, 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978), the Service used a rate that it considered reasonable under the circumstances. In *Dickman*, noted Justice Powell, the Service urged the rate under I.R.C. § 6621 for interest due on underpayments or refunds of taxes. *Dickman*, 465 U.S. at 350 n.9. Justice Powell also noted that in a recently docketed Tax Court case, *La Rosa v. Commissioner*, No. 29632-82 (Tax. Ct. filed Dec. 22, 1982), the Service proposed a separate rate for each month the loan was outstanding provided by an expert “who relied on estimated fair market interest rates considering the credit-worthiness of the borrowers.” *Dickman*, 465 U.S. at 350 n.9.

Justice Powell also criticized the Court for departing from “a long-standing principle of gift tax law, supported by IRS inaction and judicial opinion”<sup>225</sup> after justified reliance on freedom from gift taxation for interest free loans.<sup>226</sup> This concern, too, has been alleviated by the enactment of § 7872.

Justice Powell was most troubled, however, by “the scope of [the Court’s] new reading of the statute,” which he saw as not limited to interest-free use of money.<sup>227</sup> He saw the Court’s ruling as encompassing “rent-free use of a home by a child over the age of minority,” or to the loan of a car for a brief period.<sup>228</sup> By limiting the application of § 7872 to loans of money, Congress has largely sidestepped this problem as well.<sup>229</sup>

Nonetheless, there seems an overriding concern on the part of Justice Powell that the Court’s approval of gift taxation of interest-free loans will create headaches for a new class of taxpayers<sup>230</sup> and the potential for abuse by the IRS because of the broad power conferred on the Service and the Court’s assumption that the “Service will exercise the power conferred on it in a reasonable way.”<sup>231</sup>

As noted earlier, § 7872 imposes the burden of reporting and explaining the tax implications of below-market loans on all of the participants thereto.<sup>232</sup> Congress has also given what amounts to a *carte blanche* to apply § 7872 to loans that may affect federal tax liability of lender or borrower.<sup>233</sup> As discussed below, the IRS has exercised this broad authority.<sup>234</sup> Justice Powell believed the sweeping authority given the Commissioner in *Dickman* could be abused.<sup>235</sup> Experience with § 7872 has shown that there is basis for similar concern with administration of that law under the broad powers given the IRS.

225. *Id.* at 347.

226. *Id.* at 348.

227. *Id.* at 349.

228. *Id.* at 350.

229. See Prop. Treas. Reg. § 1.7872-2(a)(1), 50 Fed. Reg. 33553, 33557 (Aug. 20, 1985).

230. As Justice Powell stated: “[T]he net result of the Court’s decision will be to create potential tax liability for many taxpayers who have never been subject to it before, and create legal, tax accounting, and return filing nightmares for many others.” *Dickman*, 465 U.S. at 352.

231. *Id.* at 351.

232. See *supra* Section II.D. This requirement is particularly remarkable with respect to split-dollar arrangements to purchase insurance. See Treas. Reg. § 1.7872-15 (2003). Split-dollar arrangements occur when two individuals agree to share premium payments, but the life insurance is written only on the life of one. BLACK’S LAW DICTIONARY 807 (7th ed. 2004).

233. I.R.C. § 7872(c)(1)(E).

234. See *infra* Section IV.

235. *Dickman*, 465 U.S. at 351.

### C. *The End of the Dean Era*

Whether the Supreme Court's resolution of the issue of the gift tax consequences of interest-free loans in the government's favor would have spilled over into the income tax, no one can say. Congress shortly thereafter adopted § 7872. The "problems" that spurred adoption of § 7872 were quite apparent in the case law of the previous two and a half decades. Most prominently, shareholders were able to obtain large interest-free loans from (usually closely-held) corporations.<sup>236</sup> This frustrated the Code's scheme of double taxation of corporate income. Taxpayers of substantial means, denizens of high marginal brackets, "loaned" substantial amounts to others (often family members) in lower tax brackets. This alternatively frustrated the gift tax or the grantor trust provisions intended to limit intra-family tax avoidance. Less obvious, in the case law anyway, but a significant matter, was the use of interest-free loans as a substitute for taxable compensation.<sup>237</sup>

Section 7872 addressed all of these issues, but also gave the IRS power to address below-market loans in contexts that did not appear to raise issues of tax avoidance in the frequent litigation in the *Dean* era. In a number of respects, § 7872 permits the IRS, at its discretion, to compel taxpayers to deal with each other in accordance with the tax collector's idea of what is a commercially reasonable, arm's length manner.

Granting such power to the IRS might well have been in accord with notions of tax policy that ran rampant during the 1980s. There seems a good deal less willingness today to permit the IRS to impose intricate regulation of business dealings. It is time to look at how § 7872 has functioned in its two decades of existence and to ponder whether the complexity embodied in the original enactment and in regulations that, for the most part, have not become final, is warranted. The remainder of this article will assess the experience with § 7872 in the judicial and administrative realms and then propose changes aimed at eliminating unwarranted complexity in the law of below-market loans.

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236. See Lokken, *supra* note 79, at 203-04 (discussing the adoption of § 7872 as a remedy to corporations' ability to give stockholders corporate income in the form of a loan without paying taxes on the income).

237. Before the enactment of § 7872, below-market loans were widely used by professional sports teams as part of player compensation. Closius & Chapman, *supra* note 89, at 507.

#### IV. HOW § 7872 HAS FUNCTIONED SINCE ITS ENACTMENT

##### *A. Section 163(h)—Congress Gives § 7872 Sharper Teeth—Did It Really Mean To?*

In the Tax Reform Act of 1986,<sup>238</sup> Congress disrupted an equilibrium between taxpayers and the tax collector that existed with respect to most of § 7872. It enacted § 163(h) which generally denies the taxpayer a deduction for personal interest.<sup>239</sup> After 1986, individual taxpayers had to meet one of the exceptions to § 163(h) in order to deduct interest.

It does not appear that Congress considered the effects of § 163(h) on § 7872, but they are significant.<sup>240</sup> Congress' justification for this measure, *i.e.*, the elimination of a disincentive to saving,<sup>241</sup> to the extent that it was not a rationalization for the sacrifice of some popular deductions in exchange for a historic rate reduction in the 1986 Act,<sup>242</sup> sounds remarkably paternalistic in the less tax-abiding twenty-first century.<sup>243</sup> Whatever its motivation, the action by Congress to curb consumer debt does not appear to have been successful, as consumers have taken on record levels of debt, much of it in the form of deductible mortgage interest.<sup>244</sup> Whatever its intent or efficacy, § 163(h) skewed

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238. Pub. L. No. 99-514, § 511(b), 100 Stat. 2246 (1986).

239. I.R.C. § 163(h). Under § 163(h)(2), this is defined as interest other than that paid or accrued in a trade or business, investment interest, interest taken into account from a passive activity, qualified residency interest, certain interest on payments of estate taxes during an extension of time for payment and interest deductible under § 221 on an educational loan. *Id.*

240. Ward, *supra* note 9, at 887. See also GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, Prepared by Staff of Joint Committee on Taxation, 262-70 (1987).

241. See S. REP. NO. 99-313, at 804 (1986), reprinted in 1986-3 C.B. 1, 804 which states: Present law excludes or mismeasures income arising from the ownership of housing and other consumer durables. Investment in such goods allows consumers to avoid the tax that would apply if funds were invested in assets producing taxable income and to avoid the cost of renting these items, a cost which would not be deductible in computing tax liability. Thus, the tax system provides an incentive to invest in consumer durables rather than assets which produce taxable income and, therefore, an incentive to consume rather than save.

S. REP. NO. 99-313, at 804 (1986), reprinted in 1986-3 C.B. 1, 804.

242. See Block, *supra* note 3, at 70.

243. It is difficult to imagine a Congress in which the Speaker of the House (Dennis Hastert) and the former majority leader (Tom Delay) favor scrapping the IRS and the current income tax in favor of a national sales tax, and would adopt such an overt attempt to control taxpayer behavior. See Kemper, *supra* note 2, at 1A.

244. Barbara Hagenbaugh, *Consumer Debt Loads at Record*, USA TODAY, March 18, 2004, at 1B. See also Kenneth Harney, *Major Lenders See Future in Home-Equity Credit Card*, BALTIMORE SUN, April 30, 2000, at 1L.



the tax neutrality of § 7872.

Before the adoption of § 163(h), § 7872 was largely tax-neutral, *i.e.*, its application to a transaction in many instances did not result in an increase in income taxes to the parties. A taxpayer who received an item that increased income in a below-market loan also had an offsetting deduction. This was particularly, but not exclusively, true with respect to compensation-related loans.

Under § 7872(a), a compensation-related demand loan entails a transfer of the forgone interest from lender to borrower and a retransfer from borrower to lender. Lender had a deductible compensation expense and offsetting interest income in the same amount. That is still true. The borrower had compensation income and an offsetting interest deduction.<sup>245</sup> This balancing was consistent with one of the schools of thought as to how to treat the no-interest loan during *Dean's* heyday.<sup>246</sup>

Section 163(h) upset this balance. Unless the interest is deductible under some exception to § 163(h), the borrower has no deduction to offset the income he or she must report on the first transfer.<sup>247</sup>

The scheme of the transfer and retransfer of forgone interest was foreshadowed in the scholarly literature before the adoption of § 7872.<sup>248</sup> It appears to have been a means of achieving symmetry in the tax consequences of the parties. If the interest the borrower “pays” on the retransfer to the lender is not deductible, such symmetry no longer exists. There is really no need for a retransfer at all. To be sure, the lender who pays compensation gets a deduction. But there is no more need to “even the score” with corresponding interest income than there is when the employer pays and deducts compensation other than through a below-market loan. In reality, the employer who resorts to a below-market loan is receiving nothing back as to the forgone interest. If the borrower cannot deduct the “repayment,” there is no longer any point in

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245. With a compensation-related term loan, there was an asymmetry of timing between the reporting of income and the corresponding deduction. Under § 7872(b)(1), the lender is deemed to transfer the amount of forgone interest to the borrower on the date the loan is made. I.R.C. § 7872(b)(1). This is treated at that time as income to the borrower. *Id.* Under § 7872(b)(2), the forgone interest is treated as original issue discount. *Id.* at § 7872(b)(2). Prior to the enactment of § 163(h), the borrower with respect to such an instrument received a deduction for interest that corresponded with the daily reporting by the lender. *See Id.* at §§ 1272(a)(1), 163(e). Thus, the timing of income and deduction did not match.

246. This was the approach of Judge Goldberg in his dissent in *Martin v. Commissioner*, 649 F.2d 1133, 1142-43 (5th Cir. 1981) (Goldberg, J., dissenting).

247. For example, if the indebtedness may be regarded as incurred in the taxpayer's trade or business or if it is secured by the taxpayer's residence.

248. *See, e.g.,* Kenneth F. Joyce & Louis A. Del Cotto, *Interest-Free Loans: The Odyssey of a Misnomer*, 35 TAX L. REV. 459, 461 (1980).

making the lender pretend that any such repayment takes place.

The effect of § 163(h) is particularly harsh with respect to term loans. Under the scheme of § 7872(b)(1), the borrower who receives compensation must report the entire difference between the amount loaned and the present value of all payments required to be made under the loan in the year the loan is made. The effect of this provision is so harsh as to serve as a deterrent to below-market term loans.<sup>249</sup> The denial of any deduction at all only enhances the harshness of the treatment of term loans.

The symmetry of the tax consequences of the parties under § 7872 may be seen most precisely with compensation-related loans since the items are income for the recipient and a deduction for the payor.

