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Gift Tax Consequences of Interest-Free Loans between Family Members

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COMMENTS

GIFT TAX CONSEQUENCES OF INTEREST-FREE LOANS BETWEEN FAMILY MEMBERS

I. INTRODUCTION

The recently decided case of *Crown v. Commissioner*[1] reinforced the tax court's position that imputed interest on an interest-free loan is not a taxable gift. The Internal Revenue Service (IRS) continues to take the contrary position that interest-free loans do constitute gifts of an amount equal to the interest charge that it usually made for the use of that amount of money.

The IRS position on the taxation of interest-free loans is consistent with both economic reality and gift tax principles. An examination of the economic substance of interest-free loans highlights the court's reliance on the form of the transaction. The right to the use of money and other property is a valuable property interest, and when no charge is made for the transfer of this property interest there is a transfer for less than adequate consideration. This constitutes a gift.

Because courts are reluctant to interfere in intrafamily loans, the decisions emphasize the formal and procedural difficulties involved in the treatment of interest-free loans as gifts. The absence of a contractual obligation to pay interest is not always a bar to finding a gift under the tax laws, and even a demand note can be valued consistently with gift tax principles. Because some courts will not independently relinquish their "form over substance" reasoning, this Comment proposes that legislative direction is needed to assure that interest-free loans are consistently treated as gift taxable events.

II. THE GIFT TAXATION OF INTEREST-FREE LOANS

A. *The Johnson Decision*

Johnson v. United States[2] dealt with interest-free loans between family members. The taxpayer made several interest-free loans to his children between 1956 and 1962, the outstanding balance of these loans never amounting to less than $200,000 at the end of each tax year. The IRS asserted that the taxpayer had made a gift in the amount of the imputed interest on the loans, but the court disagreed, primarily because of the absence of a contractual or statutory obligation to pay

1. No. 77-1898 (7th Cir. Sept. 19, 1978). All references to the *Crown* court are to the decision of the Seventh Circuit Court of Appeals unless otherwise indicated.
2. 254 F. Supp. 73 (N.D. Tex. 1966).

interest.[3] There was no express contract, and the court found that because the parties had intended the loan to be interest-free there was no implied contract. The court emphasized that when parents loan money to their children there is no legal requirement that they must charge interest.

B. *The Crown Decision*

The seventh circuit in *Crown v. Commissioner*,[4] affirming the tax court, refused to find a gift in another series of interest-free loans from a parent to his children. Areljay Company, owned by Lester Crown and his two brothers, made approximately eighteen million dollars in loans to twenty-four trusts established for the benefit of the owners' children and close relatives. About thirteen percent of the indebtedness was represented by demand notes, and the rest was open account loans.[5] No provision was made for any interest on these loans. The IRS estimated the interest which the Crown brothers' company could have charged at six percent of the principal, and allocated one-third of this gift to Lester Crown. The tax court,[6] following the rationale of *Johnson*, refused to find a gift of the imputed interest.

On appeal, the seventh circuit affirmed the tax court decision, emphasizing the difficulty of evaluating demand loans. The IRS argued that the major purpose of the gift tax statutes is to protect the income and estate taxes.[7] Permitting interest-free loans to escape the gift tax permits a transfer of income that escapes income taxation at a higher rate and is not subject to gift taxation. The court observed that both demand and term loans effectuated a shift of income from parent to child by allowing the income earned by the principal to be taxed to the child at a lower rate.[8]

The IRS also argued that interest-free loans reduce the taxpayer's estate and permit him at the same time to escape wealth transfer taxation if the reduction is not subjected to the gift tax. The court admitted, looking at the note as an asset of a decedent's estate, that a term loan could result in an untaxed reduction in the taxpayer's estate. The reduction is the difference between the present discounted value of the note and its face value. But because a demand note presumptively has

3. "The right to interest must arise from an express or implied contractual obligation or from statute." *Id.* at 77.

4. No. 77-1898 (7th Cir. Sept. 19, 1978).

5. The court did not distinguish between the two types of loans in its analysis. *Id.*

6. Crown v. Comm'r, 67 T.C. 1060 (1977). The IRS published its nonacquiescence in this decision. 1978-27 I.R.B. 6.

7. No. 77-1898, slip op. at 3.

8. *Id.*

a value equal to its face, the court saw no equivalent reduction in the estate.[9] The IRS also argued that the loan reduced the taxpayer's future estate because the taxpayer was prevented from investing the loaned money in income-producing assets. The court rejected this argument, saying that the purpose of the estate tax is not to protect the taxpayer's potential estate[10] by insuring that its assets were utilized to their fullest income-producing capacity.

The court said that it is doubtful whether a property interest which could be terminated by another at any time, such as the use of money under a demand note, could be characterized as a property interest sufficient to qualify as a gift.[11] The IRS's argument that the gift consisted of the value of the forbearance to call the loan was rejected by the court because of the absence of a preexisting contractual or statutory obligation.[12]

Thus, there are two principle barriers to gift taxation of imputed interest on interest-free loans in the seventh circuit: (1) The absence of a preexisting contractual obligation to pay interest; and (2) the valuation problem in ascertaining the benefit to the borrower of a loan which can be called in at any moment.

