University of Dayton Law Review

Volume 8 | Number 2 Article 8

1982

Interest-Free Loans: The Court of Claims Attempts to Correct Dean

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Recommended Citation

Wendeln, John H. (1982) "Interest-Free Loans: The Court of Claims Attempts to Correct Dean," *University of Dayton Law Review*: Vol. 8: No. 2, Article 8.
Available at: https://ecommons.udayton.edu/udlr/vol8/iss2/8

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INTEREST-FREE LOANS: THE COURT OF CLAIMS ATTEMPTS TO CORRECT *Dean* — *Hardee v. United States*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459 (Ct. Cl. Trial Div. July 6, 1982), *appeal docketed*, No. 84-79 (F. Cir. Feb. 7, 1983).*

I. INTRODUCTION

For over twenty years the Tax Court has followed *Dean v. Commissioner*[1] in maintaining that an interest-free loan made by a corporation to its shareholder or employee results in neither income nor an interest deduction to the shareholder or employee.[2] In an apparent at-

* On October 1, 1982, the United States Court of Claims ceased to exist. The Federal Courts Improvement Act of 1982 replaced its function as a trial court with the new and independent United States Claims Court. Additionally, it supplanted its function as an appellate court with the new United States Court of Appeals for the Federal Circuit. The Court of Claims recommended opinion in *Hardee v. United States* is now pending appeal in the Federal Circuit Court of Appeals. For the discussion of the changes brought about by the Federal Courts Improvement Act of 1982, see *infra* notes 55 & 56, 77.

1. 35 T.C. 1083 (1961), *appeal dismissed per stipulation, nonacq.* 1973-2 C.B. 4. The court held that "an interest-free loan results in no taxable gain to the borrower." 35 T.C. at 1090 (footnote omitted). J. Simpson Dean and his wife, Paulina duPont Dean, were sole shareholders of Nemours Corporation. During 1955 and 1956, the Deans held outstanding loans in excess of $2 million from Nemours. These loans were evidenced by non-interest bearing notes and the Deans did not pay interest on the loans. *Id.* at 1087-88.

The Commissioner argued that the Deans realized a taxable economic benefit from the interest-free use of the money, measured by the 3-4% prime interest rate the Deans would have been required to pay had they borrowed the money in an arms-length transaction. *Id.* In support of this position, the Commissioner relied on the established rule that the rent-free use of corporate property by a shareholder or officer results in the realization of income, measured by the fair rental value of the property for the term of the use by the shareholder or officer. *Id.* at 1089 (citing Rodgers Dairy Co. v. Commissioner, 14 T.C. 66 (1950) (rent-free use of corporation's automobile); Dean v. Commissioner, 9 T.C. 256 (1947), *aff'd*, 187 F.2d 1019 (3d Cir. 1951) (rent-free use of corporation's house); Chandler v. Commissioner, 41 B.T.A. 165 (1940), *aff'd*, 119 F.2d 623 (3d Cir. 1941) (rent-free use of corporation's apartment and lodge); Reynard Corp. v. Commissioner, 30 B.T.A. 451 (1934) (rent-free use of corporation's house); Frueauff v. Commissioner, 30 B.T.A. 449 (1934) (rent-free use of corporation's apartment)). Judge Raum's majority opinion, however, distinguished these cases and held that the Deans were not required to recognize income from the interest-free loans. 35 T.C. at 1090. For the relevant excerpt of Judge Raum's majority opinion, see *infra* note 4.

2. *See* Baker v. Commissioner, 75 T.C. 166 (1980), *aff'd*, 677 F.2d 11 (2d Cir. 1982); Marsh v. Commissioner, 73 T.C. 317 (1979); Zager v. Commissioner, 72 T.C. 1009 (1979), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Greenspun v. Commissioner, 72 T.C. 931 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982); Epstein v. Commissioner, 43 T.C.M. (CCH) 666 (1982); Trowbridge v. Commissioner, 41 T.C.M. (CCH) 1302 (1981); Beaton v. Commissioner, 40 T.C.M. (CCH) 1324 (1980), *aff'd*, 664 F.2d 315 (1st Cir. 1981); Parks v. Commissioner, 40 T.C.M. (CCH) 1228 (1980), *aff'd*, 686 F.2d 408 (6th Cir. 1982); Estate of Liechtung v. Commissioner, 40 T.C.M. (CCH) 1118 (1980); Martin v. Commissioner, 39 T.C.M. (CCH) 531 (1979), *aff'd*, 649 F.2d 1133 (5th Cir. 1981); Suttle v. Commissioner, 37 T.C.M. (CCH) 1638 (1978), *aff'd*, 625 F.2d 1127 (4th Cir. 1980). *Cf.* Creel v. Commissioner, 72 T.C. 1173 (1979) (distinguishing *Dean* on the facts), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d

