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Interest-Free Demand Loans Now Subject to Gift Tax - Dickman v. Commissioner

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INTEREST-FREE DEMAND LOANS NOW SUBJECT TO GIFT TAX: *Dickman v. Commissioner*, _ U.S. _, 104 S. Ct. 1086 (1984).

INTRODUCTION

One day, Mr. Jones walks into your office and tells you that he wants to help junior start his own business, but he does not want to incur any gift tax. "No problem," you say, and you proceed to tell him about the advantages of an interest-free demand loan to junior. You tell him that based on *Johnson v. United States*[1] and *Crown v. Commissioner*,[2] an interest-free demand loan will not result in a taxable gift. So junior can get the money to start his new business, Mr. Jones can transfer some of his wealth without adverse gift tax consequences, and all is right with the world — well, almost. On February 22, 1984, the United States Supreme Court handed down its decision in *Dickman v. Commissioner*[3]. The Court overruled the decisions in *Johnson*[4] and *Crown*[5] and held that an interest-free demand loan between family members does result in a taxable gift. Sorry, Mr. Jones, but do not despair. If you make yourself comfortable, we will take a look at the High Court's reasoning and the implications of the *Dickman*[6] decision.

THE CASE

Between 1971 and 1976, Paul and Esther Dickman loaned substantial sums of money to their son, Lyle.[7] Lyle gave interest-free demand notes as evidence of all debts (except one which was a loan made on "open account").[8] Paul died in 1976, and the Internal Revenue Service audited his estate. The IRS determined that the loans to Lyle constituted taxable gifts "to the extent of the

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1. 254 F. Supp. 73 (N.D. Tex. 1966)
2. 585 F.2d 234 (7th Cir. 1978).
3. _ U.S. _, 104 S. Ct. 1086.
4. 254 F. Supp. 73.
5. 585 F.2d 234.
6. 104 S. Ct. 1086.
7. The balance of Paul's loans to Lyle varied from $144,715 to $342,915 over the five year period under review; Esther loaned $226,130 to Lyle during the same period. *Id.* at 1088.
8. *Id.*

value for the use of the loaned funds."[9]

The Tax Court followed the earlier decisions in *Johnson*[10] and *Crown*[11] and held that the interest-free demand loans to Lyle were not taxable gifts.[12] The United States Court of Appeals for the Eleventh Circuit reversed the Tax Court decision.[13] After a review of the statutory language and history of the gift tax provisions of the Internal Revenue Code of 1954, the Appellate Court concluded that Congress intended the gift tax to have the broadest and most comprehensive coverage possible.[14] That court held that the making of an interest-free demand loan constitutes a "transfer of property by gift" within the meaning of I.R.C. § 2501(a)(1), and is subject to the gift tax.[15]

Petitioner Dickman argued that gift tax consequences should not attach to interest-free demand loans because:

(1) there is no "transfer" of property when the loan is made;[16]

(2) our system of taxation does not recognize the possibility that money lent might have enhanced a person's taxable income or taxable estate if it had never been lent, but had been invested wisely;[17]

(3) the Commissioner's rationale could be carried to extremes and subject commonplace transactions (e.g. the loan of a cup of sugar to a neighbor; loan of lunch money to a friend) to gift taxation;[18] and

(4) the Commissioner's position represents a departure from prior IRS practice. The Commissioner's new position would injure those taxpayers who have relied on prior practice in planning their transactions.[19]

The IRS took the position that an interest-free demand loan

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9. *Id.*
10. 254 F. Supp. 73.
11. 585 F.2d 234.
12. 104 S. Ct. at 1089.
13. *Id.*
14. Dickman v. Commissioner, 690 F.2d 812, 815 (11th Cir. 1982).
15. *Id.* at 819.
16. "Petitioners urge that the term 'transfer' connotes a discrete, affirmative act whereby a person conveys something to another person, not a continuous series of minute failures to require return of something loaned." Brief for Petitioners 22. 104 S. Ct. at 1091 n.7.
17. *Id.* at 1092.
18. *Id.* at 1093.
19. The Court referred to this argument as the "taxpayer reliance" argument. *Id.* at 1093-94.