III. THE ECONOMIC SUBSTANCE OF THE TRANSACTION

In holding against the Commissioner, the courts are employing a "form over substance" argument which has been overwhelmingly criticized by legal commentators.[13] When money is transferred without an interest charge, the substance of the transaction is that a benefit is being transferred gratuitously. The value of that benefit is not diminished by technical differences in the form of the note given for the loan, or by the absence of a contractual agreement to pay interest. An examination of other federal gift and income tax provisions[14]

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9. *Id.* at 3-4. This discussion assumes the note is outstanding at the time of the taxpayer's death. *See* Tidwell, *Lester Crown Points the Way to Estate Tax Reduction Under the 1976 Tax Reform Act,* 55 TAXES 651 (1977).

10. No. 77-1898, slip op. at 4-5.

11. *Id.* at 9-10.

12. *Id.* at 12.

13. Comment, *Interest-Free Loans and the Gift Tax: Crown v. Comm'r,* 38 OHIO ST. L.J. 903 (1977); Schlifke, *Taxing as Income the Receipt of Interest-Free Loans,* 33 U. OF CHI. L. REV. 346 (1968); 65 MICH. L. REV. 1014 (1967); 19 STAN. L. REV. 870 (1967); *but see* 14 WAKE FOREST L. REV. 150 (1978).

14. This comment considers cases and statutes in both the gift tax and the income tax areas. The income tax provisions and the gift tax provisions are separate bodies of law and are not to be read in pari materia. *See, e.g.,* Farid-es-Sultaneh v. Comm'r, 160 F.2d 812 (2d Cir. 1947). Nevertheless, certain underlying economic concepts and the policy against tax avoidance are consistent throughout federal taxation and provide a strong basis for analogy among sections dealing with similar issues.

shows, first, that the right to use property such as money is a valuable property right. Secondly, this examination shows that when a property right is transferred without corresponding compensation, the transfer is not for full and adequate consideration, and is generally a gift.

A. *The Use of Money as a Property Interest*

For income tax purposes, courts have recognized that a benefit is conferred upon a taxpayer who uses another's property free of charge, whether or not there is a contractual obligation for the payment of the use of the property.[15] Courts have consistently held that where corporations allow shareholders or officers the use of property rent-free, the fair rental value is taxable to the recipient as income under Internal Revenue Code, section 61(a).[16] Although the willingness to recognize income may be partly explained by the broadly inclusive statutory language in section 61,[17] the income taxation of the right to use property as a transfer of economic value can provide a helpful analogy for gift tax treatment.

The treatment of a shareholder's use of the corporation's property without paying rent sharply contrasts with the treatment of a shareholder's use of the corporation's money without paying interest. In *J. Simpson Dean v. Commissioner,*[18] the taxpayer obtained loans from his controlled corporation in exchange for noninterest-bearing notes. The IRS charged the taxpayer with gross income equal to the amount of the interest that he would have had to pay on the loan in an arm's length transaction. The court refused to uphold the assessment, distinguishing between the rent-free use of property and the interest-free use of money. It said that if the taxpayer had paid interest on the loan, he would have been able to deduct the expense under section 163(a).[19] Therefore, if it imputed income for the interest he should have paid, it should also impute a deduction he could have taken. It would be as if the taxpayer received the amount of interest as income from the corporation, then paid it back to the corporation as interest for the use of the money loaned. Because any imputed income would

15. *See, e.g.,* 58th St. Plaza Theatre v. Comm'r, 195 F.2d 724 (2d Cir. 1952); Int'l Artists Ltd. v. Comm'r, 55 T.C. 94 (1970); Challenge Mfg. Co. v. Comm'r, 37 T.C. 650 (1962).

16. I.R.C. § 61(a). All "section" citations in the text are to the Internal Revenue Code unless otherwise indicated.

17. "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived . . . ." *Id.*

18. 35 T.C. 1083 (1961). The tax court's decision in *Crown* cited to *Dean* for the proposition that courts refuse to tax non-interest bearing loans under either income or gift tax laws. 67 T.C. at 1064.

19. I.R.C. § 163(a).

be offset by an interest deduction, it would be futile to impute income at all. Rent, however, is a nondeductible personal expense.[20] Therefore, there is no equivalent offsetting deduction for the imputed income from the use of this type of property.

The *Dean* court reasoning is not soundly based on Code interpretation. Under income tax principles, income and deductions are entirely separate concepts, and the existence of income is not negated by the existence of a corresponding deduction of equal amount.[21] Therefore, the predication of income on the nonexistence of an offsetting deduction, as the tax court did, is erroneous. Deductions are enactments of legislative grace;[22] the section providing for an interest deduction was the result of a Congressional policy decision and has no direct implications for the treatment of income.