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tempt to give tax parity to interest-free loan transactions *vis-à-vis* marketplace loan transactions,[3] the court in *Dean* devised the rationale of the offsetting interest deduction[4] and held that no income derived from the interest-free loans. The court analogized that since interest-free loans result in no interest deduction for the borrower[5] nor interest income to the lender,[6] "[w]e think it to be equally true that an interest-free loan results in no taxable gain to the borrower."[7] Despite dissenting opinions,[8] critical commentary, and vigorous attack by the Com-

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1133 (5th Cir. 1981); Genshaft v. Commissioner, 64 T.C. 282 (1975) (distinguishing *Dean* on the facts); Lisle v. Commissioner, 35 T.C.M. (CCH) 627 (1976) (distinguishing *Dean* on the facts).

3. *Dean's* holding of no income to the borrower is an attempt to equate the tax effects of an interest-free loan transaction to that of a marketplace loan transaction—that is, one in which interest is actually paid for the use or forbearance of money and which normally leads to an interest deduction. In *Greenspun*, the Tax Court reinforced *Dean's* attempt to equate the tax effects of both loan transactions but interpreted the language of Judge Raum's opinion in *Dean* to be referring to a different standard, an interest-bearing loan made by a corporation to its shareholder or officer accompanied by an increase in dividends or salary. For *Greenspun's* interpretation of *Dean* and resulting "substitution of standards," see *infra* note 29.

4. Simply stated, the *Dean* rationale of the offsetting interest deduction is that since a marketplace loan transaction leads to an interest deduction which would, in the court's view, completely offset the interest paid or "wash" the transaction, so too, the interest-free loan transaction should result in the same "wash" or no net cost effect. Thus, in an attempt to give equal tax effect to both loan transactions, *Dean* held that the borrower of an interest-free loan should not be required to report income. Judge Raum distinguished the rent-free corporate property cases asserted by the Commissioner and articulated the rationale of the offsetting interest deduction as follows:

> In each of . . . [the corporate property cases] 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. We think this circumstance differentiates the various cases relied upon by the Commissioner, and perhaps explains why he has apparently never taken this position in any prior case.

35 T.C. at 1090.

5. *Id.* (citing Loveman & Son Export Corp. v. Commissioner, 34 T.C. 776 (1960), *aff'd*, 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 (1962); Howell Turpentine Co. v. Commissioner, 6 T.C. 364 (1946), *rev'd on other grounds*, 162 F.2d 316 (5th Cir. 1947); Rainbow Gasoline Corp. v. Commissioner, 31 B.T.A. 1050 (1935); Backus & Sons v. Commissioner, 6 B.T.A. 590 (1927)).

6. 35 T.C. at 1090 (citing Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416 (1960); Society Brand Clothes, Inc. v. Commissioner, 18 T.C. 304 (1952); Combs Lumber Co. v. Commissioner, 41 B.T.A. 339 (1940)).

7. 35 T.C. at 1090 (footnote omitted).

8. Judge Bruce's dissent in *Dean* foreshadowed much of the critical commentary engendered by *Dean*. He agreed with Judge Opper's concurring opinion that the majority's holding was "much too broad a generalization to make here." *Id.* at 1091 (Bruce, J., dissenting)(quoting concurrence by Judge Opper). He also criticized the majority's blanket statement of the deductibility of interest as being "likewise too broad a generalization to make here." *Id.* at 1092. Specifically, he noted the § 265(2) exception to § 163(a) which denies an interest deduction for indebtedness

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missioner,[9] the Tax Court has held firm in its position.[10]

The Tax Court's "no income-no deduction" approach fails to give proper tax treatment to the component parts of an interest-free loan transaction. Economically speaking, an interest-free loan is a two-payment transaction. First, it is as if the shareholder or employee receives an interest-bearing loan from the corporation, accompanied by an increase in dividends or compensation in an amount equal to the interest charged. Second, it is as if the shareholder or employee pays back to the corporation the enhanced dividend or compensation in satisfaction of the interest charged.[11] This economic "two-payment" analysis lays

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incurred to purchase or carry tax-exempt obligations. *Id. See* I.R.C. §§ 163(a), 265(2) (1976 & Supp. IV 1980). Judge Bruce also agreed with the Commissioner that the case was indistinguishable in principle to the rent-free use of corporate property resulting in the realization of income. He argued that " '[i]nterest' in the sense that it represents compensation paid for the use, forbearance, or detention of money, may be likened to 'rent' which is paid for the use of property." 35 T.C. at 1091.