consists of two transactions. The first transaction is "an arm's-length loan from the lender to the borrower, on which the borower pays the lender a fair rate of interest."[20] The second transaction is "a gift from the lender to the borrower in the amount of that interest."[21] Therefore, the taxable gift that results from the loan equals the value of receiving and using money without any obligation to pay interest. According to the IRS, a gift tax should be computed on the reasonable value of the use of the money lent.[22]

The Supreme Court affirmed the Eleventh Circuit holding that an interest-free demand loan is a "transfer of property" within the meaning of § 2501(a)(1).[23] This holding overruled eighteen years of favorable gift tax treatment for interest-free demand loans by the courts. Too bad, Mr. Jones.

BACKGROUND

A quick review of statutory material shows that I.R.C. § 2501(a)(1) imposes a tax on the "transfer of property by gift" during the year by an individual. Treas. Reg. § 25.2511-1(c) also reflects the broad scope of the language used by the Code.[24] However, neither the Code nor the Treasury Regulations give a precise definition of what constitutes a "transfer of property" for purposes of the gift tax.

The first case to consider the broad scope of I.R.C. § 2501 in the context of interest-free demand loans to family members was *Johnson v. United States*.[25] That case involved a fact situation similar to that in *Dickman*.[26] Kirk and Elizabeth Johnson made substantial loans to their two children between 1959 and 1962.[27] A non-interest bearing note payable on demand represented part of the outstanding balance due from each child; open accounts repre-

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20. *Id.* at 1090 n.5.

21. *Id.*

22. *Id.* at 1090.

23. *Id.* at 1094-95. Unless otherwise indicated, all references to Code sections are to the Internal Revenue Code of 1954 and regulations thereunder.

24. "The gift tax also applies to gifts indirectly made. Thus, all transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax." Treas. Reg. § 2511-1(c).

25. 254 F. Supp. 73.

26. 104 S. Ct. 1086.

27. By May 31, 1962 the total loan outstanding to each child was $305,001 and $235,792. 254 F. Supp. at 76.

sented the remaining balance.[28] Kirk and Elizabeth, however, made each loan payable on demand without interest.[29] In June 1962, each child repaid his debt in full, and the only loan that remained outstanding when Kirk died in late 1962 was a $30,000 loan to Kirk, Jr.[30] The IRS argued that each year between 1955 and 1962, the Johnsons made a gift to their children of the value of the use of the money.[31] The United States District Court for the Northern District of Texas noted the lack of judicial authority in this area of taxation and held that the Johnsons did not make taxable gifts to their children.[32] The court determined that the transaction did not defeat the purpose of the gift tax law (i.e. prevention of estate tax avoidance) because the Johnson children repaid most of the loans, and Kirk's estate included the value of the loan still outstanding.[33] The Court also noted that the children were not under a statutory or contractual duty to pay interest, and the parents were not under a statutory or contractual duty to collect interest.[34] In dictum, Judge Brewster said that Congress is in a better position than the courts to consider a gift on interest-free demand loans.[35]

The IRS officially announced its nonacquiescence to the *Johnson*[36] decision almost seven years later in Rev. Rul. 73-61.[37] That ruling also announced the IRS position regarding interest-free demand loans. The IRS viewed the right to use money as an interest in property, which is subject to the gift tax unless the donor receives full and adequate consideration in exchange for that right.[38] The IRS said that the rate of interest determines the value of the property right, and the amount of interest that represents adequate consideration varies, depending on the circumstances of the transaction.[39] Therefore, the IRS concluded that a non-interest bearing demand loan results in the transfer of a property interest

28. *Id.* at 74.
29. *Id.*
30. *Id.* at 76.
31. The IRS computed the use value of the money at 3 percent per annum on the average unpaid balance for that year. *Id.* at 73.
32. *Id.* at 77.
33. *Id.*
34. *Id.*
35. *Id.*
36. 254 F. Supp. 73.
37. 1973-1 C.B. 408.
38. *Id.* at 409.
39. *Id.*

which is subject to the gift tax for the portion of the year in which the loan is outstanding.[40]