There are additional problems with the *Dean* analysis. First, if a taxpayer does not elect to itemize deductions on his income tax return, he may be unable to utilize the deduction for interest paid.[23] Second, all interest payments are not deductible.[24]

Dean also relied on a revenue ruling dealing with "split dollar" insurance agreements that is no longer in effect.[25] The ruling compared payments made by employers toward their employees' life insurance policies to interest-free loans, but said that "[t]he mere making available of money does not result in realized income to the payee or a deduction to the payor."[26] Since the IRS's present position is directly

20. I.R.C. § 262.

21. Section 61(a) does not provide that items are to be included in gross income only when there is no offsetting deduction.

22. *See, e.g.,* Comm'r v. Tellier, 383 U.S. 687 (1966).

23. I.R.C. § 63(g) (1977). The interest, if business related, may be deducted in computing gross income even if zero bracket tax is selected. I.R.C. § 162 (1976).

24. *See, e.g.,* I.R.C. § 265(2) (1976). The concurring and dissenting opinions in *Dean* pointed out that the taxpayer should have to prove that the loan was eligible for the interest deduction before he can be exempted from the tax on imputed interest. 35 T.C. at 1090-91 (Fisher, J., concurring; Bruce, J., dissenting).

25. Rev. Rul. 55-713, 1955-2 C.B. 23. This ruling was superceded by Rev. Rul. 64-328, 1964-2 C.B. 11, in which the IRS said that benefit to the employee will be recognized in split-dollar insurance agreements.

The Tax Court, in Genshaft v. Comm'r, 64 T.C. 282 (1975), found taxable income to the employee to the extent of the value of insurance protection to the beneficiaries, and not to the extent of the premium payments made by the employer, as argued by the IRS. The court thereby evaded the issue of whether it should treat these payments as interest-free loans.

26. 1955-2 C.B. at 24. Under a "split dollar" insurance plan, the employer usually pays the insurance premium to the extent of the yearly increase in the policy's cash surrender value, and the money advanced by the employer is secured by the cash value of the policy. The employee contributes the difference between the actual premium charge and the cash surrender value increase. Schlifke, *supra* note 13, at 350-51.

contrary to this ruling, reliance upon this statement is no longer feasible.

Despite these problems in the *Dean* decision, no court has held to the contrary.[27] A subsequent tax court memorandum decision has also refused to attribute income to employees and shareholders on interest-free open account loans from their corporation.[29]

Recognition of the transfer of the use of property for charitable purposes as something of economic value provides a further helpful analogy. Section 170(c)[30] specifically allows a deduction for a gift "for the use of" a charitable organization. There is also a legislative policy of encouraging charitable contributions.[31] Before the enactment of section 170(f)(3)(a),[32] which denies a charitible deduction for the contribution of a partial interest in property, courts recognized a charitable contribution of property when a taxpayer allowed a charitable organization to use his property rent-free.[33] The courts reasoned that the use of property is "the most essential and beneficial" of all the rights associated with property, and that the grant of the use of property is a gift of value.[34]

Mason v. United States[35] specifically recognized a benefit where money was loaned to a charity at an interest rate lower than that which could have been charged on the open market. The court allowed a charitable contribution deduction of the difference between the interest that the taxpayer actually charged on the mortgage and the current market interest rate for equivalent mortgages.

Although the use of money is treated as a valuable right for deduction purposes but not necessarily recognized as a valuable right for income purposes, the use of other property is considered an economic benefit with tax consequences in both areas. The *Crown* decision noted

27. Lisle v. Comm'r, 35 Tax Ct. Mem. Dec. 627 (1976); 38 OHIO ST. L.J. *supra* note 13, at 906.

28. Lisle v. Comm'r, 35 Tax Ct. Mem. Dec. 627 (1976). Tax planners recommend interest-free loans to provide tax free benefits to employees. *See* FED. TAX COORDINATOR 2D, ¶ H-1756 (1978); Matchinger, *Compensating the Executive by Bargain Purchases, Restricted Stock, Convertible Securities, and Convertible Debentures,* 22 MAJOR TAX PLANNING 245, 258-59 (1970).

29. I.R.C. § 170(c).

30. *See, e.g.,* Threlfall v. United States, 302 F. Supp. 1114 (W.D. Wis. 1969); Mattie Fair v. Comm'r, 27 T.C. 866 (1957).

31. Treas. Reg. § 1.170A-7(a)(1) (1972) includes rent-free leases in this category.

32. Orr v. United States, 343 F.2d 553 (5th Cir. 1965); Passailaigue v. Comm'r, 224 F. Supp. 682 (M.D. Ga. 1963); Mattie Fair v. Comm'r, 27 T.C. 866 (1957); Priscilla M. Sullivan v. Comm'r, 16 T.C. 228 (1951).

33. *See* note 32 *supra*.

34. 513 F.2d 25 (7th Cir. 1975).

35. No. 77-1898, slip op. at 8 n.11.

that under the gift tax laws money is considered property.[36] Because the use of property is a valuable property right and under gift tax principles money is property, it logically follows that the use of money is a valuable property right, and should be subject to the gift tax when that use is transferred gratuitously.