Judge Nims, in his dissent in *Greenspun*, stated without discussion that he would have held for income on the value of the low-interest loan to the taxpayer. He also warned that if the majority's *dicta* argument of the implied interest deduction is followed, the court could eventually be confronted with the issue of whether the lender-corporation would be deemed to have imputed interest income. 72 T.C. at 957-58 (Nims, J., dissenting). For *Greenspun's* discussion of the implied interest deduction, see *infra* notes 32-38 and accompanying text.

Judge Goldberg, in his lengthy and spirited dissent in *Martin*, advocated an approach of requiring the interest-free borrower to recognize income of the interest value of the loan and then allowing him an implied interest deduction. This result, he argued, would solve the problems generated by *Dean* and would afford equal tax treatment of the interest-free loan to its economically identical counterpart of an interest-bearing loan accompanied by additional compensation or dividends. 649 F.2d at 1142-43 (Goldberg, J., dissenting). For further discussion and support of Judge Goldberg's approach, consistent with the "two-payment" analysis of this note, see *infra* notes 11-14, 109-25, 133-37 and accompanying text.

9. The Commissioner issued his nonacquiesence in *Dean* in 1973. *See* 1973-2 C.B. 4. However, it was not until 1979 that the Commissioner began to vigorously attack the area of interest-free loans. Since then, the issue has proven to be an increasing source of litigation.

10. As a corollary to its position of no taxable income from interest-free loans from corporations to shareholders or employees, the Tax Court has followed *Dean* in holding that interest-free loans between family members are not taxable as a gift. *See* Crown v. Commissioner, 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978), *nonacq.* 1978-2 C.B. 3. *See also* Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966). *Cf.* Blackburn v. Commissioner, 20 T.C. 204 (1953) (taxable gift made when taxpayer sold a building to her children and received a note with interest stated at less than the current market rate of interest); Estate of Berkman v. Commissioner, 38 T.C.M. (CCH) 183 (1979) (term loans made at a lower rate than the current bank prime interest rate were held taxable gifts in the amount of the difference between the amount of the loans and the discounted values of the notes).

For analysis and discussion of gift tax aspects of inter-family interest-free loans, see Joyce & Del Cotto, *Interest-Free Loans: The Odyssey of a Misnomer*, 35 TAX L. REV. 459, 460-69, 498-501 (1980) [hereinafter cited as Joyce & Del Cotto]; O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. L. REV. 1085, 1086-94 (1974) [hereinafter cited as O'Hare]. More recently however, the Eleventh Circuit Court of Appeals disagreed with *Crown* and held that an interest-free loan between family members is taxable as a gift. *See* Dickman v. Commissioner, 690 F.2d 812 (11th Cir. 1982).

11. Professor Keller accurately identifies the true economic or "two-payment" character of

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the foundation for the proper tax treatment of the two component parts of an interest-free loan transaction—namely, the recognition of income of the interest value of the loan or the amount of the additional cash hypothetically received under section 61(a)[12] of the Internal Revenue Code and the allowance of an interest deduction for the amount hypothetically paid to the corporation under section 163(a).[13] It is the posi-

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the interest-free loan transaction as follows:

> Economically, [the effect of an interest-free loan] . . . is identical to that of a loan on which interest is charged, accompanied by an increase in either dividend or compensation, in an amount equal to the interest charged. That is, the two-payment transaction is economically indistinguishable from the interest-free loan.

Keller, *The Tax Consequences of Interest-Free Loans from Corporations to Shareholders and from Employers to Employees*, 19 B.C.L. REV. 231, 231 (1978) (footnote omitted) [hereinafter cited as Keller].