The next case involving the taxability of interest-free demand loans was *Crown v. Commissioner*.[41] In that case, Areljay Company, a partnership owned by three brothers, loaned approximately $18 million to a series of trusts established for the benefit of the children and relatives of the three brothers.[42] Interest-free demand notes represented a small portion of the loans, but a majority of the loans consisted of open accounts with no provision for interest.[43] The IRS determined that the loans to the trusts constituted gifts by the partners.[44]

In *Crown*, the IRS argued that an interest-free demand loan bestows an economic benefit on the recipient and that this transfer is inimical to the purpose of the gift tax — protecting the income tax and estate tax.[45] The Seventh Circuit Court of Appeals noted that this argument is correct with respect to the income tax,[46] but rejected the argument with respect to the estate tax because the lender's estate can demand repayment of the loan.[47] Although the IRS attempted to bring this type of transfer within the broad sweep of I.R.C. § 2501, the court rejected the IRS position. The court rejected the "unequal exchange" argument under I.R.C. § 2512(b) which says that the promise to repay a certain amount of money on demand is less in "money's worth" than the amount loaned.[48] The court found that the IRS did not present evidence supporting this proposition and that, realistically, the value of the promise to repay is both unknown and unknowable at the time of the exchange.[49] Since the "unequal exchange" argument implicitly

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40. Although the value of the right to use the money is not ascertainable at the date of the exchange, the value of the use of the money during the calendar quarter is determinable as of the last day of each quarter that the loan remains outstanding. *Id.*

41. 585 F.2d. 234.

42. *Id.* at 235.

43. *Id.*

44. To calculate the amount of the gifts the IRS applied an interest rate of 6 percent per annum to the daily outstanding balance of the loans. *Id.*

45. *Id.*

46. Interest-free loans permit income splitting between taxpayers in a high bracket and taxpayers in lower tax brackets. *Id.* at 236.

47. *Id.*

48. *Id.* at 238.

49. There is an incomplete transfer of the economic benefit at the time of exchange because the transaction depends on the lender's continued willingness

assumes that the values being compared will be measured at the same point in time, the IRS could not use this theory to support a gift tax on the loan.[50]

The court also rejected the IRS argument that an interest-free demand loan is an outright transfer of a property right (i.e., the right to use the money for an indefinite period).[51] There was no evidence to show that the recipient of a loan payable on demand had a legally enforceable interest against the lender, and there was no evidence that the borrower's interest had an exchangeable value.[52] Finally, the court rejected the IRS position that a gift occurred continuously throughout the life of the loan because the mere right to use property is not a property right within the meaning of the gift tax statutes.[53]

In addition to squarely rejecting the IRS position, the Seventh Circuit court cited several problems with the judicial approval of the IRS position. First, judicial approval would require the courts to determine an appropriate rate of interest to impute to interest-free loans. The absence of statutory guidance on this question would make it difficult for taxpayers to know when a particular loan gave rise to a taxable gift and the amount of the gift.[54] The court also cited the potential broad application of a judicial decision to everyday instances of family exchanges.[55] Third, the court felt that equitable considerations did not permit it to adopt the IRS position. After all, the IRS did not appeal the *Johnson*[56] decision and did not announce its nonacquiescence until seven years later.[57] These policy considerations moved the Seventh Circuit to affirm the Tax Court decision and hold that interest-free demand loans are not taxable gifts.[58] Thus, the *Crown*[59] decision by the Seventh Circuit set the stage for the conflict with the Eleventh

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to refrain from demanding repayment. *Id.*

50. *Id.* at 239.

51. *Id.*

52. *Id.*

53. *Id.* at 240.

54. *Id.* at 240-41.

55. For example, the court reasoned that the IRS position might be used to impute a gift when a worker lends another employee $10 until next payday or when a friend provides a night's lodging to out-of-town guests at no charge. *Id.* at 241.

56. 254 F. Supp. 73.

57. 585 F.2d at 241.