B. A Transfer of an Interest in Property for Less than Full and Adequate Consideration is a Gift.

In general, a gift tax will be levied on a transfer for less than adequate consideration, and this principle encompasses the situation in which the beneficial use of money is transferred to another who pays no interest in return.

Gift tax code sections 2501(a)(1)[37] and 2511(a) define gifts broadly. Section 2511(a) states expansively that the gift tax "shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."[38] The regulations accompanying these sections are similarly broad and all-inclusive.[39] Additionally, the committee reports indicate that Congress intended the gift tax provisions to be applied

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36. "A tax . . . is hereby imposed . . . on the transfer of property by gift . . . by any individual . . . ." I.R.C. § 2501(a)(1) (1976).

37. I.R.C. § 2511(a).

38. Treas. Reg. § 25.2501-1(a)(1), T.D. 7296, 1974-1 C.B. 255, 273, reads in pertinent part: "The tax applies to all transfers by gift of property, wherever situated, by an individual . . . ."

Treas. Reg. § 25.2511-1(a) (1958) reads in pertinent part: "The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."

Treas. Reg. § 25.2511-1(c) (1958) reads in pertinent part: "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. § 25.2511-1(g)(1) (1958) reads in pertinent part:

> Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.

39. The House and Senate reports concerning the gift tax contain the identical langauge:

> The terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense; *The term "property" reaching every species of right or interest protected by law and having an exchangeable value.*
>
> The words "transfer . . . by gift" and "whether . . . direct or indirect" are designed to cover and comprehend all transactions (subject to certain express conditions and limitations) whereby, and to the extent . . . that, property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment.

H.R. REP. NO. 708, 72d Cong., 1st Sess. 27 (1932); S. REP. NO. 665, 72d Cong., 1st Sess. 39 (1932) (emphasis added).

sweepingly, and that it intended to include in the term "property" every species of right or interest protected by law and having exchangeable value.[40]

Section 2512(b) states that a transfer of property for less than adequate and full consideration in money or money's worth is a gift.[41] The Supreme Court of the United States interpreted this section in *Commissioner v. Wemyss*[42] and its companion case, *Merrill v. Fahs.*[43] Both *Wemyss* and *Merrill* involved the transfer of assets prior to marriage in accordance with the provisions of an antenuptial agreement. In *Wemyss*, the transfer was made in order to compensate the future bride for income she would lose by her remarriage, and in *Merrill* the transfer was in exchange for the future bride's release of dower rights. In both cases the Court determined that a gift resulted because there was a transfer of property for less than full and adequate consideration in money or money's worth.[44] If the transfer passes this objective test, there is a gift. Donative intent of the transferor is not a requirement.[45] The Court also emphasized that the term "gift" should be read in the broadest and most comprehensive sense.[46]

The *Crown* decision concedes that under the gift tax laws money is considered property.[47] This property is transferred to the borrower when a loan is made; the interest paid thereon represents the consideration flowing back to the lender for the use of his property. The economic reality is that lenders do not transfer the beneficial right to use their money without being compensated.[48] Adequate consideration

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40. I.R.C. § 2512(b) (1971) reads in pertinent part: "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift . . . ."

41. 324 U.S. 303 (1945).

42. 324 U.S. 308 (1945).

43. In *Wemyss*, the Court said that the detriment to the donee (loss of income) did not satisfy the requirement of equal consideration. *Id.* at 307-08. In *Merrill*, the Court determined that the release of dower did not constitute consideration in money or money's worth. 324 U.S. at 312.

44. This statement by the Court in *Wemyss* is similar to Treas. Reg. § 25.2511-1(g)(1). *See* note 37 *supra*.

45. 324 U.S. at 306.

46. No. 77-1898, slip op. at 8 n.11.

47. "For the purpose of tax law the word 'interest' is defined as a payment for the use of money, or compensation for the use of [or] forbearance of money." Blackmon v. United States, 22 A.F.T.R.2d 5860, 5864 (N.D. Tex. 1968). *Accord*, Deputy v. du Pont, 308 U.S. 488 (1940); Old Colony R.R. v. Comm'r, 284 U.S. 552 (1932); Lloyd v. Comm'r, 154 F.2d 643 (3d Cir.) *cert. denied*, 329 U.S. 717 (1946); Gardner v. United States, 21 A.F.T.R.2d 490 (N.D. Ind. 1968).

48. The dissent in *Crown* in the Tax Court made the point that the majority, in holding that an interest-free loan was not a gift, ignored economic reality. "Had the petitioner [taypayer] in this case arranged for the borrowers to obtain the money from

to be paid for the use of money is established by market rates of interest. While the interest rate will fluctuate, there is a range of rates that is reasonable. Loans which carry interest rates below that range, or which do not provide for any interest, constitute a transfer of the beneficial use of money for less than full and adequate consideration. Under section 2512(b) and cases such as *Wemyss*, such a transfer is a gift.