This "two-payment" analysis of the interest-free loan transaction finds its origin in the concept of the cash equivalent theory of in-kind benefits. When an individual is permitted the free-use of property, a taxable economic benefit clearly has been bestowed upon the individual. Thus, although no cash has been given to the individual in the conventional receipt of income form, it is as if the individual has *received* the equivalent of cash to *purchase* the use of the property. Accordingly, any in-kind transaction, whether it be the free use of money or the free use of some other property, can be properly characterized, economically speaking, as a "two-payment" transaction.

Although the Tax Court has also identified the true economic character of the interest-free loan, it has refused to give proper tax treatment to the transaction's two component parts. For the identification made by the Tax Court in *Greenspun*, see *infra* note 29. *See also Martin*, 649 F.2d at 1134-45 (Goldberg, J., dissenting).

Professors Joyce and Del Cotto have also utilized an economic analysis to determine the true character of the interest-free loan transaction. Although their economic characterization of the interest-free loan as a "hybrid transaction which is part compensation-part loan" is inconsistent with the true economic character of the interest-free loan transaction, their analysis results in the proper tax treatment of the interest-free loan, i.e., the recognition of income and the allowance of a deduction. *See* Joyce & Del Cotto, *supra* note 10, at 470.

12. The definition of gross income in I.R.C. § 61(a) (1976), "all income from whatever source derived," has been broadly construed to include any economic or financial benefit, in whatever form or mode effected, except those specifically exempted by Congress. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1955) (money received from award of punitive or exemplary damages held to be taxable as income); Commissioner v. Smith, 324 U.S. 177, 181-82 (1945) (benefit derived from bargain purchase of stock through employee stock option plan held to be taxable income). *See also* Treas. Reg. § 1.61-1(a) (1953) (gross income includes "income realized in any form [in-kind benefits], whether in money, property, or services.").

The use of funds without a corresponding obligation to pay interest for the use of those funds is inescapably an economic benefit within § 61(a) and, therefore, taxable as income. Insofar as it rejects the Commissioner's reliance on the rent-free use of corporate property cases, *Dean* does not analyze the issue of the taxability of the economic benefit conferred by an interest-free loan. Although the Tax Court in *Greenspun* discussed the issue and acknowledged the presence of a valuable economic benefit, the court held that the borrower of an interest-free loan does not realize a taxable economic benefit. *Greenspun* also cited Mason v. United States, 513 F.2d 25 (7th Cir. 1975), which permitted a charitable deduction for a low-interest loan to a charity and thereby supported the view that an interest-free loan confers a taxable economic benefit. For the relevant excerpts of the *Greenspun* opinion, see *infra* notes 24 & 29. *See also* Marsh v. Commissioner, 73 T.C. 317, 328 (1979) (economic benefit of an interest-free loan not realized as income).

13. Section 163(a) allows a deduction for "interest paid or accrued within the taxable year on indebtedness." The language of § 163(a) has been interpreted to mean that as a general rule

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tion of this note that the tax consequences resulting from the "two-payment" analysis are dictated by economic reality and supported by logic and statutory interpretation of the Internal Revenue Code.[14]

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interest is deductible when it arises pursuant to an enforceable legal obligation to pay a principal sum. Christensen v. Commissioner, 40 T.C. 563, 578 (1963). *See* Sellers v. Commissioner, 22 T.C.M. (CCH) 1327 (1963). *See also* 4A MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 26.04 (1979).

Dean cited cases which denied an interest deduction to the borrower of an interest-free loan. *See supra* note 5. Although the Tax Court has not established that an interest deduction would be available to the borrower of an interest-free loan, the *Greenspun* court stated in *dictum* that a deduction would be allowed if the taxpayer were required to recognize income from an interest-free loan. The Tax Court in *Creel* did actually hold for such an implied interest deduction, but on a factual exception with respect to some of the interest-free loans. For discussion of the implied interest deductions in the *Greenspun* and *Creel* opinions, see *infra* notes 32-38, 45-48 and accompanying text. For the discussion of the implied interest deduction under the "two-payment" analysis, see *infra* notes 109-25 and accompanying text.

14. For a detailed examination of this "two-payment" analysis and the statutory support for the resulting tax treatment of the interest-free loan transaction, see *infra* notes 109-25, 133-37 and accompanying text.