58. *Id.*

59. 585 F.2d. 234.

Circuit decision in *Dickman*[60] and led the Supreme Curt to consider the problem of interest-free demand loans.

ANALYSIS

The Supreme Court began its analysis in the *Dickman* case by examining the gift tax statutes, specifically I.R.C. § 2501(a)(1) and I.R.C. § 2511(a). After reviewing the legislative history of these statutes, the Court concluded that Congress intended the gift tax to reach all transfers of property and property rights having significant value.[61]

The Court next looked at the transfer of money to another without any obligation to pay interest and found that the transfer involved the right to use a substantial amount of cash for an indefinite period.[62] Chief Justice Burger analogized the right to use cash for an indefinite period to the right to use real property, rent-free, for an indefinite period of time. He found that, in both cases, there is a measurable economic value associated with the property transferred.[63] Although the demand status of the loan reduced its value, the value was not eliminated.[64] Therefore, the Chief Justice concluded, the interest-free transfer of funds is a "transfer of property" within the meaning of the federal gift tax statutes.[65]

The Court then justified its holding by saying that the holding is consistent with the purpose of the federal gift tax — protecting the income tax and the estate tax. According to the Court, failure to impose the gift tax in this case would seriously undermine this

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60. 690 F.2d 812.

61. I.R.C. § 2501(a)(1) imposes a tax on all transfers of property by gift. I.R.C. § 2511(a) says that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and no matter what type of property the transfer involves. 104 S. Ct. at 1089.

62. *Id.* at 1090-91.

63. "In either case, there is a measurable economic value associated with the use of the property transferred. The value of the use of money is found in what it can produce; the measure of that value is interest — 'rent' for the use of the funds." *Id.* at 1091.

64. *Id.* at 1091.

65. The Court rejected the taxpayer's argument that the transfer was not a taxable gift. The taxpayer based this argument on language in Treas. Reg. § 25.2511-2(b)(1983), which requires the transferor to give up dominion and control of the property to make a complete gift. Chief Justice Burger noted that the transferee retains some dominion and control when the loan passes, but as time goes by without recall, the transferor allows the transferee to use the principal and the gift becomes complete. *Id.* at 1091, n.7.

goal.[66]

In the remainder of the opinion, the Court rejected the taxpayer's main arguments. The taxpayer argued that the gift tax is a tax on transfers and is not applicable to other acts of consumption; a transferor may squander, conceal or use his money as he pleases.[67] The Court pointed out that its holding does not require the transferor to invest his money profitably, but merely recognizes that certain tax consequences result from a decision to make a transfer by gift.[68] With respect to the taxpayers argument about the extremes to which a judicial decision upholding the IRS position might be carried, the Court assumed that the IRS focus was not on traditional familial transfers, such as the use of a car or cottage by a child.[69] Finally, the Court rejected the taxpayer's "detrimental reliance" theory by pointing out that the IRS may change its interpretation of the law, even though the change is retroactive in effect.[70]

Justices Powell and Rehnquist dissented from the majority and argued that the interest-free demand loan should not be subject to gift tax because of IRS inaction.[71] In other words, the dissenters felt that judicial enforcement of the IRS argument would be unfair to the many taxpayers who relied on the prior law concerning interest-free loans.[72]

The majority opinion based part of the rationale for its holding on the broad language of I.R.C. § 2501(a)(1) and I.R.C. § 2511(a). However, the language of these statutes seems less than clear because interest-free demand loans have gone untaxed for so many years. A more convincing reason for the majority decision is

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66. How? The Court noted that the transfer of cash results in income tax consequences to the lender. If a lender in a high tax bracket loans money to his children in a lower bracket, he avoids tax on the income earned on the funds. He also avoids future estate tax on the earnings which would have become part of his estate. *Id.* at 1092.

67. *Id.*

68. *Id.*

69. Chief Justice Burger felt that the exemptions for educational and medical payments on another's behalf [I.R.C. § 2503(c)], the $10,000 annual exclusion per donee [I.R.C. § 2503(b)], and credits, such as the mandatory use of the I.R.C. § 2505 unified credit, absorb the *de minimus* gifts. *Id.* at 1093.

