University of Baltimore Law Forum

Volume 12
Number 1 *Fall 1981*

Article 3

1981

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directed to state or local agencies and private industry that operate in the vicinity of the Bay. We will lose some of the value of the study if we are not able to promulgate the results of the study, and make it available. It may be a matter of interest that the study took place, but to make it a matter of profit in the public sense of profit—people are going to have to know what the study disclosed, and they are going to have to be able to govern themselves in the light of those findings in the years to come. So, I think if EPA is not allowed to carry out its basic function in this regard, we will have, in large measure, wasted the 25 million dollars that have already been spent. It is just one example of how the effort to save money today can really be more expensive in the long run if we are not very careful where and how we make the cuts.

S: Senator, what are the greatest satisfactions of your office?

M: Well, there were two examples today. As I was crossing Hopkins Plaza this afternoon, a woman who was sitting on a bench jumped up and said, "Oh I didn't expect to see you today, but I want to tell you how wonderful your office has been in helping the YWCA in getting their project completed." I came back to the office and there was someone waiting who said, "I just came to see you and to tell you how much it has meant to have your help in getting our projects completed." The ultimate satisfaction really is to see your help to other people enable them to do things that they might not be able to accomplish without that little bit of encouragement.

Interest-Free Loans: Recent Developments Provide Tax-Saving Opportunities

by Edward A. Johnston and
David M. Abramson

The 1961 decision of the United States Tax Court in *J. Simpson Dean*, 35 T.C. 1083 (1961), set forth in broad form the general principle that interest-free loans from a corporation to a shareholder do not give rise to imputed taxable income. A series of recent cases involving challenges to this doctrine by the Internal Revenue Service have been uniformly rejected by the courts. Thus, a properly structured interest-free loan provides many opportunities to corporations and individuals for significant income tax savings. The rationale of *Dean* is that although the borrower may have realized an economic benefit to the extent of the interest expense which would otherwise have been incurred, any imputed interest income would be fully offset by a deductible expense (I.R.C. §163), leaving the borrower in the same overall economic and tax position.

An example will serve to illustrate the income tax advantage of a classic interest-free loan between a shareholder and his controlled corporation. Assume that a corporation has $100,000 extra cash available. If invested by the corporation, the interest earned on the $100,000 is taxable to it, reducing the amount ultimately available to the shareholder. Any such interest income distributed to the shareholder is taxed a second time as a dividend. If the corporation instead lent that same $100,000 directly to the shareholder as an interest-free demand loan, taxation is avoided at the corporate level: the corporation does not have to pay taxes on the interest generated by the $100,000. There is no tax consequence to the corporation as a result of the interest-free loan, and under *Dean* and its progeny there is no imputed income to the shareholder.

Substantial gift and estate tax savings can also arise when interest-free loans are used, rather than the traditional Clifford Trust,[1] to shift income from high-to-low-bracket taxpayers. For example, suppose a daughter in a high tax bracket has $100,000 to help her elderly father. The father is in a low-income bracket and has extensive medical bills. If the daughter puts that $100,000 into a Clifford Trust, she has to contend with detailed Clifford Trust statutory requirements, the $100,000 must remain in the Trust for over ten years, and the daughter has gift tax consequences based on the actuarial value of the assumed earnings of the Trust and a resultant use of the unified gift and estate tax credit.[2] All of this can be avoided if the daughter gives her father the $100,000 as an interest-free demand loan. There are no statutory requirements for an interest-free loan, the $100,000 is not committed for any length of time, and the daughter has no gift tax consequences. Income generated by the Clifford Trust or the interest-free loan is taxable to the father, but this tax is offset by the father's low-income bracket and deductions for medical expenses. In both the interest-free loan and the Clifford Trust, the principal will be includable in the estate of the decedent daughter, but in the case of the loan, no gift is deemed to have been made, and therefore there is no reduction in the unified tax credit available to the decendent's estate. *See: Crown v. Commissioner*, 67 T.C. 1060 (1967), aff'd, 585 F.2d 234 (1978).