With respect to corporation-shareholder loans, the transfer from the corporate-lender to the shareholder-borrower may represent a dividend to the shareholder.<sup>250</sup> The IRS has recognized that the transfer may be treated as a distribution of earnings and profits by the corporation.<sup>251</sup> These items, of course, do not offset each other, but each party “gets something” with respect to the forgone interest.<sup>252</sup>

As with compensation-related loans, both parties reckon with tax consequences on the transfer from lender to borrower. Since the shareholder/borrower has no deduction most of the time there is no reason to have taxpayers “square accounts” with a retransfer. Eliminating that second step would mean that the corporation/lender would not have to report the interest income. But again, Congress has seen no need when a corporation pays a dividend through some means other than a below-market loan to provide for some mechanism to offset

249. Consider the following example:

(i) On July 1, 1984, corporation Abe Co. makes a \$200,000 interest-free three-year term loan to shareholder Bob. The applicable Federal rate is 10-percent, compounded semiannually.

(ii) The present value of this payment is \$149,243.08, determined as follows:

$$\$149,243.08 = \frac{\$200,000}{[1 + (.10/2)]^6}$$

(iii) The excess of the amount loaned over the present value of all payments on the loan (\$200,000 – \$149,243.08), or \$50,756.92, is treated as a distribution of property (characterized according to section 301) paid to Bob on July 1, 1984. The same amount, \$50,756.92, is treated as original issue discount under IRC § 1272 and IRC § 163(e).

15A U.S. TAX RPTR., U.S.T.R. ¶ 78, 724.06 (2006).

250. A rule for distinguishing compensation from shareholder loans with respect to employers who are significant shareholders is presented at Prop. Treas. Reg. § 1.7872-4(d)(2), 50 Fed. Reg. 33553, 33561 (Aug. 20, 1985).

251. See I.R.C. § 312(a). See also I.R.S. Pvt. Ltr. Rul. 95-45-007 (Aug. 10, 1995).

252. If there are no earnings and profits, there should be no income consequences to the borrower, or at least no dividend income consequences. See I.R.C. § 316(a).

the charge to earnings and profits.

With respect to gift loans, the symmetry of tax consequences of lender and borrower endemic to § 7872 is again not as scrupulous as that pertaining to compensation-related loans, but it is evident nonetheless. The lender, of course, has no deduction when making a below-market loan to the borrower; indeed he or she may incur a gift tax. Since the transaction represents a gift for income tax purposes, the borrower has no income tax consequences from the transfer.

Unlike the circumstances involving compensation-related or corporation-shareholder loans, the lender enjoys no tax benefit on the transfer. And up to a point, there is no offsetting retransfer. To the extent loans between individuals do not exceed \$100,000 and the borrower does not have net investment interest, there is no retransfer.<sup>253</sup>

To the extent that the loan fails either condition, there is a retransfer to from borrower to lender. In this instance, it cannot be contended that § 163(h) works any mischief in conjunction with the retransfer provision. Indeed, it would not be appropriate to allow a deduction to the borrower. The allowance of exclusion and deduction would be a double benefit, generally abhorred by tax law.<sup>254</sup> In this instance, the retransfer provision works a mischief all its own. It compels the lender to “enjoy” a return of capital he or she has foresworn and, when it is applicable simply because the loans between the parties exceed \$100,000 and the borrower has no investment interest, a return that simply does not exist. The anomalous consequences of this retransfer are addressed in more detail below.

Section 163(h) had a significant effect on § 7872. It is quite likely that this effect was not specifically intended by Congress. Such a change to a complicated scheme should preferably be made with a clear acknowledgment of its consequences.

### *B. Development of the Law Pertaining to Gift Loans Under § 7872*

The primary issue involving gift loans under § 7872 has involved sales of property that may be regarded as part-sale, part-gift.<sup>255</sup> Assume, for example, that a mother of an adult child owns a large tract of unimproved land the value of which is likely to increase dramatically between the present time and when it would be includable in her estate

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253. See I.R.C. § 7872 (d).

254. See *Nash v. United States*, 398 U.S. 1 (1970).

255. See *Schneider*, *supra* note 37, at 100 (discussing the relation between § 7872 and gifts of property given to children).

at the time of her death. She therefore decides to “sell” the tract to her son. Assume that the son pays \$100,000 and gives a fifteen-year note for \$400,000 at six percent interest per annum, compounded semi-annually. Total payments over that time will be \$907,904.99.<sup>256</sup> Assume, however, that the applicable federal rate is ten percent. The present value of the payments under the contract, discounted at the applicable federal rate, is \$234,242.94. The difference between this amount and the amount loaned, \$400,000, is \$165,757.06. Because the present value of total payments under the loan, discounted at the applicable federal rate, is less than the amount loaned, \$400,000, it is a below-market loan under § 7872, at least according to the IRS.<sup>257</sup>

According to the law of one circuit, however, there is no gift loan in this situation. Since the loan bears interest at six percent and involves a sale of property between relatives, the interest rate is sufficient for purposes of § 483. That section generally requires treatment of a portion of a payment under a contract for sale of property as interest to the extent that unstated interest is allocable to such payment.<sup>258</sup> The unstated interest is the excess of the sum of payments due under the contract over the sum of the present values of such payments and any interest payments under the contract.<sup>259</sup> The present value of the latter payments is determined by using, as does § 7872, the applicable federal rate under § 1274(d).

Pertinent to the circumstances of the taxpayer at hand, perhaps, is § 483(e), which provides for a maximum discount rate in determining unstated interest of six percent in land sales between related parties<sup>260</sup> to the extent that the sales price, when added to the aggregate sales price for such prior sales between individuals during the calendar year, does not exceed \$500,000.<sup>261</sup> This special rule under § 483(e) would provide more favorable treatment to the mother than § 7872 in that as long as the contract of sale with her son provides an interest rate of at least six percent,<sup>262</sup> there may be no unstated interest and, hence, no taxable gift.

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256. The source of these calculations is the compound interest calculator, *available at* [www.moneychimp.com](http://www.moneychimp.com) (last visited May 11, 2006).

257. I.R.S. Gen. Couns. Mem. 39,566 (Oct. 23, 1986).

258. Under § 483(a)(2), the allocations to the payments under the contract are made in a manner consistent with § 1272(a), that is, the daily portions of the unstated interest, or original issue discount, are allocated to each day the seller holds the buyer's debt instrument. I.R.C. § 483(a)(2).

259. *Id.* at § 483(b)(1), (2).

260. *Id.* at § 267(c)(4) (mother and son would qualify).

261. *Id.* at § 483(e)(3) (assume our mother and son have no other such sales in the calendar year).

262. If the applicable federal rate is *less* than six percent, the normal rule of subsection (b) would apply and the contract rate would only have to at least equal that lower rate in order for the

This special provision of § 483 was originally included as subsection (g) in 1981 and provided for a maximum seven percent interest rate.<sup>263</sup> Prior to that time, a six percent maximum rate for such transactions was fixed by regulation.<sup>264</sup> It was designated as subsection (e) with a maximum interest rate of six percent in 1985.<sup>265</sup>

This assumes, of course, that § 483, and more particularly § 483(e), have anything to do with the calculation of a gift tax. As to that issue, the signals are mixed. Section 7872 itself is superficially unambiguous: it provides that it does not apply to loans to which § 483, 641(i), or § 1274 applies.<sup>266</sup> The Service has promulgated regulations under § 483 that provide that it is inapplicable to certain obligations to which § 7872 applies.<sup>267</sup> This could apply to the above transaction involving mother and son.

The IRS set out the rationale for its rejection of § 483(e) to the part sale/part gift transactions involving a below-market interest rate in General Counsel Memorandum (G.C.M.) 39,566.<sup>268</sup> That document dealt with a transfer by a taxpayer of a farm to her children in 1981 at a time when the prevailing rate of interest was assumed to be fifteen percent. The note was given by the children in the amount of \$184x less than the fair market value of the farm with a base interest rate of six

parties to avoid unstated interest. *Id.* at § 483.

263. Pub. L. No. 97-34, § 126(a), 95 Stat. 172, 202 (1981).

264. Treas. Reg. § 1.483-1(b)(1)(ii) (1966), *superseded by* T.D. 2517 1994-1 C.B. 38.

265. Pub. L. No. 99-121, § 102(c)(1), (3), 99 Stat. 505, 508.

266. I.R.C. § 7872(f)(8). Both §§ 483 and 1274 employ the applicable federal rate in recharacterizing principal as interest when debt instruments do not provide interest at the applicable federal rate. *See id.* at §§ 1274(b), 483(b). Both apply to sales of non-publicly traded property. *See id.* at §§ 1274(c)(3)(D), 483(d)(1), which also provides that § 483 does not apply where § 1274 applies. For § 1274 to be applicable, there must be payments under a debt instrument more than six months after the sale or exchange. *See id.* at § 1274(c)(1)(B). Under § 1274(c)(3)(C), the general demarcation between the applicability of § 1274 and § 483 is whether a sale involves payments of more than \$250,000. *Id.* at § 1274(c)(3)(C). If payments do not involve more than \$250,000, generally § 483, unless otherwise excluded, is applicable. *Id.* Under § 1274(c)(3)(F), transactions involving related parties within the ambit of § 483 rather than § 1274. *Id.* at § 1274(c)(3)(F). That is significant when the applicable federal rate exceeds six percent because § 1274 employs the applicable federal rate, while § 483(e)(1) employs a maximum rate of six percent. *See id.* at §§ 1274(b)(2)(B), 483(e)(1).

267. Under Treas. Reg. § 1.483-1(c)(3)(ii) (1994), § 7872 applies for an obligee under a contract for the sale or exchange of personal use property within the meaning of § 1274(b)(3), *i.e.*, property not used in connection with a trade or business or activity for the production of income under § 212, and that evidence a below-market loan described in § 7872(c)(1). Treas. Reg. § 1.483-1(c)(3)(ii) (1994). Treas. Reg. § 1.483-1(c)(3)(iii) provides that § 483 does not apply to any payment under a contract that evidences a demand loan that is a below-market loan under § 7872(c)(1). *Id.* at § 1.483-1(c)(3)(iii).

268. I.R.S. Gen. Couns. Mem. 39,566 (Oct. 23, 1986).

percent.<sup>269</sup> The document acknowledged that in a previous G.C.M., the IRS had employed § 483 in valuing a note given in exchange for stock in a transaction involving related parties.<sup>270</sup>

In G.C.M. 39,566, the Service saw the critical issue as whether § 483 applied to the entire Code or simply to income taxes, and concluded that it applied only to income taxes.<sup>271</sup> The IRS based its conclusion on what was largely a commonsense analysis that Congress intended § 483 to address a problem that did not involve the gift tax. Rather it was aimed at transactions involving installment sales of capital assets in which the parties opted not to provide for interest payments. This allowed the seller to treat what should have represented interest payments as capital gain and allowed the buyer to treat such payments as basis.<sup>272</sup>

According to the IRS, Congress saw this as manipulation of the tax law.<sup>273</sup> The IRS contended that such manipulation is not possible in the gift tax context because “[w]hen the consideration in part gift, part sale transactions is consistently valued at fair market rates, there is no opportunity for manipulation.”<sup>274</sup>

It is certainly fair to say that Congress was not thinking in 1964 about avoidance of gift taxation on donative transactions involving below-market “loans.” At that time, the government had not even signaled its disagreement with *Dean*. Nevertheless, the reasoning of the Service plausibly applies to the part sale, part gift circumstances. Under § 7872 the existence of a taxable gift with respect to *interest* is determined not by the fair market value of the asset, but by whether an acceptable interest rate is charged on payments made at some time after the sale or exchange of the asset. That is the same process employed under § 483 to determine how much of payments represents interest and how much represents capital gain. The type of tax avoided by unrealistic demarcations between principal and interest may differ, but both demarcations are redrawn, in appropriate cases, by reference to a realistic interest rate.