The *Johnson* and *Crown* courts did not directly address the application of the less than full and adequate consideration concept of section 2512(b). Instead, *Crown* dwelt on the problem of valuing the benefit flowing to the debtor in an interest-free demand loan and of determining the amount of the gift.[49] Difficulty of administration of a Code provision should not be a sufficient reason for ignoring its enforcement.

Perhaps the real reason for the reliance by *Johnson* and *Crown* on distinctions of form rather than on strenuous statutory and economic analysis is the court's desire not to become involved in taxing intrafamily loans of money or other property. As the *Johnson* court said:

> 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, to go into the oil business on a substantial scale, or to begin life on their own in some other way.[50]

Similarly, the tax court in *Crown* said that if the IRS's position were sustained, "the principle established could be extended to a multitude of situations involving gratuitous use or sharing of real or personal property among relatives."[51]

Johnson may partly have confused gift and income tax questions. The recognition for gift tax purposes of the benefit flowing from the parents to the child does not necessarily compel the recognition of an imputed flow of income in the opposite direction to the parent for income tax purposes. The fact that there is no legal requirement to charge children interest, and no contractual or statutory obligation to

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financial institutions and agreed to pay the interest thereon, clearly, the payment of such interest would constitute a taxable gift." Crown v. Comm'r, 67 T.C. 1060, 1066 (1977).

49. No. 77-1898, slip op. at 7-8.

50. 254 F. Supp. at 77.

51. 67 T.C. at 1065.

pay interest, may or may not prevent the imputaton of income to the parent. It does not change the fact, however, that a valuable property interest passes to the child for less than full and adequate consideration. For example, there is no legal requirement to charge children the fair market value of property transferred to them, yet there is clearly a gift if the child pays less than fair market value for the property.[52]

The critical question is not one of requiring arm's length dealing between family members. It is the question whether Congress intended to subject all gratuitous transfers of property and interests in property to gift taxation.

IV. Form Over Substance: The Formal Distinctions Raised by the Courts

Refusing to acknowledge that an interest-free loan is essentially a gratuitous transfer of an economic benefit, the courts have emphasized the technical difficulties of applying a gift tax in this area. *Crown* pointed out that the amount of the gift should be determined at the time of transfer but that the benefit from the use of money under a demand note can only be valued in retrospect by looking at the period during which the lender did not exercise his right to call the loan. Both *Johnson* and *Crown* were reluctant to impute interest where there was no legal obligaton to enforce the lender's right to receive such payments. Both technical difficulties, however, have been overcome in other areas of federal tax law.

A. Demand Loans and the Valuation Problem.

Crown left open the possibility that, because of the time value of money, interest-free term loans are taxable gifts measured by the difference between the present discount value of a term note and its face value.[53] Demand notes cannot be prospectively valued in terms of the time value of money because at the time of the loan the borrower does not know when the loan will be called in. Any current discount from the face value of a demand note results from the credit rating of the borrower. If the borrower is financially strong enough to repay the loan immediately, the fair market value of the note is its face amount. For gift and estate tax purposes there is a presumption that a note is worth its face value.[54] Therefore, absent evidence of a poor credit rating on the part of the borrower, a demand note is worth its face value. Even if the note were not worth its face amount, an argument

52. I.R.C. § 2512(b) (1970); Treas. Reg. § 25.2512-8, T.D. 6334, 1958-2 C.B. 627.
53. No. 77-1898, slip op. at 5 n.7.
54. Treas. Reg. §§ 20.2031-4, 25.2512-4 (1958).

could be made that there is no taxable gift because the claim is for the face amount.

Crown refused to find a gift in an interest-free demand loan because it could not be valued at the time of making the loan.[55] The IRS argued that there was a measurable gift, if not at the time of the loan at least at the expiration of each gift tax period during which the lender did not exercise his right to call in the loan.

For demand loans the lender's forbearance from exercising his legal right to demand repayment of his non-interest bearing note could be a gift taxable event. The benefit that was passed to the debtor was the right to use the money for that gift tax period free of charge.[56] A gift theoretically occurred each day the lender refrained from calling the loan. It is as if the creditor called up the debtor each day and said, "I will give you the use of my money today without charge."

Revenue Ruling 73-61[57] sets forth a method of taxing interest-free demand loans which is consistent with this theory. A gift is made in each quarter during which the borrower had the use of the funds without charge. The appropriate time to value the gift is therefore at the end of each gift tax quarter and not when the loan is made. The revenue ruling taxes a term loan at the time of making the loan by discounting the note to its present value, and taxes a demand loan at the end of each quarter during which it remained outstanding.

Crown refused to find a gift taxable property right in a demand loan because it could be terminated at any time.[58] A demand loan, however, may be directly compared to a revocable trust in which the gift tax is measured after the transfer of the property. A revocable trust is a gift of property in trust that may be revoked at any time, like a demand note. The trust principal, because of its uncertain character, is not considered a completed gift, but the trust income is taxable as a gift to the beneficiaries in the year it is received.[59] Thus, the method of

55. No. 77-1898, slip op. at 8-10.

56. I.R.C. § 2502(b), (c) (1976) sets this taxable period as a calender quarter for gifts made after 1970, and as a calender year for gifts made before 1971.