Although these examples are set forth in general terms, and there are numerous factors affecting both the potential tax benefits and savings from interest-free loans, they do serve to highlight the attractiveness of interest-free loans. A discussion of *Dean* and several other recent cases is helpful in fully understanding how interest-free loans should be structured, as well as some of the potential trouble spots.[3]

In *Dean*, an interest-free loan of an

amount in excess of two million dollars was made to the taxpayer by his controlled corporation. The Internal Revenue Service argued that this loan was similar to the situation in which the Tax Court had previously imputed income when the use of corporate property was made available to a shareholder without charge. Similarly, the Service maintained that the use of corporate funds provided a taxable "economic benefit derived from the free use of borrowed funds" and taxable income to the extent of the fair rental value of corporate property used by a shareholder. The Court rejected this contention of the Commissioner:

> In each of. . .[the cases relied on by the Service] a benefit was conferred upon the stockholder or officer in circumstances such that had the stockholder or officer undertaken to procure the same benefit by an expenditure of money such expenditure would not have been deductible by him. Here, on the other hand, had petitioners borrowed the funds in question on interest bearing notes, their payment of interest would have been fully deductible by them under section 163, I.R.C. 1954. Not only would they not be charged with the additional income in controversy herein, but they would have a deduction equal to that very amount. 35 T.C. at 1090.

This "no-income, no-deduction" approach of the majority of the Tax Court was criticized in concurring and dissenting opinions. In these opinions, the Court observed that where the shareholder used an interest-free loan in a trade or business an offsetting deduction would arise. In situations where the proceeds of the loan were invested in federally tax-exempt obligations, however, no interest deduction would be permitted under section 265(2) of the Code.[4]

Recently, the Internal Revenue Service has mounted an all-out attack upon the tax status of interest-free loans. In the last two years, in no fewer than seven reported decisions, the government has attempted to have the *Dean* decision overruled or narrowed. In the case of *Greenspun v. Commissioner,* 72 T.C. 931 (1979) a loan was made by Howard Hughes to a local newspaper owner and publisher with the expectation that Hughes would receive favorable publicity beneficial to his business interests. In *Greenspun,* the Commissioner argued that because the loan was admittedly below the prevailing market interest rate at the time it was made (3%), interest income should be imputed to the borrower to the extent of the economic benefit to him. In refusing to accept the Commissioner's invitation to overrule *Dean,* the Court restated the general principle of *Dean* that if interest income were imputed, there would be an offsetting deduction under section 163. However, the Court did recognize that the broad language in *Dean* may have been an overstatement and that, if the money were invested in tax-exempt securities, then, under section 265(2) a different question would be presented. In addition, the Court rejected the Commissioner's contention that a taxpayer would not be entitled to an offsetting interest deduction under section 163 because the interest "has not been actually paid." 72 T.C. at 950.

One week after *Greenspun,* the Tax Court was again requested by the Commissioner to overrule *Dean* in *Zager v. Commissioner,* 72 T.C. 1009 appeal docketed, (5th Cir. 1981). *Zager* involved the classic interest-free loan between a controlled corporation and its dominant shareholder. Refusing to overrule *Dean,* the Court noted that exceptions to the general rule may exist, observing:

> Thus, if the indebtedness were incurred by the stockholder or officer to purchase or carry tax exempt bonds, a different result might perhaps be reached in view of the provision of section 265(2) of the Code which disallows a deduction for interest paid in respect of such indebtedness. *Id.* at 1012.

However, because the issue was not presented in *Zager,* the Court declined to address this question. With regard to the fundamental argument of the Service that *Dean* be overruled, the Court took the position that the practice of not taxing interest-free loans was too deeply entrenched in the law to be judicially displaced and that, if a change were to be made, the appropriate remedy should be legislative rather than judicial.

The first deviation from the broad holding of *Dean* was applied by the Tax Court several weeks later in *Creel v. Commissioner,* 72 T.C. 1173 (1979), aff'd, No. 80-3135 (5th Cir., filed July 6, 1981). In that case, one of the corporations incurred a substantial increase in its indebtedness just prior to making these loans to its shareholders. This increase in the obligations of the corporation was incurred specifically for the purpose of making interest-free loans to the shareholders. Although the Court again refused to reconsider its holding in *Dean*, it did limit one aspect of the *Dean* decision, declaring:

> However. . .we think that the large amounts owed by [the corporation] and guaranteed by petitioners herein during the taxable years in issue, distinguish that corporation's loans to petitioners. ...[W]e think the conclusion inescapable that, to the extent that it had made interest-free loans to petitioners, [the corporation] was required to carry interest bearing obligations to third parties. We believe and hold, therefore, that the substance of the transaction before us was that [the corporation] acted as petitioners' agent in obtaining loans from its various creditors to petitioners, and that it paid interest to these creditors on behalf of petitioners. . . .Thus, we conclude that [the corporation's] payment of that amount of interest allocable to its interest-free loans to petitioners was actually a discharge by [the corporation] of petitioner's own obligations. To the extent that these *actual* payments were in fact made during the taxable years in issue, the taxpayers are deemed to have both received dividend income and made an interest payment. *Id.* at 1179-1190.