Of course, both §§ 483 and 7872, in referring *generally* to the applicable federal rate, would offer no solace to our mother and son

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269. *Id.*

270. In I.R.S. Gen. Couns. Mem. 39,331 (Jan. 23, 1985), the IRS stated that with respect to any contract for the sale of property, but its terms, § 483 applies for all purposes of the Code. *Id.*

271. I.R.S. Gen. Couns. Mem. 39,566 (Oct. 23, 1986).

272. *Id.* at 11-12.

273. *Id.* at 12. See also S. REP. NO. 88-830, at 101-02 (1964), reprinted in 1964-1 C.B. 505, 605-06.

274. I.R.S. Gen. Couns. Mem. 39,566 at 12.

taxpayers. It is only § 483(e) that appears to apply to the transaction between related parties. Neither § 483 generally nor § 7872 do so.

In light of the conflicting legislative and administrative signals concerning the scope of § 483 and its relationship to § 7872, it is not surprising that court decisions addressing this matter do not reach a single result, although those of the Tax Court do. There are three cases that consider the applicability of § 483(e) to circumstances like our part sale, part gift transaction. The first two<sup>275</sup> involved transactions that occurred in 1981, a time of remarkably high interest rates,<sup>276</sup> before the effective date of § 7872.<sup>277</sup> Thus, the IRS urged the applicability of a market approach for the interest rate used to discount the sellers' obligations similar to what the Tax Court approved in *Blackburn v. Commissioner*.<sup>278</sup> In one of the cases, § 7872 was available and the Service successfully argued its applicability.<sup>279</sup>

In *Ballard v. Commissioner*, the taxpayer sold real estate to her three children that she contended (and the IRS ultimately agreed) was worth \$572,000.<sup>280</sup> The buyers gave taxpayer a note, payable over forty-five years in the amount of \$386,000.<sup>281</sup> It bore interest at six percent per annum. Using an eighteen percent interest rate, the IRS discounted it to \$134,290.26 thus substantially increasing the amount of the taxable gift for the taxpayer.

The taxpayer argued that as long as she charged six percent interest on the money her children borrowed from her, she had made no gift. Although the court agreed with the taxpayer that the language in the first sentence of § 483(a), which stated that it applied "for purposes of this title," connoted that its applicability was not limited to income taxes, it could not agree that phrase was applicable to valuation for gift tax purposes.<sup>282</sup>

The court viewed the value of property as "the price at which such property would change hands between a willing buyer and a willing

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275. See *Krabbenhoft v. Commissioner*, 94 T.C. 887 (1990), *aff'd*, 939 F.2d 529 (8th Cir. 1991); *Ballard v. Commissioner*, 53 T.C.M. (CCH) 323 (1987), *rev'd*, 854 F.2d 185 (7th Cir. 1988).

276. Hobart Rowan, *The Interest Rate Roller Coaster*, WASH. POST, Nov. 26, 1981, at A27.

277. Section 7872 became effective June 6, 1984. See Prop. Treas. Reg. § 1.7872-1(b), 50 Fed. Reg. 33553, 33556 (Aug. 20, 1985).

278. *Blackburn*, 20 T.C. 204. See *supra* notes 181-186 and accompanying text for discussion.

279. *Frazee v. Commissioner*, 98 T.C. 554 (1992).

280. *Ballard v. Commissioner*, 53 T.C.M. (CCH) 323 (1987), *rev'd*, 854 F.2d 185 (7th Cir. 1988).

281. At which time the seller would have been 113 years old! *Ballard*, 53 T.C.M. (CCH) at 324.

282. *Id.* at 326.

seller.”<sup>283</sup> The court found § 483 as not concerned with that, but rather, with recharacterizing portions of payments, “when not enough interest has been provided for in [an] installment contract.”<sup>284</sup>

In stating that § 483 was not concerned about the present value of payments under the contract but rather about characterization of capital gain as ordinary income, the court overlooked that both inquiries really entail determining the same number in the same way. The different names given to the calculations did not logically compel selecting one notion or the other of what interest rate to use in establishing how much of the payments must be regarded as interest. The court assumed that Congress would not have changed the “basic valuation principle followed in *Blackburn*” without saying so.<sup>285</sup>

Remarkably, the taxpayer relied on § 7872 as an example of Congress’ providing that no gift will be found as long as a specified rate is charged.<sup>286</sup> The court simply deflected the taxpayer’s argument related to § 7872 on the basis of its inapplicability to the transaction because of its effective date.<sup>287</sup> The court did determine that interest rates on mortgages in the taxpayer’s locale were a more appropriate guide for determining the interest rate and thus discounted the buyers’ obligation at sixteen percent rather than the government’s eighteen percent.<sup>288</sup>

The Seventh Circuit reversed the Tax Court.<sup>289</sup> It regarded the language in § 483(a) applying “for purposes of this title” as unambiguously applying to gift as well as income taxes.<sup>290</sup> The court could not see any indication in the legislative history that the section did not apply to gift taxes.<sup>291</sup> The court ridiculed the Commissioner’s

283. *Id.*

284. *Id.*

285. *Id.* at 326. But Congress literally did so. For Justice Scalia, that of course, would be sufficient:

The meaning of terms on the statute books ought to be determined, not on the basis of which meaning can be shown to have been understood by a larger handful of the Members of Congress; but rather on the basis of which meaning is (1) most in accord with the context and ordinary usage, and thus most likely to have been understood by the *whole* Congress which voted on the words of the statute. . . .

*Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 528 (1989) (Scalia, J., concurring).

286. Surely the taxpayer would not have referred favorably to § 7872 had it actually been applicable, for § 7872’s use of the applicable federal rate would have yielded a result much like what the government urged in *Ballard*. See I.R.C. § 7872.

287. *Ballard*, 53 T.C.M. (CCH) at 327.

288. *Id.* at 328.

289. *Ballard*, 854 F.2d 185.

290. *Id.* at 188.

291. *Id.*



construction of § 483 as akin to Humpty Dumpty's insistence that a word means "what I choose it to mean – neither more nor less."<sup>292</sup> The court viewed § 483 as a safe harbor even for purposes of gift tax valuation.

The Tax Court next considered the question of the proper rate to discount a buyer's obligation in a part sale, part gift transaction in *Krabbenhof v. Commissioner*.<sup>293</sup> In that case, the taxpayers sold farm land worth \$404,000 to their sons under a contract providing for thirty annual payments of \$29,060 at six percent interest.<sup>294</sup> The Commissioner discounted the buyers' obligation using an interest rate of eleven percent, determining a present value of \$252,642.<sup>295</sup> It treated the difference between the value of the land and the present value of the contract as a gift.

Because its decision in *Krabbenhof* was appealable to a different circuit than that in *Ballard*, the Tax Court was not bound by the Seventh Circuit's decision in *Ballard*.<sup>296</sup> The court essentially reiterated its conclusion in *Ballard* that while § 483 applied to all sections of the Code to which it was relevant, it had nothing to do with valuation for purposes of the gift tax.<sup>297</sup>

The Eighth Circuit affirmed the Tax Court, disagreeing with the Seventh Circuit in *Ballard*.<sup>298</sup> It agreed with the Tax Court that § 483 had nothing to do with valuation for gift tax purposes. It opined that the decision of the Seventh Circuit was based on government counsel's "fairy tale logic," *i.e.*, the "specious[ ]" argument that the taxpayer would have suffered imputation of only a seven percent interest rate if she had charged less than six percent.<sup>299</sup> Since the government had repudiated that contention and the court no longer confronted "fairy tale logic," it determined that the IRS was unshackled by the maximum six percent interest rate in discounting the buyers' purchase obligation under

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292. *Id.* at 189 (quoting LEWIS CARROL, ALICE IN WONDERLAND). In particular, the court ridiculed the IRS contention of the statute that if the taxpayer had failed to provide the minimum six percent rate in statute, an interest rate of seven percent would have been imputed. *Id.* It quoted the attorney for the Commissioner as contending that a rate of eighteen percent could be imputed when the taxpayer complied with the statutory minimum of six percent "because § 483 does not mean what it says." *Id.*

293. *Krabbenhof*, 94 T.C. 887.

294. *Id.* at 888.

295. *Id.*

296. See *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971).

297. *Krabbenhof*, 94 T.C. at 890.

298. *Krabbenhof*, 939 F.2d 529.

299. *Id.* at 532-33.

the contract.<sup>300</sup>

In the final case involving valuation of a purchase obligation, *Frazer v. Commissioner*, the transaction at issue occurred after the effective date of § 7872.<sup>301</sup> The Tax Court applied the same reasoning as it had in the two earlier decisions and held against the taxpayer.

In *Frazer* the taxpayers transferred 12.2 acres of improved real estate to their four children.<sup>302</sup> In exchange, taxpayers received a promissory note with a principal amount of \$380,000 bearing interest at seven percent.<sup>303</sup> The note called for a twenty-year graduated repayment schedule of quarterly payments. A good part of the court's opinion involved the question of the value of the real property transferred. The court ultimately determined that the value was \$1,000,000, \$950,000 to the land and \$50,000 to the improvements.<sup>304</sup>

In order to value the gift, the court had to value the consideration given by the children: the \$380,000 note.<sup>305</sup> The issue was whether there was a gift in addition to that representing the difference between \$1,000,000 and \$380,000, the amount of the note that bore a below-market interest rate.<sup>306</sup>

The court noted that this was its first opportunity to consider the scope of § 7872 in light of § 483.<sup>307</sup> In resolving this issue, the court noted the conflicting IRS positions. The first was in gift tax regulations proposed for § 2512, and complementing income tax provisions,<sup>308</sup> which would treat § 483 as controlling with respect to valuing a below-market debt instrument.<sup>309</sup> The court noted that the Commissioner took the opposite position in G.C.M. 39,566.<sup>310</sup> Although that did not specifically involve § 7872 because the transaction therein preceded its effective date, it indicated that § 7872 would apply to the part sale/part

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300. *Id.* at 533-34.

301. *Frazer*, 98 T.C. 554.

302. *Id.* at 555.

303. *Id.*

304. *Id.* at 560.

305. *Frazer*, 98 T.C. at 561-62. Under § 2512(b), the amount by which the value of the property exceeds that of the consideration exchanged is the amount of the gift. I.R.C. § 2514(b).

306. *Frazer*, 98 T.C. at 579-80.

307. *Id.* at 580.

308. See Prop. Treas. Reg. § 25.2512-8, 51 Fed. Reg. 12022, 12096 (April 8, 1986).

309. Rather than employing the proposed regulations as a matter of estoppel against the government, the court treated them as a "body of informed judgment as to which courts may draw on for guidance." *Frazer*, 98 T.C. at 582 (quoting *Bolton v. Commissioner*, 694 F.2d 556, 561 n.10 (9th Cir. 1982)).

310. *Frazer*, 98 T.C. at 582. See also I.R.S. Gen. Couns. Memo. 39,566 (Oct. 23, 1986).

gift transaction after its effective date.<sup>311</sup> The court stated that it would decide the issue on the basis of the Code sections, the legislative history and the case law.<sup>312</sup>

Looking at the appellate holding in *Ballard*, which had treated § 483 as applicable, the court opined that it would create an “anomalous result[.]” to instances in which the transferor dies before the note is paid.<sup>313</sup> The court stated that in such a situation the note would be valued at its then remaining face value rather than its discounted present value.<sup>314</sup> The court stated that this creates an estate tax on wealth that does not really exist.<sup>315</sup>

Such a phenomenon is really more of a tradeoff than an anomaly, at least when the applicable federal rate is greater than six percent, and then only if the loan is not paid off. In resorting to the part sale/part gift perhaps years before the asset sold would have to be included in the testamentary estate, the seller has an opportunity to reduce the wealth subject to the tax.