Two corollary issues produced by this analysis and by the interest-free loan transaction itself with respect to the lender-corporation are: first, whether the corporation would have interest income and, second, whether the corporation would be allowed a deduction for compensation. The "two-payment" analysis would clearly attribute such income to the corporation. *Dean*, however, cited authority which holds that the lender-corporation of an interest-free loan to a shareholder or employee would not be charged with such interest income. *See supra* note 6. *See also* Ltr. Rul. 7731007 (Apr. 29, 1977), *acq.* 1964-2 C.B. 7. Since the passage, in 1965, of I.R.C. § 482 (1976) authorizing the Commissioner to distribute, apportion, or allocate gross income, deductions, credits, or allowances among two or more "organizations, trades, or businesses" that are "owned or controlled by the same interests," courts have attributed interest income to the corporation-lender of interest-free loans between related corporations. *See, e.g.*, Fitzgerald Motor Co. v. Commissioner, 508 F.2d 1096 (5th Cir. 1975); Kerry Investment Co. v. Commissioner, 500 F.2d 108 (9th Cir. 1974); Liberty Loan Corp. v. United States, 498 F.2d 225 (8th Cir.), *cert. denied*, 419 U.S. 1089 (1974); Commissioner v. Forman and Co., 453 F.2d 1144 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972). For a discussion of this particular issue and proposals to tax interest-free loans between corporations and shareholders or employees under § 482, see Joyce & Del Cotto, *supra* note 10, at 480-82; Keller, *supra* note 11, at 244-55, 270-75; O'Hare, *supra* note 10, at 1096-105; Roth, *Can Lender Be Charged With Receiving Taxable Income as a Result of an Interest-Free Loan?*, 52 J. TAX'N 136 (1980); Comment, *Income Taxation of the Economic Benefit of Interest-Free Loans*, 13 LOY. L.A.L. REV. 503, 516-18 (1980) [hereinafter cited as Comment, *Economic Benefit*]. For proposals to find income attributed to both the borrower and lender, and an interest deduction to the borrower, of an interest-free loan under I.R.C. § 483 (1976 & Supp. IV 1980), which provides for the finding of interest in payments from sales or exchanges of property where no interest or lower interest has been specified, see Joyce & Del Cotto, *supra* note 10; Keller, *supra* note 11, at 264-70.

Generally the income realized by a shareholder from the free use of corporate assets is treated as dividend income so that the corporation does not get a deduction. *See, e.g.*, International Artists, Ltd. v. Commissioner, 55 T.C. 94 (1970); Challenge Mfg. Co. v. Commissioner, 37 T.C. 650 (1962); Rethorst v. Commissioner, 31 T.C.M. (CCH) 1101 (1972). *Cf.* Peterson v. Commissioner, 25 T.C.M. (CCH) 1002 (1966).

There is no dispositive authority on the issue of whether the corporation-lender of an interest-free loan will be allowed a deduction for additional compensation. In Bellows v. Commissioner, 26 T.C.M. (CCH) 978 (1967), the Tax Court held that the amount of the rental value of an apartment given rent-free to a resident manager could not be deducted by the taxpayer as an expense

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The Tax Court's exclusion of income approach is flawed in two important respects. First, and most importantly, the Tax Court's approach violates the Internal Revenue Code's basic premise that income and deductions are separate tax concepts.[15] The Tax Court's approach commingles the income and deduction issues and permits the realization of the economic benefit conferred by an interest-free loan under section 61(a)[16] to be determined by the allowability of an interest deduction under section 163(a).[17] With respect to the unquestioned

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since the rental value was not included in his income. However, the decision in Mason v. United States, 513 F.2d 25 (7th Cir. 1975), where a charitable deduction was allowed for the sale of property to a charity for cash and a note with interest stated at less than the fair market rate of interest, would seem to support such a deduction. For other cases and discussion of this particular issue, see Joyce & Del Cotto, *supra* note 10, at 486-89; Keller, *supra* note 11, at 253; Schlifke, *Taxing as Income the Receipt of Interest-Free Loans*, 33 U. CHI. L. REV. 346, 348 (1966) [hereinafter cited as Schlifke]. It should be noted that analysis of these two issues, particularly the issue of income to the lender, which become especially relevant in light of the tax consequences of the "two-payment" analysis, are outside the scope of this note.