Thus, in the first case of its kind, the Tax Court held that where a corporation deliberately borrowed money in order to make interest-free loans to its shareholders, the corporation was nothing more than the agent of the shareholders. The shareholders were receiving taxable income in the amount of the economic benefit bestowed by the corporation; that is, the shareholders were receiving a dividend. However, at the same time, the Court did permit the taxpayers to deduct under section 163 of the Code the interest payments attributed to them disregarding the Commissioner's argument that interest had not been "paid" as required by the Code.

In *Marsh v. Commissioner*, 73 T.C. 317 (1979), the Tax Court once again refused to overrule the *Dean* case in context of a commercial transaction and held that an interest-free loan under such circumstances is without income tax effect. In *William G. Martin*, 39 T.C.M. 531 (1979), *appeal docketed*, (5th Cir. 1981), arguments of the government were uniformly rejected in the context of an interest-free loan between a corporation and a non-shareholder.

In two additional recent Tax Court rulings involving interest-free loans, *Est. of Benjamin Liechtung*, 40 T.C.M. 1118 (1980) and *Jack Baker*, 75 T.C. 166 (1980), the Commissioner requested that *Dean* be overruled or distinguished. In each case, after once again refusing to reconsider *Dean*, the Court found the Commissioner's argument that the proceeds of the loans were used to invest in tax-exempt securities was not properly before the Court. Thus, in both *Liechtung* and *Baker*, the Court refused to address the merits of the Commissioner's argument.

The United States Court of Appeals for the Fourth Circuit, in *Suttle v. Commissioner*, 625 F.2d 1127 (4th Cir. 1980), affirmed the decision of the Tax Court and applied the rationale of *Dean* to the facts before it. In *Suttle*, the taxpayer was the majority shareholder in a closely held corporation which had, for many years, made open account interest-free loans to the taxpayer. Arguing that *Dean* should be overruled, the Commissioner pressed his economic benefit theory as justification for this position. Rejecting this request, the Court declared:

> As in *Dean*, the Commissioner draws analogy between Suttle's interest free loans and the free usage of other corporate property. Since Suttle neither paid nor incurred a legal obligation to pay interest, the Commissioner argues that no basis for the offsetting 'washout' deduction exists. We find the *Dean* rationale to be persuasive as applied to the facts of this case. *Id.* at 1128.

Based upon the absolute rejection by the Tax Court of the Internal Revenue Service's continuing obsession that the *Dean* case be overruled, as well as upon the Fourth and Fifth Circuit's affirmation of the basic principle of *Dean*, interest-free loans may be regarded as relatively safe until such time that Congress enacts legislation to limit or overrule the *Dean* result. However, certain basic safeguards should be observed in connection with any interest-free loan. First, it is absolutely imperative that these loans be made only on demand, and not a term basis; otherwise, potential gift tax problems may arise. *See: Crown v. Commissioner, supra; see also: Jimmy J. Huffman*, 41 T.C.M. 619 (1980). Second, these loans should at all times be evidenced by promissory notes. Actual repayments should, in fact, be made at irregular intervals. The use of a formal written note and the making of actual repayments will prevent the Service from establishing that the loans were, in reality, either a taxable dividend to the shareholder or a taxable gift to the purported borrower. Third, the lender should not be placed in a position of an intermediary or agent by borrowing money and lending it to the ultimate borrower. Within the framework of the *Creel* decision, under such circumstances a court may impute income to the borrower. Finally, the borrower should not invest the proceeds of the loan in tax-exempt securities. Although the law is unsettled as to whether *Dean* would be applied under such circumstances, the Tax Court, in several of the cases discussed above, has clearly intimated that *Dean* may be inapplicable. Again, until this question has been definitively answered, a substantial risk would be undertaken by investing the proceeds of an interest-free loan in tax-exempt securities.

Until such time as Congress acts to change the tax-free status of no-interest loans, properly structured, they continue to achieve tax savings.