The court also viewed the use under § 483(e) of a single rate of six percent as facilitative of land sales in times of high interest.<sup>316</sup> The court identified no Congressional consideration of such a purpose with respect to gift taxes. Nevertheless, the imposition of stiff gift tax liability under the circumstances of *Ballard*, *Krabbenhof*, and *Fraze* amounts to a taking away with one hand whatever facilitation Congress intended to provide to intrafamily sales with the other.

Since *Fraze* there has been silence with respect to the issue of whether § 483 or § 7872 controls in discounting the buyer’s obligation in a part sale/part gift among related parties. In light of the interest rates that have prevailed in the years since the last word of the Tax Court in 1992, that is not surprising.<sup>317</sup> Until interest rates rise above six percent,

311. See *supra* note 278.

312. *Fraze*, 98 T.C. at 583.

313. *Id.* at 584.

314. *Id.*

315. *Id.*

316. *Id.* at 585.

317. A look at the trend of the long-term applicable federal rate, compounded semi-annually, which would be applicable to these long-term part sale/part gift transactions shows a steady decline in the rate to less than the six percent rate of § 483(e) for much of the time:

YearSourceRate[.]

1990Rev. Rul. 90-52, 1990-2 C.B. 192—8.55%

1992Rev. Rul. 92-50, 1992-2 C.B. 205—7.59%

1994Rev. Rul. 94-44, 1994-2 C.B. 190—7.33%

1996Rev. Rul. 96-34, 1996-2 C.B. 75—7.00%

1998Rev. Rul. 98-33, 1998-2 C.B. 25—5.80%

§ 7872 is most likely to be a sleeping beast, at least with respect to loans among related parties in which some interest is charged. Even if interest rates were to rise to the point that the applicable federal rate exceeded the six percent “safe harbor” of § 483(e), the \$1,000,000 unified credit applicable to gifts since 2002,<sup>318</sup> would reduce the likelihood of disputes over taxable gifts between taxpayers and the government. Thus, the twists and turns of tax law in this area may, like so much else in the economy, be as dependent on things such as the floating of the Chinese yuan, *vel non*, as it is on the behavior of the taxpayer and the tax collector.<sup>319</sup>

Although there have been no recent reported cases involving gift taxable part sale/part gifts, the IRS has invoked *Frazer* in a private ruling involving a stock redemption that has the effect of transferring corporate control between related individuals. In Private Ruling 9408018 all of the stock in Company was held by A and B, A’s son.<sup>320</sup> A held ninety-two percent of the stock, B the rest. A decided to terminate his interest in Company.

Company exchanged notes in redemption of A’s stock. One note required monthly payments of principal and interest over twenty years. The other required monthly payments of interest and a single balloon payment on the first day of the one-hundred-forty-fifth month after the redemption. The Service assumed that the notes bore at least the applicable federal rate.

The Service “held,” among other things, that B, who through the transaction obtained A’s interest in the corporation, did not have a constructive dividend.<sup>321</sup> It also noted that provision of the applicable federal rate precluded imposition of the gift tax. The Service also discussed *Frazer* on the question of whether the fair market value of a promissory note issued by children to their parents in exchange for real property must be determined by a discount rate under § 7872 or the safe harbor rate of § 483(e).

Although the Service does not say so explicitly, the reference to *Frazer* indicates that the scrutiny of the transaction for the sufficiency of the interest rate on the obligation of the *corporation* concerns whether

2000Rev. Rul. 2000-32, 2000-2 C.B. 1—6.30%

2002Rev. Rul. 2002-40, 2002-2 C.B. 30—5.61%

2004Rev. Rul. 2004-66, 2004-27 I.R.B. 4—5.27%

2005Rev. Rul. 2005-38, 2005-27 I.R.B. 6—4.30%

318. See I.R.C. § 2505(a)(1).

319. See, e.g., *How High Will China’s Yuan Fly?*, WASH. POST, Jul. 24, 2005, at F2.

320. I.R.S. Pvt. Ltr. Rul. 94-08-018 (Nov. 29, 1993).

321. *Id.* at 32 (citing Rev. Rul. 58-614, 1958-2 C.B. 920).

there is a gift loan to B, the son. The Service noted that the Gift Tax Regulations provide that the gift tax applies to gifts made indirectly, to any transaction in which property is passed gratuitously or conferred upon another, regardless of the means or device employed.<sup>322</sup> It appears from the analysis of the Service that while A's interest is passed gratuitously to the son, as long as the interest rate on the obligation is at least the applicable federal rate, there is no taxable gift. The ruling demonstrates the ability of the Service to look beyond the transaction as structured by the parties to find a loan taxable under § 7872.

### 1. Beware the "Unintended" Gift Loan!

One of the most significant decisions involving taxable gift loans under § 7872 (other than those involving the part sale/part gift issue) is *True v. Commissioner*.<sup>323</sup> The better part of the lengthy Tax Court and Tenth Circuit opinions were devoted to valuing estate assets that were subject to buy-sell agreements. For present purposes the most significant aspect of the case involves the application of § 7872 to what was quite likely not intended to be a gift. The predicament in which the taxpayer found herself serves as a powerful warning to move along in a businesslike way the transfers of assets even among relatives – especially among relatives!

In *True*, the taxpayer was a widow whose husband had established large family-owned oil and cattle ranching businesses. Before his death, the *paterfamilias* transferred most of his interests in the business to a trustee and the rest to a qualified terminable interest trust (QTIP)<sup>324</sup> for the taxpayer.

After her husband's death, the taxpayer no longer wished to be involved in the family businesses. She sold her interests to her sons pursuant to buy-sell agreements her husband had devised to keep the

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322. I.R.S. Pvt. Ltr. Rul. 94-08-018 (Nov. 29, 1993) (citing Treas. Reg. § 25.2511-1(c)(1) (1997)). The proposed regulations under § 7872 suggest two ways for accomplishing what the ruling implies would happen if the obligation to the seller were below-market, *i.e.*, a taxable gift from mother to son. Prop. Treas. Reg. § 1.7872-4(g)(1), 50 Fed. Reg. 33553, 33561 (Aug. 20, 1985) would provide for below-market loans from the mother to the corporation and then from the corporation to the son.

Subsection (g)(2) of the same proposed regulations addresses circumstances when use of a intermediary is intended to avoid application of § 7872. *Id.* at § 1.7872-4(g)(2). That would not be the case here, since use of a corporation in which both mother and son are shareholders would invoke § 7872. Where it is applicable, however, this subsection simply permits ignoring the intermediary and treating the loan as between parties that would cause applicability of § 7872.

323. 82 T.C.M. (CCH) 27 (2001), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).

324. *True*, 82 T.C.M. at 45. See also I.R.C. § 2056(b)(7).

businesses in the family.

The taxpayer gave notice to her sons that she desired to sell her interests on June 30 and July 1, 1994. This notice triggered her obligation to sell these interests but the agreements provided that sales did not have to be consummated until six months after those dates. She was not paid until three months after those dates.<sup>325</sup>

The price she received for her interests from her sons was \$13,298,978. The agreement did not provide for any interest to be paid representing the time between the taxpayer's notice date and the date she was paid for her interests. The IRS contended that under the buy-sell agreement, the sale was consummated on the notice date and that in receiving payment three months later she had made a gift loan of the interest on the purchase price in the amount of \$192,307.

The taxpayer made three arguments against the IRS's assertion of a gift. First, she argued that the sale was completed on the payment date and that there was, therefore, no loan at all. The court looked to the agreement itself, Wyoming law, and federal law to conclude otherwise.<sup>326</sup>

Secondly, the taxpayer contended that either § 483 or § 1274 prevented the application of § 7872. The taxpayer relied on § 483 on the basis that no payment could be made more than one year after the contract,<sup>327</sup> and on § 1274 because none of the payments were due more than six months after the contract.<sup>328</sup> Thus, since neither section permitted recharacterization of the principal amount of the purchase price as interest, she had made no gift of interest.

The court turned to *Frazer* in rejecting taxpayer's attempt to avoid § 7872 by resort to § 483 or § 1274. It again concluded that those sections pertained only to characterization of installment payments for income tax purposes.<sup>329</sup>

The court also relied on *Frazer* for the proposition that § 7872 does not apply solely to loans of money but also to seller-provided financing for the sale of property.<sup>330</sup> The court then concocted a term loan from

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325. *True*, 82 T.C.M. at 120.

326. *Id.* at 122.

327. *See* I.R.C. § 483(c)(1).

328. *Id.* at § 1274(c)(1).

329. *True*, 82 T.C.M. at 124. The court acknowledged that proposed regulations under § 7872, specifically Prop. Treas. Reg. § 1.7872-2, 50 Fed. Reg. 33553, 33557 (1985), provide that § 7872 is inapplicable to any loan given in consideration for the sale or exchange of property within the meaning of § 483(c)(1) or § 1274(c)(1) even if those sections are inapplicable. *Id.* The court regarded proposed regulations as to be accorded no more weight than a "litigating position." *Id.*

330. *Id.* at 125.

the dealings of the taxpayer and her sons. Since the agreement required the sale to be consummated within six months of the notice dates, rather than on demand of the taxpayer, it was not a demand loan and, hence, was a term loan.<sup>331</sup> Since the parties did not provide for any interest (which is not an unreasonable course as they probably did not imagine they were making a loan when the buyers did not promptly remit the purchase price to their mother on the notice dates) the difference between the amount “loaned” and its present value discounted at the applicable federal rate was deemed to be loaned on the notice dates.

The court also rejected the taxpayer’s contention that § 7872 was inapplicable because the transaction was in the ordinary course of business and thus not a gift.<sup>332</sup> The court subjects intrafamily transactions claimed to be in the ordinary course to special scrutiny.<sup>333</sup> It noted that it had held in another part of the opinion that the inadequate price the taxpayer had received under the buy-sell agreement for her interests in the businesses had given rise to taxable gifts.

In using the simple fact of a gift in the exchange of property itself, which entails no requirement of a donative intent,<sup>334</sup> but rather, a disparity between the values of the consideration exchanged, the court reaches too far. The court adverted to no indication of donative intent with respect to the execution of payment by the buyers. Payment simply did not occur at the first legal moment it could have. If the Tax Court is willing to uphold such a far-fetched imposition of a gift tax on what was most likely a simple failure to consummate the transaction as promptly as possible, taxpayers involved in intra-family transactions should be attentive. Every day one delays may be a gift – to the government!

## 2. The Anomalous Retransfer for Gift Loans

As with all of the other types of below-market loans to which § 7872 applies, § 7872 contemplates that the forgone interest transferred by the lender to the borrower may be retransferred from borrower to lender. The difference between gift loans and other below-market loans in this respect is that there is a floor at which it begins. Unless the outstanding loans between lender and borrower exceed \$100,000, or the borrower has net investment income, there is no retransfer.<sup>335</sup> Thus,

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331. *Id.* See also I.R.C. § 7872(f)(6).

332. See Treas. Reg. § 25.2512-8 (1992).

333. *True*, 82 T.C.M. at 125 (citing *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff’d*, 786 F.2d 1174 (9th Cir. 1986) (without opinion)).