57. 1973-1 C.B. 408. The IRS relied upon Blackburn v. Comm'r, 20 T.C. 204 (1953), where the Tax Court found a taxable gift when the taxpayer sold some property to her children in exchange for their promissory note which provided for less than fair market value interest payments. The gift assessed by the IRS and approved by the court consisted of the difference between the fair market value interest rate and the rate actually charged.

58. No. 77-1898, slip op. at 9-10.

59. *Id.* at 6, citing, *inter alia*, Treas. Reg. § 25.2511-2(f), T.D. 7238, 1973-1 C.B. 544.

It has been suggested that the value of the income actually generated by the borrowed funds should be taxed to the lender both as income, and as a gift. Schlifke, note 12 *supra*. Another commentator suggests treating an interest-free loan as an allocation of income problem. A parent in the position of lending substantial amounts of money taxing gifts as they accrue subsequent to the transfer of property is already accepted in the gift tax area.

B. Lack of Contractual Obligation to Pay is Not a Bar to Imputing Interest.

Where there is a contractual obligation to pay a debt, and where the creditor waives the right to collect the debt, there are both income and gift tax consequences.[61] Specific language provides for the inclusion of the forgiveness of indebtedness in gross income in section 61(a)(12), which was enacted in response to prior case law.[62] Thus, the waiver of the contractual right to collect interest income in a business context results in an income taxable event with the income accruing to be debtor at the time the creditor relinquishes a legal right.

The same reasoning is applied in the gift tax area. When the obligation to pay a debt is forgiven gratuitously a gift tax is imposed on the amount of the debt forgiven. *Republic Petroleum Corp. v. United States*[63] recognized a gift of the amount of the interest when a father gratuitiously forgave his son's contractual obligation to pay interest on a loan. The gift tax here was imposed not when the loan was made, but when the contractual interest was subsequently forgiven.

The *Johnson* and *Crown* courts emphasized the absence of a contractual or statutory obligation to pay interest.[64] The lack of a legal

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is usually in a higher tax bracket than his children; therefore, the profit from the children's use of the money would be taxed at lower rates. These loans could be treated the same as grantor trusts under sections 671, 673(a), and 676. I.R.C. §§ 671, 673(a), 676. A grantor who creates a revocable trust or a trust that will revert back to the grantor in ten years or less is taxed directly on the income generated by the trust as well as being subjected to a gift tax on that income. If an irrevocable trust with a minimum duration of more than ten years is created, the grantor will not be taxed on the trust income, but a gift tax is imposed at the time the trust is funded; the amount of the gift is the actuarial value of the term interest of the beneficiary. O'Hare, *supra* note 13, at 1090-92.

60. *See* notes 61-63 and accompanying text *infra*.

61. I.R.C. § 61(a)(12). *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929).

If the forgiveness if indebtedness qualifies as a gift, section 102(a) excludes it from gross income. Forgiveness of indebtedness is excluded from gross income under section 108, if there is a reduction in the bases of the taxpayer's assets under section 1017. I.R.C. § 102; I.R.C. §§ 108, 1017 (1976).

62. *See, e.g.,* Comm'r v. Jacobson, 366 U.S. 28 (1948), apparently overruling Helvering v. American Dental Co., 318 U.S. 28 (1943); U.S. v. Kirby Lumber Co., 284 U.S. 1 (1931); Reynolds v. Boos, 188 F.2d 322 (8th Cir. 1957); Mervin M. Lippman v. Comm'r, 52 T.C. 135 (1969); George Hall Corp. v. Comm'r, 2 T.C. 146 (1943).

63. 397 F. Supp. 900 (E.D. La. 1975).

64. "The right to interest must arise from an express or implied contractual obligation or from statute." Johnson v. United States, 254 F. Supp. at 77.

"But absent a contract provision providing otherwise there is no legal obligation for the borrower to pay interest . . . ." Crown v. Comm'r, No. 77-1898, slip op. at 11.

obligation to pay interest does not, however, defeat IRS attempts to tax imputed interest in other areas. Sections 482[65] and 483[66] provide for imputation of interest even when there is no contractual or statutory obligtion to pay it.