70. The Court also noted that there could be no detrimental reliance by the Dickmans because they made almost one-half of the loans after the IRS announced its official position in Rev. Rul. 73-61, 1973-1 C.B. 408. *Id.* at 1094 n.13.

71. *Id.* at 1096-97.

72. *Id.*

the argument that a borrower receives economic value when a lender allows him to use funds without any obligation to pay interest. That economic value equals the amount of interest which the loan permits the borrower to avoid. This approach recognizes the economic reality of interest-free demand loans, at least between family members. In other words, family members often loan money to one another with no expectation of profit, hoping to help the borrower avoid a loan from a commercial institution which does expect a profit on a loan. The Court recognizes the economic basis for the transaction and finally calls an interest-free demand loan by its true name — a gift.

Clearly, the majority opinion represents a victory for the IRS by holding that interest-free demand loans are subject to gift tax. However, the Court failed to address several important areas.

(1) The Court offered no guidance on the proper interest rate to use to value the property right that is subject to the gift tax. As Justices Powell and Rehnquist point out, the IRS used three different methods in three different cases to determine the interest rate.[73]

(2) The Court did not address the income tax consequences of an interest-free demand loan. The IRS position views an interest-free demand loan as involving two separate transactions. The first transaction is "an arm's-length loan from the lender to the borrower, on which the borrower pays the lender a fair rate of interest."[74] The second transaction is "a gift from the lender to the borrower in the amount of that interest."[75] Theoretically, the lender is subject to income tax on this imputed interest and the borrower receives an interest deduction for the same amount.

(3) The Court did not limit its decision to interest-free demand loans, but included other transactions involving the use of property.[76] In effect, the question remains: What transfers or loans

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73. In *Johnson*, the IRS used the interest rate specified in the regulations for valuing annuities, life estates, terms for years, remainders and reversions; in Crown, the IRS used a rate that it determined to be reasonable; in this case, the IRS used the rate specified in I.R.C. § 6621 for determining interest on underpayments or refunds of taxes. *Id.* at 1098 n.9.

74. *Id.* at 1090 n.5.

75. *Id.*

76. *See* Justice Powell's dissenting opinion, "Under this theory, potential tax liability may arise in a wide range of situations involving the unrecompensed use of property." He cites the rent-free use of a home by an adult child, and the loan of a car as examples. *Id.* at 1097.

are considered gifts?[77] Chief Justice Burger's opinion neatly sidestepped this issue when he said, "When the government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case."[78] Clearly, if a transfer of certain property is a taxable gift, then a loan of that same property is also a taxable gift under the *Dickman* decision.[79]

(4) Finally, the IRS can apply the *Dickman* decision retroactively.[80] That is, interest-free demand loans made prior to the *Dickman* decision are also subject to the gift tax. If the donor has not filed a gift tax return, the three year statute of limitations will not have begun to run with respect to the particular gift. In such case, the IRS might try to subject the transaction to the gift tax and interest for each year that the loan has been outstanding.[81] The annual exclusion will offset the effects of retroactive application to some extent, but not if the loan is extremely large, or the donor has already used the annual exclusion with respect to a particular donee.[82]

Although the Supreme Court did not address these areas, Congress apparently took the hint from Justice Powell[83] and addressed most of them in the Tax Reform Act of 1984. The Act subjects the foregone interest portion of interest-free demand loans to gift tax.[84] The Act also subjects the imputed interest portion of the transaction to income tax.[85] The interest element for interest-free loans is determined by reference to the "applicable federal rate."[86]

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77. Pearle, *Supreme Court Finds Interest-Free Intrafamily Loans Are Taxable Gifts, But Valuation Left Open*, 11 ESTATE PLAN. 130, 132 (1984).

78. *Id.* at 132 (quoting 104 S. Ct. at 1093).

79. Pearle, *supra* note 77, at 132. Presumably, this conclusion results because the loan transfers valuable property in the rent-free use of the property.

80. *Id.* at 134.