334. See *Tax Analysts & Advocates v. Schultz*, 376 F. Supp. 889 (D.D.C. 1974).

335. I.R.C. § 7872(d)(1)(D). Net investment income has the same meaning as in § 163(d)(4).

there is no retransfer when the loans between borrower and lender do not exceed \$100,000 and the borrower does not have more than \$1,000 in net investment income; and all forgone interest transfers to the lender when a loan exceeds \$100,000 without regard to the borrower's net investment income. Making retransfer dependent on the borrower's net investment income serves as a useful weapon against tax avoidance. To the extent that the retransfer operates without respect to the borrower's productive use of the loaned funds, as it does when the loans among the parties exceed \$100,000, it taxes the phantom of the lender's opportunity cost and brings needless complexity to the tax law.

With respect to a gift loan, unlike other loans to which § 7872 applies, the retransfer is the only aspect of the loan transaction that has income tax implications. The transfer, as a gift, may have gift tax implications for the lender. As a gift, the transfer does not represent income to the borrower.<sup>336</sup> To the extent the borrower enjoys income from the loaned proceeds there is an opportunity for abuse. If the borrower is in a lower income tax bracket than the lender, below-market loans would present an opportunity to get around the restrictions on shifting income intended for the grantor trust provisions of the Code.<sup>337</sup> This is responsive to a significant tax avoidance problem during *Dean's* heyday.<sup>338</sup> To the extent that there is a retransfer under any other circumstances, no valid tax policy is served.

The transfer and retransfer entailed in § 7872(a) and (b) was foreshadowed in some of the scholarship that preceded the enactment of § 7872.<sup>339</sup> Professor Halperin described the transfer/retransfer scheme as a disaggregation and contended that it implements the "Haig-Simons' ideal of current taxation of investment income to the party who receives the income in one form or another."<sup>340</sup> To the extent that there *is* income to be taxed, indeed it does.

But the essence of the Haig-Simons principle of income taxation is that there be a gain in the accounting period.<sup>341</sup> Retransferring the

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*Id.* at § 7872(d)(1)(E)(i). The first \$1,000 of net investment income is disregarded in determining whether there is a retransfer.

336. See I.R.C. § 102.

337. See *id.* at §§ 671-677.

338. See *supra* notes 181-190.

339. See Joyce & Del Cotto, *supra* note 248, at 504-05 (as to some transactions). See also Robert I. Keller, *The Tax Consequences of Interest-Free Loans from Corporations to Shareholders and from Employers to Employees*, 19 B.C. L. REV. 231, 275 (1978).

340. See Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 515 (1986).

341. See ROBERT MURRAY HAIG, *THE CONCEPT OF INCOME* (1920), reprinted in *THE FEDERAL INCOME TAX* 1, 27 (Robert Murray Haig ed., Columbia University Press 1921) (stating that "[t]he



forgone interest as to loans between lender and borrower in instances in which the borrower has not put the borrowed funds to good use, or cannot be deemed to have done so, imposes an income tax when there has been no economic gain.

In a sense, retransferring income to the lender, who may already have incurred liability for gift tax on the transfer, taxes the opportunity cost of the lender in making the below-market loan. The courts in *Crown v. Commissioner*,<sup>342</sup> and particularly the district court in *Johnson v. United States*<sup>343</sup> sensibly saw this as reaching the arm of the tax collector too far.

This retransfer would seem to frustrate the exclusion from gift tax in § 2503(e) for qualified transfers for tuition or medical care for a borrower-donee.<sup>344</sup> While a transfer of interest with respect to a below-market loan for these purposes would not be subject to gift tax, no provision prevents a retransfer of forgone interest to the lender when gift loans for these purposes exceed \$100,000 to a borrower.<sup>345</sup>

To the extent that the borrower has net investment income, it should be taxed to the lender.<sup>346</sup> The transaction is not serving the purpose intended by the gift tax exclusion. On the other hand, if the borrower does not have such income, there is no tax avoidance entailed in the lender's assistance to the borrower with such expenses. It is ridiculous to impose a tax on such generosity. The same is true if the lender makes a below-market loan to assist the borrower with the purchase of a home. There is no gift tax exclusion with respect to a gift of the transferred interest to the borrower, but there is no justification in imposing an *income* tax on the lender through a retransfer. That would amount to a tax on the imputed rental value of the borrower's home imposed on the lender. Congress in the Tax Reform Act of 1986 rejected such taxation of the homeowner<sup>347</sup> and should do so with respect to gift loans used for this purpose.

As the years since the enactment of § 7872 have passed, Congress

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formal definition of *economic* income, which, in the opinion of the writer, provides the most acceptable concept of income, may be stated as follows: *Income is the money-value of the net accretion to economic power between two points of time*" (emphasis in original). See also HENRY C. SIMONS, PERSONAL INCOME TAXATION 51 (1938) (stating that "[t]he essential connotation of income . . . is *gain*—gain to someone during a specified period and measured according to objective market standards").

342. *Crown*, 67 T.C. 1060. See *supra* notes 188-199 for discussion.

343. *Johnson*, 254 F. Supp. 73.

344. See I.R.C. § 2503 (e).

345. See *id.* at § 7872 (d)(1)(D).

346. See *id.* at § 7872 (d)(1)(E).

347. See H.R. REP. NO. 99-426, at 297 (1986).

has provided that taxpayers may take penalty-free distributions for this purpose from certain individual retirement accounts.<sup>348</sup> It would be sensible to eliminate the tax burden on the use of below-market loans to allow a borrower to obtain an education, medical care or to purchase a home, even when the amount loaned exceeds \$100,000, as long as the borrower does not have net investment income. The retransfer provisions of § 7872 should be modified to provide for retransfer of forgone interest to the lender only when the borrower has such income.

### C. Compensation Loans

The most significant development with respect to compensation loans is the promulgation of regulations concerning split-dollar insurance loans.<sup>349</sup> These lengthy regulations are the only permanent regulations promulgated under § 7872 so far. They dovetail with regulations under § 61 that address circumstances in which split-dollar life insurance is provided as compensation and not in the form of a loan.<sup>350</sup> A split-dollar life insurance arrangement is defined as:

[A]ny arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria:

(i) Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;

(ii) At least one of the parties to the arrangement paying the premiums . . . is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and

(iii) The arrangement is not part of a group-term life insurance plan described in section 79 unless the group-term life insurance plan provides permanent benefits to employees. . . .<sup>351</sup>

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348. See I.R.C. §§ 72(t)(8), 408A(d)(5).

349. See Treas. Reg. § 1.7872-15 (2003).

350. See *id.* at § 1.61-22(b)(3) (which provides generally that the rules for taxing to employees the economic benefit of employer-provided life insurance (not excludable under I.R.C. § 79) contained in these regulations do not apply to split-dollar loans within the meaning of Treas. Reg. § 1.7872-15).

351. *Id.* at § 1.61-22(b)(1).

If a split-dollar arrangement does not involve a split-dollar loan within the scope of the regulations under § 7872 or is not made in consideration for economic benefits under the regulations under § 61, then it is treated under general income, employment, self-employment and gift tax principles.<sup>352</sup> An extensive commentary on split-dollar insurance arrangements has stated that with the promulgation of regulations under §§ 61 and 7872 in 2003 “the taxpayer friendly split-dollar arrangements we have known ceased to exist.”<sup>353</sup>

The statement in the regulations under § 61 that benefits of split-dollar arrangements might be taxed to beneficiaries under general principles of taxation belies the necessity for the extensive new regulations under § 61.<sup>354</sup> Nevertheless, with respect to loan-financed split-dollar arrangements, taxation of the forgone interest of a loan used to finance such an arrangement is a departure from the past. Once upon a time the IRS ruled that payment by an employer of annual premiums on life insurance of an employee to the extent of the increases in the cash surrender value of the policy with the employer to be repaid at the death of the employee did not create income to the employee.<sup>355</sup> This was based on the notion that, “[t]he mere making available of money does not result in realized income to the payee.”<sup>356</sup>

This, of course, was in the midst of that long period before *Dean* during which the government did not treat interest-free loans as creating income for borrowers. Now “[i]f a split-dollar loan is a below-market loan, then . . . the loan is governed by section 7872.”<sup>357</sup> Consequences to lender and borrower depend on the relationship of the parties and whether it is a demand or a term loan.<sup>358</sup> Some of the cumbersome aspects of § 7872 are manifest in the application of the regulations with respect to split-dollar insurance arrangements.

First, the transfer and retransfer scheme of § 7872(a) and (b) applies to split-dollar loans.<sup>359</sup> The retransfer serves no useful purpose regardless of the relationship between lender and borrower. If it is a gift loan, the lender may have incurred gift tax liability and the borrower has a non-taxable gift. The borrower is not generally able to deduct interest

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352. *Id.* at § 1.61-22(b)(5).

353. See Donald O. Jansen, *Split Dollar Has Split — So How Do We Finance Premiums Now?*, 38 ANN. HECKERLING INST. ON EST. PLAN. ¶ 1300 (2004).

354. Treas. Reg. § 1.61-22(b)(5) (2003).

355. See Rev. Rul. 55-713, 1955-2 C.B. 23.

356. *Id.*

357. Treas. Reg. § 1.7872-15(a)(1) (2003).

358. *Id.*

359. *Id.* at § 1.7872-15(e)(3)(iii), (4)(iv), (v).

“paid” on any retransfer to the lender.<sup>360</sup> If the loans between the parties exceed \$100,000 there is a retransfer to the lender but, as contended previously, this is simply a tax on an opportunity cost of the lender.<sup>361</sup> This is consonant with the fiction of the implied loan that § 7872 entails, but in fact, the lender has foresworn the making of such a commercially realistic loan. Treating the lender as transferring the forgone interest to the borrower carries the fiction far enough.

If, as is most likely the case, it is a compensation-related loan there is again no need for a retransfer from employee or independent contractor to the lender. The lender has a deductible expense in the amount of the forgone interest and the borrower has taxable compensation. The borrower generally has no deduction on a retransfer to the lender, as might have been the case before the enactment of § 163(h) in 1986. There is no need to cancel out the lender’s deduction for compensation expense simply because the lender will someday have a return of the principal. Until that time the lender does not have use of the principal, the amount of interest used to pay compensation has been foresworn, the same as if it had been paid without resort to a below-market loan. Only the first transfer of interest by lender to borrower is necessary to reflect the tax effects of the transaction. The retransfers entail needless complexity and, under the tax treatment of indirect loans under the new regulations, may generate a surreal number of transfers.<sup>362</sup> While, as noted previously, a retransfer serves a useful purpose when the borrower with respect to a gift loan has net investment income, it serves no such purpose with respect to a compensation loan.<sup>363</sup>

A second unnecessary aspect of § 7872 is that in defining compensation-related loans, § 7872 specifies loans between “an employer and an employee.”<sup>364</sup> This means that § 7872 might apply to a loan made by an employee to his or her employer. While this might serve some notion of legislative symmetry, it is completely unnecessary. Before the enactment of § 7872 there was a significant amount of tax

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360. *Id.* at § 1.7872-15(c).

361. *See supra* IV.B.2.

362. *See* Treas. Reg. § 1.7872-15(e)(2) (2003) (See particularly example 1, in which Employer X makes a premium payment by loan to A, who is the child of X’s employee, B. That loan is restructured as two loans, a compensation loan between X and B and a gift loan between B and A. Such loans would entail transfers and retransfers with respect to each loan. Such circuitry seems unnecessary when the value of the insurance coverage itself could be taxed to B without resort to § 7872. *See* Treas. Reg. 1-61.2(d)(2)(ii) (2003)).

363. *See supra* notes 308-311 and accompanying text (offering a discussion of gift loans in the context of a borrower’s net investment income).