Section 482 authorizes the IRS to allocate income, deductions, credits, and allowances among related business entities as necessary "to prevent evasion of taxes or clearly to reflect [their] income."[67] The regulations promulgated under section 482 impose an arm's length standard on transactions between related business entities. In particular, the regulations authorize the imputation of arm's length interest rates on loans.[68]

Using section 482 as authority, the IRS has attempted to impute interest income to the lending business when interest-free loans are made to related businesses. The Tax Court has refused to follow the regulations in cases involving such loans where no income was generated directly out of the transaction. This "tracing doctrine" requires, as a condition precedent to imputation of interest income under section 482, that the debtor business earn income on the borrowed funds.[69]

The IRS has gained support in its struggle against the Tax Court's tracing doctrine in some federal circuit courts and in the Court of Claims.[70] The Eighth Circuit, quoted with approval by the Ninth Cir-

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65. I.R.C. § 482 (1976).
66. I.R.C. § 483 (1976).
67. I.R.C. § 482 (1976).
68. Treas. Reg. § 1.482-2(a), T.D. 7394, 1976-1 C.B. 135. *See* Kerry Investment Co. v. Comm'r, 58 T.C. 479 (1972), *modified*, 500 F.2d 108 (9th Cir. 1974); Kahler Corp. v. Comm'r, 58 T.C. 496 (1972), *rev'd*, 486 F.2d 1 (8th Cir. 1973); Huber Homes, Inc. v. Comm'r, 55 T.C. 598 (1971); PPG Indus., Inc. v. Comm'r, 55 T.C. 928 (1970); Smith-Bridgman & Co. v. Comm'r, 16 T.C. 287 (1951). The IRS acquiesced in *Huber Homes* but later said the acquiescence was merely in the proposition that if interest income is to be imputed, a corresponding deduction must be made. *Acq.*, 1951-1 C.B. 3, *clarified*, Rev. Rul. 67-79, 1967-1 C.B. 117.
69. Fitzgerald Motor Co. v. Comm'r, 60 T.C. 957 (1973), *aff'd on other grounds*, 508 F.2d 1096 (5th Cir. 1975); Kerry Inv. Co. v. Comm'r, 58 T.C. 479 (1972), *modified*, 500 F.2d 108 (9th Cir. 1974); Kahler Corp. v. Comm'r, 58 T.C. 496 (1972), *rev'd* 486 F.2d 1 (8th Cir. 1973). *See generally*, Huber Homes, Inc. v. Comm'r, 55 T.C. 598 (1971); PPG Indus., Inc. v. Comm'r, 55 T.C. 928 (1970).

It is significant that one of the Tax Court's positions in the section 482 cases is similar to a position asserted in the *Johnson* and *Crown* cases, i.e., transactions that "only *would have* produced income" are not taxable events. Huber Homes, Inc. v. Comm'r, 55 T.C. at 608 (emphasis in original).

70. Liberty Loan Corp. v. United States, 498 F.2d 225 (8th Cir.), *cert. denied* 419 U.S. 1089 (1974). Aristar, Inc. v. United States, 553 F.2d 644 (Ct. Cl. 1977); Kerry Inv. Co. v. Comm'r, 500 F.2d 108 (9th Cir. 1974); Kahler Corp. v. Comm'r, 486 F.2d 1 (8th Cir. 1973); B. Forman Co. v. Comm'r, 453 F.2d 1144 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972). *But cf.*, Tennessee-Arkansas Gravel Co. v. Comm'r, 112 F.2d 508 (6th Cir. 1940) (the court refused to impute interest income).

cuit,[71] held that the direct generation of income by the borrowed funds as required by the Tax Court was unnecessary and was not required by the Code or the regulations.[72] "The proper standard to be applied in cases such as this is whether or not the loans . . . would have been made on an interest free basis in arm's length dealings between uncontrolled taxpayers."[73]

This conflict between the Tax Court and some circuit courts over the appropriate conditions under which to impute interest demonstrates the confusion that results when there is no clear and explicit congressional guideline. The Tax Court's approach, to require a showing of actual generation of income, creates complex proof problems and places "a premium on accounting sophistication."[74] Interest-free loans do result in the shuffling of income and deductions between the parent and subsidiary corporations, leading to the distortion of taxable income reported by the business entities involved. The conflicting views of the courts under section 482 lead to the conclusion that clear statutory guidelines are of great assistance if the IRS is to impute interest for tax purposes.

Section 483 is similar to section 482 in that it provides for imputation of interest income. While section 482 is a general allocation section with the imputation of interest provided in the accompanying regulations,[75] section 483 specifically permits imputation of interest in the case of installment sales which carry no interest, or less than a designated rate of interest.[76] Prior to the enactment of section 483, taxpayers could obtain capital gains treatment on what would otherwise be taxed as ordinary income by including the interest charge in the price of the property sold.[77] Section 483 represents a specific legislative response to an area where tax avoidance was previously possible.[78]

71. Kerry Investment Co. v. Comm'r, 500 F.2d at 110 (quoting Kahler Corp. v. Comm'r, 486 F.2d at 5).

72. Fitzgerald Motor Co. v. Comm'r, 508 F.2d 1096 (5th Cir. 1975). *See* Kerry Inv. Co. v. Comm'r, 500 F.2d 108 (9th Cir. 1974); Kahler Corp. v. Comm'r, 486 F.2d 1 (8th Cir. 1973); B. Forman Co. v. Comm'r, 453 F.2d 1144 (2d Cir. 1972).