Footnotes

1 Clifford Trusts are regulated by I.R.C. §671-77 loosely called the Clifford Rules because they supplanted Helvering V. Clifford, 309 U.S. 331 (1940). The trust device is useful from the standpoint of a donor of property

who wishes to retain elements of control over the disposition of her gift. However, failure to closely follow statutory regulations can make the trust income attributable to the donor rather than the donee. *MERTENS, The Law of Federal Income Taxation (Malone ed. (1974)*

2 *Id.*

3 The Courts considering the question of the status of no-interest loans have essentially limited their discussion to the tax effect upon the borrower. Thus, this article will only discuss the taxability of the borrower. For an analysis of the potential tax consequences to the lender, *See Generally,* R.I. Keller, The Tax Consequences of Interest-Free Loans from Corporations to Shareholders and from Employers to Employees, 19 BOSTON COL. L. REV. *231 (1978).*

4 This analysis of the Court is flawed for several additional reasons. First, for those deductions based upon gross income, there would be miscalculations. Second, where a corporation does not have sufficient earnings and profits to give rise to a taxable dividend, although a nontaxable return of capital would be given to a shareholder, the shareholder should be entitled to an offsetting interest deduction. Third, interest is not always deductible by a shareholder if he does not itemize his deductions. In addition, under section 163(d) of the Code, there are certain limitations on interest deductions. *See generally:* R.I. Keller, The Tax Consequences of Interest-Free Loans from Corporations to Shareholders and from Employers to Employees, supra at 235-340.

The Pyramid Scheme: Don't Be The Mortar Between The Bricks

by Clinton R. Black IV

While the practicing business lawyer faces a variety of possible issues and problems when dealing with clients, one area which calls for particularly close scrutiny is securities regulation. Several types of business problems raise obvious securities implications. It should be noted, however, that unconventional investment vehicles which do not appear to have securities implications can be a trap for the unwary and lead to liability for both client and lawyer if not recognized early and addressed properly. These unconventional investment vehicles usually fall within the definition of "security" under the concept of investment contract.

Once defined as a security, the plan must either be registered with federal and state agencies or find an exemption from registration under federal and state laws and regulations. A graphic example of an unconventional investment opportunity which falls within the definition of an investment contract, and is therefore a security, is the pyramid scheme or chain letter concept.

The evolution of the investment contract theory as applied to unconventional investments has been stated no more eloquently than in those recent cases dealing specifically with pyramid promotional schemes.

A pyramid scheme operating in Maryland during the summer of 1980, the so-called $16,000 pyramid, employed the classic pyramid structure. In the basic $16,000 scheme, a chart is drawn consisting, generally, of five levels of boxes. A single large box is on top, two slightly smaller boxes are on the next level, four boxes are below that, eight boxes fall on the following plane, and sixteen boxes lie across the bottom. There is one additional spot, called the zero position, which rests above the top box.

Players "buy in" to the chart with $1,000. A new investor, entering the pyramid at the bottom, gives $500 to the person in the slot directly above and another $500 to the lucky player in the zero position. Players progress to the zero position and the $16,000 prize as the bottom level fills up.

In order to recoup more than one's initial $1,000 investment many new players must be brought in. They fill a sixth level of 32 slots. Once these are filled, the pyramid splits into four new charts, each starting out with one-fourth the needed investors.

When these big splits occur, investors move up rapidly in the new pyramids. Once in the zero position, only 32 new prospects are needed to earn a player his $16,000 reward. Totaling it all up, at least 128 new players are needed to give each starting player the $16,000 jackpot.

Further, the simple mathematical factors inherent in the scheme show the fallacy upon which the $16,000 pyramid is based. In a six level pyramid such as the $16,000 scheme, 128 new people must join after any given person for that person to reach the top and collect the profit. For each of those 128 new people to profit, 16,384 new persons are needed. For each of those 16,384 people to profit over 2,097,000 new people are needed. This is equal to approximately one-half the population of Maryland.

Thus, using the classic illustration, if a number of people put the same amount of money into a box, each time any person withdraws more from the box than he put in, some other person will lose the same amount the other person gained. *See: O'Toole vs. State,* Case No. CJ-80-1984 (Okla. Co. Dist. Ct. 1980).

Based upon federal and state case law, as well as releases stating the official position of the Securities and Exchange Commission, Maryland authorities concluded that the $16,000 pyramid constituted an investment contract. Therefore it was a security