364. I.R.C. § 7872(c)(1)(B)(i).

avoidance through use of loans by employers to employees.<sup>365</sup> There is no indication that there was any sort of avoidance involving loans running the other way. It is difficult to imagine what such abuse might entail other than circumstances in which an employee wishes or needs to make a loan to preserve his or her employment by creating or financing the employer. In such instance, there sometimes is a question, particularly when the employer is unable to repay the “debt,” whether the employee’s advance was a loan or a capital contribution. This is important as to whether the creditor-employee may take a bad debt deduction under § 166.<sup>366</sup> In such instance, it is important to characterize the advance properly. That interest is served by existing regulations and case law.<sup>367</sup> There is no legitimate interest in requiring an employee who is somehow motivated to lend to his or her employer to do so at arm’s length, as § 7872 does when it is applicable. Applying § 7872 invokes the retransfer which can result in the employer receiving income.

The Tax Court criticized in dictum the application of § 7872 to loans *by* employees. In *Albertson’s, Inc. v. Commissioner*, an employer sought to deduct interest on a portion of amounts set aside as deferred compensation.<sup>368</sup> The taxpayer sought to deduct amounts of the deferred compensation treated as interest in the year accrued rather than in the year paid.<sup>369</sup> The government successfully contended that the “interest” was deferred compensation, deductible only under § 404(a)(5) or (d).<sup>370</sup> The court held that there was no forbearance of money of which payment was due because the employees had no right to demand payment in the year at issue.<sup>371</sup>

In a footnote, the court stated that if it characterized such a transaction as a loan in instances which it did not include an interest factor, it would have to treat it as an interest-free loan under § 7872.<sup>372</sup> That would require the employees to report an amount of imputed interest income even in years such employees did not have a right to receive the principal amount. The court stated that Congress did not

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365. See Closius & Chapman, *supra* note 89.

366. See, e.g., *Litwin v. United States*, 983 F.2d 997 (10th Cir. 1993).

367. See *Treas. Reg. § 1.166-1(c)* (1959). See also, e.g., *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987).

368. *Albertson’s, Inc. v. Commissioner*, 95 T.C. 415 (1990).

369. *Id.* at 418-19.

370. *Id.* at 430.

371. *Id.* at 422-23.

372. *Id.* at 423 n.6.

desire such a result in enacting § 7872.<sup>373</sup>

Such a construction is *not* far-fetched, however, at least as § 7872 is now drafted. That an employee might not be permitted to withdraw the funds in the deferred compensation account would mean only that it is not a demand loan. As such, it would be a term loan.<sup>374</sup> To eliminate this potential anomaly, § 7872(c)(1)(B)(i) should be amended to provide that compensation-related loans are loans only by an employer to an employee.

Finally, when the split-dollar loan, or any compensation loan, is a term loan, the taxation of the amount of the original issue discount, that is, the difference between the amount loaned and the present value of payments required to be made under the terms of the loan, must be reported by the borrower on the day the loan is made.<sup>375</sup>

The harshness of the application of this tax treatment appears in an example in the new regulations under § 7872.<sup>376</sup> In this example, Employer T, pursuant to a split-dollar arrangement, makes a \$100,000 payment for a policy on the life of Employee G.<sup>377</sup> The loan is for a term of three years. The repayment provided is the principal plus an amount based on the increase in price of a specified commodity. The example assumes this latter amount to be O. It further determined the present value of the payment due three years hence was \$76,289.52.<sup>378</sup> Thus, the difference between that amount and the amount loaned, or \$23,710.48, was deemed to be transferred to the taxpayer on the day the employer paid the premium.<sup>379</sup>

It is a grotesque distortion of income to tax the entire amount of forgone interest attributable to the term of the loan on the day of the transfer. The borrower's income, which is easily calculable and allocable to the term of the loan, is allocated to one day of one taxable year. The longer the term, the more grotesquely unrealistic is this imposition of taxation. Since the transaction in this case does not

373. *Id.* To some extent the proposed regulations support the idea that Congress could not have intended that employee to employer loans may be within the ambit of § 7872. Prop. Reg. § 1.7872-4(c)(1) provides that a compensation loan is "a below-market loan that is made in connection with the performance of services." Prop. Reg. § 1.7872-4(c)(1), 50 Fed. Reg. 33553, 33567 (Aug. 20, 1985). It would be absurd to contend that an amount advanced by an employee to his or her employer would be compensatory unless there existed between them an independent employment relationship working the other way.

374. I.R.C. § 7872(f)(6).

375. *See* I.R.C. § 7872(b)(1).

376. *See* Treas. Reg. § 1.7872-15(j)(5), Example 1 (2003).

377. *Id.* at § 1.7872-15(j)(5), Example (1)(i).

378. *Id.* at § 1.7872-15(j)(5), Example (1)(iii).

379. *Id.* at § 1.7872-15(j)(5), Example (1)(iv).

directly provide the borrower with cash to pay the taxes on the income, the tax treatment itself is a strong disincentive to resort to a below-market loan. The borrower with respect to a term loan should be permitted to report the transferred amount ratably over the term of the loan. Although the reporting of original issue discount income by the lender on the retransfer is not logically analogous to the position of the borrower with respect to a term loan,<sup>380</sup> there is no reason that enjoyment of the value of money should not be allocated over the time of such enjoyment whether taxpayer is a lender or a below-market debtor.

#### D. Corporation-Shareholder Loans

Loans between corporations and shareholders have generated about half of the case law involving § 7872. As with the other forms of below-market loans, cases have shown areas in which § 7872 might appropriately be amended to create a simpler statute.

##### 1. Loans by Corporations to Shareholders

A good deal of the case law before the enactment of § 7872 involving corporations, shareholders and below-market loans involved egregious use of close corporations as piggy banks, avoiding dividend treatment or essentially bailing out corporate earnings, at least temporarily.<sup>381</sup> That was a conspicuous reason for adopting § 7872 and it appears taxpayers got the message – there are not many reported cases involving such behavior.<sup>382</sup>

An example of the attention to form required in corporation-shareholder transactions created by § 7872 may be seen in *Mason v. Commissioner*.<sup>383</sup> In that case, the married taxpayers were the sole shareholders of a corporation, Rebuilding Service, Inc. (RSI). They had a “revolving credit relationship” with RSI under which they borrowed

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380. The lender is the creditor with respect to that transaction also for purposes of § 1272(a).

381. See *supra* notes 86-104 for discussion.

382. A case that might have involved § 7872, but did not, was *Yarborough Oldsmobile Cadillac, Inc. v. Commissioner*, 70 T.C.M. (CCH) 1282 (1995). Taxpayer received hundreds of thousands of advances from his closely held corporation over four taxable years, three of which were after the effective date of § 7872. *Id.* Many of these advances were for personal expenses of the taxpayer. *Id.* Taxpayer was charged with criminal tax offenses for the years at issue and pleaded guilty. *Id.* Taxpayer was held to have income as a result of constructive dividends of the loan proceeds themselves on the basis that the court found taxpayer never intended to repay the advances. *Id.* at 33-34. As a means of buttressing his contention that the advances were loans, taxpayer contended that he began to pay interest on them when § 7872 became effective. *Id.* at 38.

383. 74 T.C.M. (CCH) 260 (1997).

and repaid advances by RSI.<sup>384</sup> In the tax years at issue, taxpayers borrowed more than \$1.5 million from RSI. In the same years they repaid over \$1.2 million. Their ending balances at the ends of the two tax years were over \$2 million.<sup>385</sup>

Unfortunately for the taxpayers, there was insufficient attention to detail for purposes of § 7872. The taxpayers did not deduct interest payments for the years at issue and RSI did not report interest income. RSI's and taxpayers' ledgers did not characterize taxpayers' repayments on either principal or interest, although they indicated a dollar for dollar reduction of taxpayers' indebtedness to RSI.<sup>386</sup> There were neither notes nor security arrangements accompanying the advances. An accounting firm hired by taxpayers after the tax years were completed retroactively reduced taxpayers' repayments to RSI treating the rest as payment of interest at the applicable federal rate. The IRS disregarded this retroactive allocation, treating the advances as no-interest loans since no interest payments were made during the taxable years. Forgone interest at the applicable federal rate was treated as a dividend to the taxpayers for the two taxable years.

The taxpayers argued, with some plausibility, that the proposed regulations treated part of the repayments on loans with fluctuating balances as payments of accrued interest.<sup>387</sup> The court blew hot and cold with the proposed regulation, first noting that it was only "proposed"<sup>388</sup> and then explaining its inapplicability to taxpayers' circumstances. The court noted that a parenthetical, "if any," in the regulation referring to accrued interest indicated that the regulation did not amount to an imputation provision with respect to revolving arrangements such as taxpayers had with RSI.<sup>389</sup>

Of course, only by imputation can the IRS contend that there *is* a dividend to taxpayers (and interest income to RSI) with respect to such an arrangement. The imputation under § 7872 is clearly a one-edged sword, cutting only against the taxpayer. If, with respect to a demand loan the agreement between lender and borrower provides for interest, part of any repayments may be regarded as interest. If that amount of interest amounts to the applicable federal rate, the loan is not below-

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384. *Id.* at 261.

385. *Id.*

386. *Id.*

387. *Id.* (citing Prop. Reg. § 1.7872-13(c), 50 Fed. Reg. 33553, 33568 (Aug. 20, 1985)).

388. *Id.* at 263 (citing *KTA-Tator v. Commissioner*, 108 T.C. 100 (1997) and *Frazee v. Commissioner*, 98 T.C. 554 (1992)).

389. *Mason*, 74 T.C.M. (CCH) at 263.



market. But the proposed regulation that the taxpayers in *Mason* attempted to employ, should it ever become final, applies only to stated interest.<sup>390</sup> The tried and true axiom that taxpayers are bound by the form of a transaction that they choose applies with respect to § 7872.<sup>391</sup>

The unintended consequences brought by § 7872 can become even more complicated with respect to multiple advances by a corporate lender. Each advance may be treated as a below-market loan if it does not provide for interest at the applicable federal rate. This problem was implicit in the facts of *Mason*, but was addressed explicitly in *KTA-Tator, Inc. v. Commissioner*.<sup>392</sup>

In that case, two married shareholders held the taxpayer, KTA-Tator, Inc. It made loans to the shareholders to finance two construction projects that shareholders would lease to the taxpayer. The taxpayer contended that it was authorized to fund both projects with a single loan and that advances were analogous to “draw downs” on a single line of credit.<sup>393</sup> It relied on the proposed regulations as treating an integrated series of transactions as a loan.<sup>394</sup> While again falling back on *Frazer* in absolving the Commissioner of accountability for proposed regulations,<sup>395</sup> the court viewed taxpayer’s reliance as misplaced. It described the regulation as an “antiabuse provision intended to address a series of transactions where each individual transaction [might] not be a loan, but collectively the series of transactions has the same effect as a loan.”<sup>396</sup> The court stated that the applicable proposed regulation provided that when loan proceeds are transferred over time, each transfer of money is a separate loan.<sup>397</sup>

In circumstances in which the applicable federal rate is falling as transfers are made to the borrower, this is not bad news to either party. If there are no stated repayment terms, as was the case in *KTA-Tator* until the projects were completed, the same problem may arise as occurred in *Mason* — repayments are not counted toward the applicable federal rate unless they are in payment of stated interest. More “loans” between the parties mean more formalities to observe if the borrower is actually repaying the advances and desires that some of the repayments

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390. *Id.*

391. *Id.* at 264 (citing *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974)).

392. 108 T.C. 100 (1997).

393. *Id.* at 102.

394. See Prop. Reg. § 1.7872-2(a)(1), 50 Fed. Reg. 33553, 33557 (Aug. 20, 1985).

395. *KTA-Tator, Inc.* at 102-03 (citing *Frazer v. Commissioner*, 98 T.C. 554 (1992)).