81. *Id.*

82. *Id.*

83. "There can be little doubt that the courts are not the best forum for consideration of the ramifications of the gift taxation of interest-free loans. Congress is the body that is best equipped to determine the rules that should govern." 104 S. Ct. at 1097.

84. I.R.C. § 7872(e)(2) defines foregone interest as the difference between the amount of interest payable using the applicable federal rate, and any interest payable under the terms of the loan itself. Thus, if the loan is an interest-free demand loan, the foregone interest is the interest payable using the applicable federal rate.

85. This results because § 7872(a)(1)(B) treats the foregone interest as "retransferred by the borrower to the lender as interest."

86. § 7872(f)(2)(B) defines the applicable rate for demand loans as the "Fed-

That rate will be redetermined every six months by comparing the average market yield on outstanding federal obligations with comparable maturities.[87] The Act provides some limitations in the following transactions:

(1) No income or gift tax consequences result if the aggregate amount of the loan is not more than $10,000.[88] However, this exception does not apply to any gift loan directly attributable to the purchase or carrying of income producing assets.[89]

(2) No income tax consequences result to the lender or borrower if the loan is $100,000 or less and the borrower's net investment income is not more than $1,000.[90]

(3) If the loan is not more than $100,000 and the borrower's net investment income exceeds $1,000, interest is imputed, but only to the extent of the borrower's net investment income.[91]

The Act, on its face, does not directly address the question of other transactions involving the use of property, but merely refers to below-market loans, gift loans, and demand loans. The Conference Committee report says, "It is intended that the term 'loan' be interpreted broadly in light of the purposes of the provision."[92] Additionally, the Committee report defines a gift loan as:

> [A]ny below-market loan where the foregone interest is in the nature of a gift. In general, there is a gift if property (including foregone interest) is transferred for less than full and adequate consideration under circumstances where the transfer is a gift for gift tax purposes.[93]

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eral short-term rate in effect under § 1274(d) for the period for which the amount of foregone interest is being determined."

87. Blattmachr, *Estate and Gift Provisions of New Law May Require Revisions of Estate Plans*, 61 J. TAX'N 140, 143 (1984).

88. I.R.C. § 7872(c)(2)(A). The taxpayer must take all loans, whether interest-free or not, into account in making this determination. If the outstanding balance of a demand loan fluctuates above or below $10,000 during the year, there may be income and gift tax consequences to the lender on some days, and no consequences on others. Balk, *Interest-Free No Longer*, 123 TR. & EST. 39, 40 (Sept. 1984).

89. I.R.C. § 7872(c)(2)(B).

90. I.R.C. § 7872(d)(1)(A) and § 7872(d)(1)(E)(ii). But note, this exception does not apply if one of the principal purposes of the loan is the avoidance of any federal tax. I.R.C. § 7872(d)(1)(B).

91. I.R.C. § 7872(d)(1)(A).

92. H. CON. R. No. 861, 98th Cong., 2d. Sess. 1018, *reprinted in 6B* U.S. CODE CONG. & AD. NEWS 751, 1012 (August 1984).

93. *Id.*

Given this broad language and the potentially broad reach of the *Dickman* decision, the IRS might argue that the rent-free use of property is also subject to the federal gift and income taxes. However, Congress has given no indication under the Act as to how the rent-free use of property must be valued.[94] Therefore, Congress, like the Supreme Court in *Dickman*, does not expressly deal with the taxability of transfers involving the use of property and leaves the door open for additional confusion.[95]

The Act applies to demand loans outstanding after June 6, 1984.[96] If a borrower repays a demand loan within 60 days after enactment of the Act (i.e., July 18, 1984), no income or gift tax consequences result under the Act.[97] Thus, the Act allows a lender to avoid the imposition of any income tax if the borrower repays his loan within the statutory time period. The Act, however, does not address the retroactive application of *Dickman* to interest-free demand loans outstanding prior to June 6, 1984. These loans remain subject to *gift* tax whether terminated within the statutory period or not.[98]

PLANNING

What are the planning possibilities in light of the *Dickman* decision and the Tax Reform Act of 1984? For loans existing prior to June 6, 1984, the lender should terminate the demand loan as soon as possible if the amount of the loan exceeds $100,000. Otherwise, the lender will be subject to both income tax and gift tax on the foregone interest since June 6, 1984. He will also be subject to gift tax on the foregone interest prior to June 6, 1984 under *Dickman*.