15. The language and structure of the Internal Revenue Code requires that income and deduction issues are to be determined independently. Thus, consistent with the "two-payment" analysis of the interest-free loan transaction, the income and deduction issues of a single transaction are to be viewed separately, or as two separate transactions, to determine the correct tax treatment of the transaction. Also, if in the same transaction the resulting allowable deduction would totally offset the income realized, or "wash" the transaction, the structure of the Code nevertheless requires both the income to be recognized and the deduction to be taken. In support of this unquestioned structure of the Internal Revenue Code, one commentator criticizes *Dean* in the following way:

> [E]ven if the tax washout were the necessary result, the [additional income] and the deduction should have been reflected in the tax return to maintain the basic structure of our tax system which involves setting out gross income and then listing deductions therefrom.

Schlifke, *supra* note 14, at 349.

16. For the Tax Court's acknowledgement of the valuable economic benefit conferred by an interest-free loan but refusal to concede that the economic benefit is realized as income, see *infra* note 24.

17. Under the basic structure of the Internal Revenue Code, a deduction has no direct bearing on the realization of income and, conversely, the realization of income is not conditioned on the allowability of a deduction. One commentator noted the concept of the separateness of income and deductions and criticized *Dean* in the following way:

> [T]here is no necessary connection between the economic benefit—that is, the income—and the interest deduction offset. The two concepts are entirely unrelated and perhaps confused because the measurement standard for the economic benefit happens to be related to a deduction.

Jordan, *Income Tax Problems of Interest-Free Loans*, 11 TAX ADVISER 300, 302 (1980).

The presence of a deduction, or the lack thereof, cannot "cross the line" and change the existence of income. The Tax Court's exclusion of income approach permits the deduction issue, and its resulting tax effects, to "cross the line" and thereby violates the Internal Revenue Code's basic structure on four specific counts. In *Dean*, the Tax Court permitted the presence of a deduction of a similar transaction, the marketplace loan, or its vision of the lack of a deduction in the existing transaction, the interest-free loan, to eliminate the existence of income. In *Greenspun*, the Tax Court permitted the interest deduction of the interest-free loan's economically identical transaction, the two-payment structured loan, and the implied interest deduction of the interest-free loan transaction itself to also eliminate the existence of income. For discussion of these two arguments of *Greenspun*, see *infra* notes 28-38 and accompanying text. For discussion of *Dean's* spe-

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structure of the Internal Revenue Code, the Tax Court's exclusion of income approach is clearly erroneous.

The second important flaw in the Tax Court's exclusion of income approach is its distortion of the taxpayer's true gross income and the resulting effect on deductions which are calculated using the taxpayer's adjusted gross income.[18] For example, since the taxpayer's true gross income would be understated by virtue of the exclusion of the economic benefit conferred by an interest-free loan, the itemized deduction for medical expenses,[19] limited to that amount which exceeds a certain percentage of adjusted gross income, would be overstated. Conversely, charitable deductions,[20] which cannot exceed a certain percentage of the individual's gross income, could be understated. Thus, the Tax Court's exclusion of income approach fails to give the proper effect to a number of provisions of the Internal Revenue Code.[21]

In *Greenspun v. Commissioner*,[22] the Tax Court undertook a detailed analysis of *Dean*, but refused to overrule it. Despite the finding of a valid consideration in the particular transaction,[23] the acknowledgement of a valuable economic benefit conferred by an interest-free

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cific violation of the Code, see Comment, *Gift Tax Consequences of Interest-Free Loans Between Family Members*, 4 U. DAYTON L. REV. 139, 143 (1979). *See also Martin*, 649 F.2d at 1140-43. (Goldberg, J., dissenting).

18. *See* I.R.C. § 62 (1976 & Supp. IV 1980).

19. I.R.C. § 213(a)(1) (1976) (as amended by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 202, 96 Stat. 324, __). *See Greenspun*, 72 T.C. at 949.

20. I.R.C. § 170(b)(1) (1976). *See Greenspun*, 72 T.C. at 949.

21. *See, e.g., Greenspun*, 72 T.C. at 949 n.21 (citing I.R.C. § 219 (1976 & Supp. IV 1980) (deduction for retirement savings); I.R.C. § 220 (1976 & Supp. IV 1980) (deduction for retirement savings for certain married individuals); I.R.C. § 6012 (1976 & Supp. IV 1980) (return filing requirements); I.R.C. § 6013(e) (1976) (innocent spouse provisions); I.R.C. § 6501(e) (1976 & Supp. IV 1980) (statute of limitations on assessment of taxes)). For *Greenspun's* discussion and "resolution" of this issue, see *infra* note 25. For further discussion of this effect on deductions by the Tax Court's exclusion approach, see Joyce & Del Cotto, *supra* note 10, at 479; Keller, *supra* note 11, at 235-36; Comment, *Interest-Free Loans and the Tax Court: A New Look at an Old Problem*, 30 CATH. U.L. REV. 497, 513-18 (1981) [hereinafter cited as Comment, *A New Look*]; Comment, *Economic Benefit, supra* note 14, at 509-10. *See also Martin*, 649 F.2d at 1140-42 (Goldberg, J., dissenting).