396. *Id.* at 103.

397. *Id.* See Prop. Reg. § 1.7872-2(a)(3), 50 Fed. Reg. 33553, 33557 (Aug. 20, 1985).

be treated as payments of interest.

With respect to indirect loans between corporations and shareholders, § 7872 received a broad construction in *Rountree Cotton Co., Inc. v. Commissioner*.<sup>398</sup> In that case, taxpayer, a close corporation owned entirely by persons related by blood or marriage, made loans to its shareholders, none of whom owned a majority of the stock in taxpayer, and to partnerships and close corporations. These other entities were owned by the shareholders who owned the taxpayer's stock, but none of the owners of the entities had a majority interest in them. The Commissioner contended that the taxpayer had interest on all of these loans at the applicable federal rate.

With respect to the loans directly to the shareholders, the taxpayer contended that they were not within § 7872 because the recipients were not controlling shareholders of the taxpayer.<sup>399</sup> The taxpayer contended that use of the term "shareholder" in the statute indicated that attribution rules are not intended to be applied.<sup>400</sup> The court rejected the taxpayer's argument on the basis that the statute itself does not require that a loan be made to a controlling shareholder in order for § 7872 to be applicable.<sup>401</sup>

Taxpayer contended that the loans to the entities did not come within § 7872.<sup>402</sup> The taxpayer argued particularly that none of the shareholders held controlling interests in these entities, and that one of those who held interest in the entities was not a shareholder of the taxpayer.<sup>403</sup> Taxpayer contended that its shareholders received only part of the benefit of taxpayer's lending to the entities.

The court conceded that neither the statute nor the proposed regulations addressed the possibility that shareholders might receive less benefit than the amount lent with respect to an indirect loan. Nevertheless, the court found the proposed regulations "an effective way to address the issue we consider here."<sup>404</sup> Under the regulation involved, the loan through the entity is treated as two loans, one to the entity from the corporation and another from the entity to the shareholder. The court acknowledged that there might be difficulty in determining the amount of any dividend to the shareholders because of the presence of a non-

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398. 113 T.C. 422 (1999), *aff'd*, 12 Fed. Appx. 641 (10th Cir. 2001) (per curiam).

399. *Id.* at 430.

400. *Id.* See also I.R.C. § 7872(c)(1)(C).

401. *Rountree v. Comm'r* 113 T.C. 422, 430-31 (1999).

402. *Id.* at 432.

403. *Id.*

404. *Id.* at 435. See also Prop. Reg. § 1.7872-4(g)(1)(i) and (ii), 50 Fed. Reg. 33553, 33561 (Aug. 20, 1985).

shareholder in the borrowing entity.<sup>405</sup> It regarded that as unnecessary because it was addressing only the corporation's income tax consequences.<sup>406</sup>

That does not seem to be quite correct, however. In order to determine the taxpayer lender's income, the court must determine the amount of the *retransfer*. The retransfer creates the taxable event for the corporation/lender. Treating the gross amount as retransferred from the shareholders, who may not control the direct recipient entity does not appear to be called for by the statute. It amounts to a strict liability on the part of the shareholders with respect to the entire amount of the forgone interest. That is what would be required to make the lender entirely taxable on all of the forgone interest on retransfer.

Both *Rountree* and *KTA-Tator* involve corporate lenders taxable on the retransfer of the forgone interest from the borrowers. As with all other loans to which § 7872 applies, other than some gift loans and tax-avoidance loans, it is contended herein that there should be no retransfer to the lender. The potential abuse inherent in the below-market corporation/shareholder loan is sufficiently remedied by taxing the transfer to the shareholder as a dividend. Most of the time the borrower receives no deduction for the retransfer and since the lender receives no deduction for making a dividend there is no need for offsetting interest income. With the scheme of the proposed regulations of the dual transfers on display in *Rountree Cotton*, the retransfer poses the spectrum of unspeakable complexity.

## 2. Loans from Shareholders to Corporations

Section 7872(c)(1)(C), in applying § 7872 to below-market loans "between a corporation and any shareholder of such corporation," literally applies to loans *by* shareholders to corporations as well as loans by corporations to their shareholders. This may be symmetrical, but it is surprising in light of the state of the law before § 7872. Cases involving loans by corporations to their shareholders were quite numerous. There do not seem to have been any involving loans the other way. That is not surprising, as there does not appear any conceivable form of abuse involving a shareholder not charging "enough" interest on a loan to one's own corporation — no possibility of avoidance of double taxation on corporate earnings, compensation masquerading as loans or the trafficking of income within a family. There is, perhaps, an implicit

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405. *Rountree*, 113 T.C. at 436.

406. *Id.*

contribution to capital when a shareholder makes what he or she calls a loan to a corporation and then does not charge interest. A taxpayer, for basis purposes, would be better off calling it the purchase of stock, but that is really no business of the government's. In two reported cases, *McGinnis v. Commissioner*<sup>407</sup> and *Estate of Hoffman v. Commissioner*,<sup>408</sup> taxpayers have had to pay tax with respect to forgone interest on loans to their corporations.

The characterization of funds committed by a shareholder to his or her corporation is already a prickly matter. Whether the sums advanced to a corporation represent stock or debt can determine whether taxpayer gets a bad debt deduction or a capital loss if the business goes bust. There is a body of law related to that issue.<sup>409</sup> It may control whether payments by a corporation to a shareholder represent deductible interest payments or non-deductible dividends. There is likewise a body of law pertaining to that area.<sup>410</sup> In short, what the world of taxation does not need is another welter of factors for an investor in a corporation to consider, or fear, in deciding what form the investment will take.

### *E. Tax-Avoidance Loans*

Section 7872(c)(1)(D) provides that § 7872 applies to "any below-market loan one of the principal purposes of the interest arrangements of which is the avoidance of any federal tax."<sup>411</sup> This potentially broad basis for reconfiguring transactions to impute interest at the applicable federal rate has received virtually no authoritative elaboration other than in proposed regulations and private letter rulings.<sup>412</sup>

The notion of tax avoidance for these purposes is stated in rather stilted fashion in the proposed regulations:

For purposes of this rule, tax avoidance is a principal purpose of the interest arrangements if a principal factor in the decision to structure the transaction as a below-market loan (rather than, for example, as a market interest rate loan and a payment by the lender to the borrower)

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407. 65 T.C.M. (CCH) 1870 (1993).

408. 78 T.C.M. (CCH) 898 (1999), *aff'd*, 8 Fed. Appx. 262 (4th Cir. 2001).

409. *See, e.g.*, *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986).

410. *See, e.g.*, *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3rd Cir. 1968). Congress intended that the Commissioner promulgate regulations pertaining to that issue under § 385, but over thirty-five years later the Commissioner has not done so.

411. I.R.C. § 7872 (c)(1)(D) (2000).

412. As noted *supra*, the Tax Court has resisted giving authoritative, or in some instances *any*, weight to the proposed regulations, *see, e.g.*, *Frazer v. Commissioner*, 98 T.C. 554 (1992). The Commissioner has always insisted that private rulings may be relied upon as precedent. *See* *Treas. Reg. § 601.201(2)(1)* (1973). *See also* *Bookwalter v. Brecklein*, 357 F.2d 78 (8th Cir. 1966).

is to reduce the Federal tax liability of the borrower or the lender or both.<sup>413</sup>

It is difficult to imagine taxpayers plotting tax avoidance as an alternative to market-rate loans accompanied by a transfer of some portion of the interest back to the borrower. The transactions provided in the proposed regulations as examples certainly indicate instances of taxpayers going the long way around.

The proposed regulations contain a presumption with respect to below-market loans pursuant to sales or exchanges of property between related parties.<sup>414</sup> If, pursuant to a plan incident to a sale or exchange of property, a party related to the seller makes a below-market loan to the buyer or makes a below-market loan to the seller that is assumed by the buyer in connection with the sale or exchange, the loan shall be treated as a tax-avoidance loan.<sup>415</sup>

An example provided in the proposed regulation demonstrates the function of this form of reconfiguring the consequences of below-market loans. In the example, S and T are wholly-owned subsidiaries of a common parent, P.<sup>416</sup> S sells property to A, an individual, for \$3 million cash. Three months after the sale, T loans A \$2 million for ten years at six percent interest when the applicable federal rate is twelve percent. The issue price of the loan is discounted to \$1,311,805. Total forgone interest is \$688,195. A is treated as having a discount of that amount, reducing his or her basis, T is treated as having made a dividend to P<sup>417</sup> and P is treated as making a contribution to S's capital, both in the same amount. It is the tax avoidance provision that permits the IRS to impose consequences on A, who is not presented as a donee, employee or shareholder of the entities.

The potentially pervasive nature of the provision of § 7872 pertaining to tax-avoidance loans may be seen in a private letter ruling related to interest-free disaster loans by a state government to disaster-stricken businesses.<sup>418</sup> The taxpayers involved were small and mid-sized businesses that received loans funded by the State of North Carolina.

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413. Prop. Reg. § 1.7872-4(e)(1), 51 Fed. Reg. 33553, 33561 (Aug. 20, 1985).

414. *Id.* at § 1.7872-4(e)(2) (The meaning of related taxpayers is taken from former § 168(e)(4)(D), Pub. L. 97-34, 95 Stat. 203, repealed by Pub. L. 99-514, 100 Stat. 2085, *i.e.*, persons bearing the relationships in §§ 267(b), 707(b)(1) or persons engaging in trades or business under common control within the meaning of § 52).

415. *Id.* (stating that there is an irrefutable presumption that such a plan exists if the loan is made within one year of the sale or exchange).

416. *See id.* at § 1.7872-4(e)(3), Example 1.

417. Presumably P might deduct this under § 243.

418. I.R.S. Pvt. Ltr. Rul. 2000-34-025 (Jun. 8, 2000).

The parties to the loan did not bear to each other any of the specific relationships included in § 7872(c)(1), such as employer/employee, corporation/shareholder, etc. Nonetheless, the service referred to § 7872(c)(1)(D) as applying § 7872 to a below-market loan “the principal purposes of the interest arrangements of which is the avoidance of any federal tax.”<sup>419</sup>

Having staked out the potential applicability of this provision to circumstances that bore no relationship to abusive situations in the case law that preceded enactment of § 7872, the IRS backed off applying § 7872 to the disaster victims and the state agencies helping them. It provided that the legislative history of § 7872 indicated that most government-subsidized loans were intended to be exempt from § 7872.<sup>420</sup>

The speculative application of § 7872 to the transaction, but for the Congressional intent with respect to government loans, indicates the broad wild card potential of the tax-avoidance provision. With a loan such as a disaster loan, no tax would be “avoided” except that on the imputed income on the loan. There is no avoidance of tax on gifts, compensation or dividend income, the clear targets of other provisions of § 7872. It thus appears that § 7872 might apply to nearly any below-market loan that might avoid taxes if they are not paid on imputed interest.

#### *F. Loans that Have a Significant Effect on Lender or Borrower*

The final category of loans to which § 7872 applies is loans the interest arrangements of which have a significant effect on any tax liability of lender or borrower.<sup>421</sup> This provision is applicable to such below-market loans “[t]o the extent provided in regulations.”<sup>422</sup> So far the Service has provided only temporary regulations that provide the factors to be considered as to whether a loan’s interest arrangements have a significant tax effect on lender or borrower, but no examples.<sup>423</sup>

419. *Id.*

420. *Id.* (citing S. REP. NO. 98-169, at 482 (1984)).