73. Kahler Corp., 486 F.2d at 5. The parent corporation could borrow at a lower interest rate than the subsidiary, and was able to take advantage of an interest deduction, while the subsidiary could not benefit from a deduction because it had little income. In *Liberty Loan* and *Aristar*, the parent companies, in the consumer finance business, borrowed money at low interest rates, and loaned this money to their subsidiaries, who in turn loaned this money to customers at a higher rate.

74. Kerry Investment Corp., 58 T.C. at 495. (Featherston, J., dissenting).

75. Treas. Reg. § 1.482-2, 1976-1 C.B. 135.

76. Treas. Reg. § 1.483-1(c), (d), T.D. 7394, 1976-1 C.B. 135.

77. H.R. REP. NO. 749, 88th Cong., 2d Sess. 72, *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1313, 1380; S. REP. NO. 830, 88th Cong., 2d Sess. 102, *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1673, 1774.

78. Both the House and Senate reports on section 224 of the Revenue Act of 1964

Sections 482 and 483 are income tax provisions, but their enactment and application indicate the general purpose of Congress to treat transactions according to the underlying economic realities and to prevent mere distinctions of form from being used to evade taxes. The analogy to gift taxation is clear. The economic benefit flowing to the borrower is the same for an interest-free loan whether the money is lent with a ninety-day note with a contractual obligation to pay interest which is forgiven, or with a demand note which is not called in for ninety days, or with a ninety-day term note. In each case there is a gift of the use of money for ninety days. Nevertheless, the first situation would be a gift under *Republic Petroleum*,[79] the second would not be a gift under *Johnson* and *Crown*,[80] and whether the third would be a gift was specifically left undecided by *Crown*.[81]

The courts only recognize an economic benefit selectively, generally when there is an obligation to pay interest created by the parties to the transaction or by statute. Therefore, as in the cases of installment sales and loans between related business entities, a legislative provision may be the best solution to the problem of tax avoidance through the use of interest-free loans.

V. PROPOSAL

The clearest legislative response to the courts' refusal to hold that interest-free loans between family members are gifts would be the enactment of specific statutory langauge addressing this problem. A Code provision is superior to a treasury regulation because a clear expression of Congress' intent would prevent contrary holdings similar to those which exist under section 482. The provision should provide that an interest-free loan is a gift taxable event, and that the amount of the gift is the interest forgone by the lender, computed at a rate established in treasury regulations promulgated under authority of the provision. The regulations should be similar to those under section 483, providing for a "safe harbor" rate of interest[82] and setting the interest rate to be used in computing the amount of the gift when the interest rate charged is less than the "safe harbor" rate.

(now I.R.C. § 483) felt section 483 was closing a serious tax loophole. Prior to section 483, similarly situated taxpayers would be treated differently based on the form of the installment sale. *Id.*

79. *See* note 64 and accompanying text *supra*.

80. *See* note 59 and accompanying text *supra*.

81. *See* note 54 and accompanying text *supra*.

82. Treas. Reg. § 1.483-1(c), T.D. 7394, 1976-1 C.B. 135. Code section 6621 also provides a scheme for determining interest rates through regulations. I.R.C. § 6621 (1976).

The approach taken in Revenue Ruling 73-61,[83] establishing a logical system of taxing interest-free loans, should provide a model for the new provision's regulations for purposes of valuing the gift in both demand and term loans. A term loan would be taxed at the time of making the loan by discounting the face amount to present value, while a demand loan would be taxed at the end of each calendar quarter during which it was outstanding.

Gifts resulting from the imputation of interest on an interest-free loan would be eligible for the $3,000 per donee exclusion provided in section 2503(b).[84] The per donee exclusion would prevent the gift taxation of small loans and avoid the attendant administrative burdens. To generate a $3,000 gift of imputed interest at 6% simple interest would require the use of $50,000 for one year without charge.[85]

VI. CONCLUSION

The courts' reluctance to interfere in family arrangements is blinding them to the reality that the use of property is a property interest which, when transferred, confers a substantial benefit upon the recipient. If the transfer is made gratuitously, it bears all of the characteristics of a taxable gift. The courts base their decisions on the adminstrative difficulties of dealing with the different forms that interest-free loans may take, and ignore the substance of the transfer. Whether the loan was made for a specified or indefinite period, and whether the parties agreed to interest and subsequently changed their minds or never agreed to interest at all, the ultimate economic benefit to the borrower is the same.

In *Crown* and *Johnson* the income from property was transferred free of gift tax. Because it appears that interest-free loans will not be subjected to taxation by the courts, a legislative enactment authorizing the imputation of interest may be necessary to prevent further evasion of federal taxes by the use of interest-free loans.

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83. 1973-1 C.B. 408. *See* text accompanying note 58 *supra*.
84. I.R.C. § 2503(b) (1970).
85. This assumes that no prior gifts had been made to the particular donee that year. If prior gifts had been made, only a portion, or perhaps none of the $3,000 per donee exclusion would be available to use against the gift of imputed interest.