22. 72 T.C. 931 (1979). In 1967, Howard Hughes, through the Hughes Tool Company, made a $4 million, eight year (later extended to 35 years) loan at 3% interest (half the current bank interest rate) to television station and newspaper-owner Herman Greenspun. *Id.* at 932-40. The Commissioner argued that the low-interest loan had been granted to Greenspun as compensation for services and, accordingly, the present value of the economic benefit should have been included in gross income. *Id.* at 941, 950. The Commissioner also relied on the established rule that a shareholder or employee realizes a taxable economic benefit from the rent-free use of corporate property. *Id.* at 947.

23. The court found that "the favorable interest rate was granted petitioner in exchange for consideration to be given. . . ." *Id.* at 945. The future consideration was, as the court put it, the expectation of "friendly press coverage" for Hughes' current real estate ventures in the Las Vegas area and to induce the anticipated sale of Greenspun's television station to Hughes. *Id.* at 943-44.

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loan,[24] and the discussion of the many problems associated with the *Dean* rationale and result,[25] the court nevertheless followed *Dean*[26] and held that the taxpayer realized no income from the low-interest loan.[27]

The *Greenspun* court properly identified the true economic character of the interest-free loan transaction, but focused on the tax effects of the characterization to support the *Dean* holding of no income. In an effort to give credence to *Dean*, the court substituted the standard of the marketplace loan transaction used by *Dean*[28] with the standard of the interest-bearing loan transaction made by a corporation to its

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24. The court articulated its finding of a valuable economic benefit from a low or non-interest loan as follows:

> Undeniably, the use of funds absent a corresponding obligation to pay interest, or to pay interest only at a preferential rate, in most, if not all, cases constitutes as valuable an economic benefit as would any rent-free use of a residence, automobile, or boat. See *Mason v. United States*, 513 F.2d 25 (7th Cir. 1975). Thus, in line with the reasoning of the above cases [referring to the rent-free use of corporate property cases cited by the court, see 72 T.C. at 947], *it would appear* as [the Commissioner] contends that where, as here, a loan at a favorable rate is granted in exchange for services, *the borrower has realized a clear economic benefit taxable as income.*

Id. at 947 (emphasis added).

The court, however, turned to the *Dean* rationale and determined that this economic benefit was not realized as income. *See id.* 72 T.C. at 945-46, 947-48. Note that the Tax Court's reliance on *Dean* to deny the existence of a taxable economic benefit has not only perpetuated *Dean's* violation of the Internal Revenue Code's basic structure, but has also given effect to *Dean's* non-statutory, judicially-legislated exception to § 61(a).

25. With respect to the *Dean* result, the *Greenspun* court noted that the exclusion from gross income of the economic benefit from a low or no-interest loan would understate or overstate deductions that are determined by reference to a percentage of adjusted gross income. 72 T.C. at 949. For the itemized deductions affected by adjusted gross income noted by *Greenspun*, see *supra* notes 19-21 and accompanying text.

With respect to the *Dean* rationale, the court noted that the payment of interest does not always result in an automatic interest deduction under § 163(a). The "most notable limitation" is § 265(2) which denies an interest deduction for interest paid on loan proceeds used to carry tax-exempt obligations. 72 T.C. at 948. The court noted other sections which also limit or deny deductions of interest: I.R.C. § 163(d) (1976) (indebtedness incurred to purchase or carry property held for investment); I.R.C. § 264(a)(2) (1976) (indebtedness used to purchase a single premium life insurance, endowment, or annuity contract); and I.R.C. § 267(a)(2) (1976) (certain unpaid interest in the case of related taxpayers); also, an interest deduction is generally not available to individuals who do not itemize deductions. 72 T.C. at 949 n.20. Despite these ramifications and unanswered questions of the *Dean* rationale and result, the court reinterated its affirmation of *Dean* and deferred specific determination of these related issues "[w]hen and if . . . confronted with such a case. . . ." *Id.* at 950. The question of whether the denial of an interest deduction would then cause income to be realized under the *Dean* rationale has also been left unanswered by other Tax Court interest-free loan cases. *See Baker*, 75 T.C. at 171 (decide the issue "only when we are confronted with a case specifically raising the issue."). *See also Zager*, 72 T.C. at 1012; *Epstein*, 43 T.C.M. (CCH) at 667. For discussion of the *Dean* rationale concerning the limitations on the deductibility of interest, see Joyce & Del Cotto, *supra* note 10, at 479; Keller, *supra* note 11, at 236-40. *See also Martin*, 649 F.2d at 1133, 1140-41 (Goldberg, J., dissenting).