421. I.R.C. § 7872(c)(1)(E).

422. *Id.*

423. See Temp. Treas. Reg. § 1.7872-5T(c)(3) (1985) which lists as factors in this inquiry:

- (i) whether items of income and deduction generated by the loan offset each other;
- (ii) the amount of such items;
- (iii) the cost to the taxpayer of complying with the provisions of section 7872 if such section were applied; and
- (iv) any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal

Interestingly, this provision of the temporary regulations is captioned “Loans without significant tax effect.”<sup>424</sup> This enables them to serve the statutory purpose of this provision, *i.e.*, bringing loans not otherwise covered by specific relationships enumerated in § 7872(c) and that are not tax-avoidance loans within the ambit of § 7872, and a second purpose — *exempting* loans otherwise covered by § 7872 from that section on the basis that the interest arrangements do not have significant tax effects on lender or borrower. The latter purpose, while not embodied in the statute, is provided for in temporary regulations.<sup>425</sup>

The inclusive, catch-all function of the statute itself was demonstrated by an example in the legislative history.<sup>426</sup> The report describes a member of a club who makes, in lieu of payment of all or part of his or her membership fee, a non-interest bearing refundable deposit to the club. The club is to take payment of the member’s dues from investment income from the deposit. As noted in the report, this has the effect of converting the membership fee into the equivalent of a deductible expense. The conferees regarded conversion of a non-deductible expense into the equivalent of a deduction as an effect on the borrower or lender.<sup>427</sup>

This example was the subject of a private ruling.<sup>428</sup> The ruling describes a transaction similar to that described in the Conference Report. The main difference is that club members are expected to pay their annual dues independently of the loan.<sup>429</sup> Nevertheless, the Service noted its awareness of attempts to use such loans to convert nondeductible expenses into the equivalent of deductible expenses.<sup>430</sup> The ruling stated that since the Service has not proposed regulations defining significant effect loans, this arrangement cannot be classified as within § 7872(c)(1)(E).<sup>431</sup>

It is somewhat ironic that, over twenty years after its enactment, the explicit statutory purpose of this provision — drawing loans into § 7872 — cannot be fulfilled because the Service has not adopted regulations while

rate and a payment by the lender to the borrower.

*Id.*

424. *Id.*

425. *See id.* at § 1.7872-5T(b)(14).

426. H.R. REP. NO. 98-861, at 1019-20 (1984) (Conf. Rep.), reprinted in 1984-3 C.B., vol. 2, 273-74.

427. *Id.*

428. I.R.S. Pvt. Ltr. Rul. 97-35-002 (May 5, 1997).

429. *Id.*

430. *Id.*

431. *Id.*

the Service has, by temporary regulation, created an opposite purpose for the statute, *excluding* loans otherwise within § 7872. One case and a handful of private regulations address this latter purpose.

In *McGinnis*, taxpayers who had made below-market loans to their wholly-owned subsidiaries contended that relatively small amounts of the adjustments made as a result of such loans, \$5,694.32 for 1985 and \$5,313.77 for 1986, indicated that the transactions should be exempted from § 7872.<sup>432</sup> The court perceived the taxpayers to have otherwise conceded application of § 7872.<sup>433</sup> The taxpayers were relying on the temporary regulations which exempt loans otherwise covered by § 7872 as to which the taxpayer is able to show that the interest arrangements have no significant tax effect on either the lender or the borrower.<sup>434</sup> They asserted that the loans did not have significant tax effects and that they had non-tax reasons for structuring the loans as they did. In the absence of introduction of the loan documents into evidence by the taxpayers the court was unconvinced that the amounts of the Commissioner's adjustments alone indicated that the loans were without significant effect. Unlike other portions of the proposed regulations in other circumstances,<sup>435</sup> the Tax Court appeared to treat the factors in the proposed regulations for evaluating the significance of the tax effects as authoritative.

The three private rulings that address this issue, two dealing with similar taxpayer problems, demonstrate how the temporary regulations can rescue a transaction from § 7872. They also raise questions as to the necessity of the substantial tax-effects portion of § 7872 as a tax enforcement tool.

Two private rulings address taxpayers who provide payroll data processing services for clients. In a 1987 ruling, the taxpayer, in order to make a client's payroll payments, deposited the client's pre-authorized draft into its own collection account.<sup>436</sup> Then the client funds were deposited in a central account where they were pooled with the funds of other clients. From that account they were transferred to a disbursement account. Because of the client's staggered payroll dates, the taxpayer accumulated substantial amounts in the central account, which it transferred to a long-term investment account. Taxpayer contended that it was administratively impossible to determine how long an individual

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432. *McGinnis*, 65 T.C.M. 1870.

433. *Id.* at 1875.

434. *Id.* See also Temp. Treas. Reg. § 1.7872-5T(b)(14) (1985).

435. See, e.g., *Frazer*, 98 T.C. 554.

436. I.R.S. Pvt. Ltr. Rul. 87-29-011 (Apr. 15, 1987).



client's funds are held or whether they are allocated to the investment account. A 1998 ruling concerning a taxpayer in essentially the same business employed an identical process of handling client funds and investment of temporary excess of client funds over disbursements.<sup>437</sup>

Interpreting the term "loan" broadly, the Service characterized the advances of funds to both taxpayers as loans between independent contractors and persons for whom they perform services to which § 7872(c)(1)(B) would apply. In both instances, however, the Service looked to the temporary regulations to determine whether the loans had a substantial effect on any federal tax liability of the lender or borrower.<sup>438</sup>

In both instances, the Service noted that if interest were imputed on the client "loans" there would be offsetting interest deductions. Since these taxpayers are businesses, they would be unaffected by the personal interest deduction limits enacted in 1986.<sup>439</sup> Although in both cases the Service indicated that the taxpayers earned significant amounts of income annually, it noted that the individual advancements were small and short-term. In both instances, the Service noted that it would be expensive for the taxpayers to comply with § 7872. It would be very difficult to account for each loan from each client.

In the 1987 ruling, the Service concluded that the client "loans" did not have significant tax effects. In the 1998 ruling, the Service stated that, "tax avoidance is a principal purpose of a loan if it is the principal factor in a decision to structure the transaction as a below-market loan rather than as a loan at the applicable federal rate."<sup>440</sup> Since the taxpayer's method of collection and disbursement of client funds was in response to administrative and technological limitations, tax avoidance was not a principal purpose of the interest arrangements of the taxpayer. Thus, the Service concluded that the transactions did not have significant effects on lender or borrower within the meaning of the temporary regulations.<sup>441</sup>

Neither ruling addressed the obvious point that since the excess, or "loaned," client funds were transferred to a particular account the interest income of which was easily identifiable, the taxpayers could easily be held to account for any economic benefit from the transaction without requiring the taxpayers to go through the expense of obtaining a letter ruling. Had the transactions been held within the ambit of § 7872,

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437. I.R.S. Pvt. Ltr. Rul. 98-52-047 (Sept. 30, 1998).

438. *Id.* See also Temp. Treas. Reg. §§ 1.7872-5T(b)(14), -5T(c)(3) (1985).

439. See I.R.C. § 163(h).

440. I.R.S. Pvt. Ltr. Rul. 98-52-047.

441. *Id.* See also Temp. Treas. Reg. § 1.7872-5T(b)(14) (1985).

the clients would have discovered that they were “lenders” owing to the business exigencies of their payroll accounting services. If a client objects to the “free” use of its money by its payroll accountant, it may look for an accountant that does not do so, or does so to a lesser degree. Free use of a client’s funds is to some extent a price of the service, and a benefit to the provider that is easily measured without resort to § 7872.

A 1989 letter ruling addressed deposit by attorneys of client funds into Interest on Lawyers Trust Accounts (IOLTA) under a program created by a state supreme court.<sup>442</sup> Under this program, client funds other than those for costs and expenses are deposited into IOLTA trust accounts, the interest of which is used for various charitable purposes unless the client insists that funds be deposited in a non-interest-bearing account. In the event that more than a certain amount is earned on client funds, such excess may be transmitted to the client.

In the ruling, the Service considered whether § 7872 should be applied to the “loan” by clients to IOLTA trusts. The Service said § 7872 did not apply, for no reason that had anything to do with § 7872 itself. It stated that the income from the trust was taxable to the client under the assignment of income doctrine.<sup>443</sup> Although sending the client a Form 1099 for interest income under such circumstances seems harsh unless the client may take a charitable deduction for the amount, the rationale of the ruling cuts to the chase with respect to the application of § 7872 in business transactions adequately accounted for by other income tax provisions. It is not necessary. Other than the example above in the 1997 letter ruling pertaining to the club membership loans, § 7872, outside the areas that were widespread abuses in *Dean’s* heyday, appears to be a superfluity.

## V. SOME SUGGESTIONS TO MAKE § 7872 SIMPLER AND FAIRER

Section 7872 has now had a history that is approximately the same length as that of the regime of *Dean v. Commissioner*. As that history demonstrated the need for some reform with respect to below-market loans, so too the history of § 7872 has demonstrated areas where the law may be made less cumbersome or more fair.

First, the retransfer of forgone interest from borrower to lender may entail some statutory symmetry, but, for the most part, it is unnecessary. There is no reason, with compensation or corporation loans respectively, to make an employer or corporation report an item of income to cancel

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442. I.R.S. Pvt. Ltr. Rul. 89-51-022 (Dec. 22, 1989).

443. *Id.* (citing *Harrison v. Schaffner*, 312 U.S. 579 (1941)).

out its deduction for compensation or charge to earnings and profits. With the elimination of the deduction for personal interest for the borrower in 1986, the retransfer is nearly vestigial. The retransfer should be retained for gift loans, when such loans between lender and borrower exceed \$10,000, to the extent that the borrower has net investment income. In such instances, there is a clear possibility of shifting income to a lower bracket taxpayer and the retransfer is a useful means to combat such avoidance.

If the borrower with respect to a gift loan does not have net investment interest there should be no retransfer regardless of the amount of the loan. Such a transaction may be subject to gift tax. Subjecting a retransfer to income tax for the lender imposes a tax on the "opportunity cost" of the lender so properly rejected by two *Dean*-era courts.<sup>444</sup> The retransfer should also be retained for tax-avoidance loans under § 7872(c)(1)(D).

The income reporting with respect to term loans creates a grotesque distortion of income with respect to a borrower. Section 7872(b)(1) treats the entire amount of the original issue discount as transferred to the borrower on the day the loan is made. If the term of the loan is long, this may result in a substantial up-front payment of taxes, and yet, in such a circumstance, the distortion of income is greatest since the borrower realistically enjoys the benefit of the loan over its term.

Compensation and corporation/shareholder loans should be redefined to limit the applicability of § 7872 to loans *by* employers to employees or *by* corporations to shareholders. There was clearly a history of abuse during the *Dean* era with respect to below-market compensation and corporate loans, particularly the latter. There was no such demonstrated history with respect to loans the other way. Analyzing advances of capital to corporations under § 7872 adds another wrinkle to a debt-equity area that is already plenty complicated.

Finally, Congress should seriously consider eliminating the classification of below-market loans in § 7872(b)(1)(E), *i.e.*, for loans where the interest arrangements of which have a significant effect on any federal tax liability of the lender or borrower. Congress has not even promulgated the final regulations upon which implementation of this part of the statute depends. The limited history of private rulings in connection with this section indicates that possibilities for tax avoidance may be addressed by other sections of the Code or doctrines of tax law.

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444. See *Crown v. Commissioner*, 67 T.C. 1060 (1977); *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966).

## VI. CONCLUSION

It is difficult to point to an income tax provision enacted in recent years that is as complicated or intrusive as § 7872. The issues that led to its creation still lurk, especially if interest rates rise from the near historical low rates of recent years. But in several significant ways, § 7872 far overshot its mark. Sound tax policy would counsel that it be amended to a more appropriately targeted tool to limit tax avoidance.