If the loan is less than $100,000, whether made before or after June 6, 1984, the lender should continue the loan. Although the loan is subject to gift tax under *Dickman* and under the new Act, the $10,000 annual gift exclusion should make the transfer nearly, if not completely, free of gift tax under the present applicable fed-

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94. Congress would have to devise an "applicable federal rate" (e.g. fair rental value) for different types of property to determine the amount of the gift and the amount of income.

95. The I.R.S. might eliminate or clarify this area through regulations promulgated under authority of I.R.C. § 7872(g). The result, however, would probably not favor taxpayers.

96. Balk, *supra* note 88, at 40.

97. *Id.*

98. *Id.* at 42 n.11.

eral rate.[99] No income tax consequence result on a $100,000 loan if the borrower's net investment income is less than $1,000. If the borrower's net investment income exceeds $1,000, the loan is subject to income tax consequences, but only to the extent that net investment income exceeds $1,000.[100]

A planner should also keep in mind two final points regarding state law. State law may provide for a lower annual exclusion than the federal exclusion under § 2503(b). Thus, an interest-free demand loan which is not subject to the federal gift tax because of the $10,000 annual exclusion, may be subject to gift tax under state law.[101] Also, the running of the state statute of limitations on a demand note constitutes a transfer of property because the note is no longer enforceable.[102] The entire amount of the outstanding loan then becomes subject to the gift tax.[103] A client who makes an interest-free demand loan must, therefore, renew his loan from time to time to avoid this result.[104]

CONCLUSION

So what can you tell Mr. Jones when he walks into your office and says he wants to loan junior some cash, interest-free? Tell him that *Dickman v. Commissioner*[105] subjects the loan to federal gift tax for the use of money without interest during the outstanding period of the loan. The Tax Reform Act of 1984 sanctions the gift tax treatment of the loan and also makes the loan subject to in-

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99. The applicable federal rate for periods before January 1, 1985 is 10%, compounded semiannually. *See*, Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 172, 98 Stat. 494, 703 (1984). Thus, the amount subject to gift tax on a $100,000 loan is $10,250 computed as follows: $100,000 $(1.05)^2$ = $110,250
$110,250 - 100,000 = $10,250
Assuming the lender has not used up the annual exclusion with respect to that particular borrower, the amount actually subject to gift tax is $250 ($10,250 - 10,000).

100. Tax planners should make their clients aware that the favorable income tax treatment of loans less than $100,000 can be lost if the IRS successfully claims that the purpose of the loan was to avoid any federal tax. I.R.C. § 7872(d)(1)(B). *See* Balk, *supra* note 88, at 40-41.

101. N.C. GEN. STAT. § 105-188(d)(1984) now provides for a $10,000 annual exclusion per donee.

102. Pearle, *supra* note 77, at 135.

103. *Id.*

104. *Id.*

105. 104 S. Ct. 1086 (1984).

come tax.[106] However, the Act limits the effect of *Dickman* by excluding loans of not more than $10,000 from both gift and income tax.[107] The Act also allows loans of $100,000 or less to escape income tax if the borrower's net investment income is not more than $1,000.[108] Therefore, Mr. Jones can loan junior $10,000 without incurring tax liability of any kind, or he can loan junior $100,000 and this amount will not be subject to income tax. If he has not used up his $10,000 annual exclusion, the $100,000 will also be free, or nearly free, of gift tax. The bottom line is that the Supreme Court and Congress, acting within six months of each other, have tightened, but not closed off, an attractive tax loophole.

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106. By application of I.R.C. § 7872(a)(1).
107. I.R.C. § 7872(c)(2)(A).
108. I.R.C. § 7872(d)(1)(A) and I.R.C. § 7872(d)(1)(E)(ii).