26. 72 T.C. at 950.

27. *Id.* at 946.

28. *See supra* note 4.

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shareholder or employee accompanied by an increase in dividends or compensation in the amount of the interest charged.[29] Because both the tax effects of the interest-free loan transaction under *Dean's* "no income-no deduction" approach and the tax effects of the *Greenspun* "substituted standard" loan transaction result in a "wash," i.e., zero effective cost,[30] the court, in its view, gave effect to *Dean's* attempt to

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29. *Greenspun* took advantage of *Dean's* somewhat unclear language to substitute the *Dean* standard of the marketplace loan transaction with its own standard, which was the true economic character of the interest-free loan transaction, and stated:

> In holding that no income was realized by the taxpayers in *Dean* . . . we reasoned that had the taxpayers borrowed the funds on interest-bearing notes, their payment of interest would have been fully deductible under section 163. Underlying this reasoning was the idea that, economically speaking, an interest-free loan from a corporation to its shareholder or employee is in substance no different from the making of a loan on which interest is charged accompanied by an increase in dividends or compensation in an amount equal to the interest charged. Consequently, to give effect to the economic reality of the situation, we attempted in *Dean* to equalize the tax treatment of *the two loan transactions.*

72 T.C. at 947-48 (emphasis added). The court later stated:

> In short, by excluding from gross income the clear economic benefit realized upon the receipt of a low- or no-interest loan to a shareholder or employee, in *Dean* we properly sought to place such a transaction on a tax parity *with interest-bearing loans accompanied by an increase in dividends and salary.*

Id. at 949-50 (emphasis added).

To illustrate its "substituted standard" and resulting "wash" effect, the *Greenspun* court gave the following example:

> [A]ssume that A, an employee of X Co., received as his only form of compensation an interest-free loan from X Co. in the amount of $20,000 for a period of 1 year. Further assume the prevailing interest rate at the time was 5 percent or $1,000 a year. The economic effect of this transaction is the same as if X Co. had charged A interest at 5 percent on the $20,000 loan, and, at the same time, paid him a salary of $1,000 which A in turn used to pay the interest. Assuming no other facts, in the second hypothetical, A would have gross income from his salary of $1,000 and an interest deduction of $1,000 or taxable income of $0. Consistent with this result, in the first hypothetical involving the interest-free loan, A's taxable income under our holding in *Dean* would be $0.

Id. at 948.

30. The zero effective cost or "wash" tax effect of these two loan transactions can best be illustrated by the use of "effective cost analysis." The purpose of this analysis is to illustrate the actual tax effects of interest-free loans under their respective taxation theories and to show how the *Greenspun* court used the "wash" effect of the true economic "two-payment" characterization of the interest-free loan transaction to support *Dean's* and its own holding of no income. Although *Greenspun's "wash"* example aptly illustrates this latter point, this effective cost analysis, with its utilization of the marginal tax rate, illustrates the "wash" effect with greater accuracy.

Other commentators have engaged in a similar though limited analysis and have concluded, as does the effective cost analysis, that the *Dean* holding of no income does not equate the tax effects of the interest-free and marketplace loan transactions. *See* Duhl & Fine, *New Case Allowing Interest Deduction Calls for Reappraisal of No-Interest Loans*, 44 J. TAX'N 34, 35 (1976); Jacobs, *Of No Interest: Truth, Substance, and Bargain Borrowing*, 9 FLA. ST. U.L. REV. 261, 282 (1981); Schlifke, *supra* note 14, at 349, 353; Comment, *Economic Benefit, supra* note 14, at 509 n.42. Judge Goldberg also engaged in this type of analysis properly using, however, the true economic "two-payment" character of the interest-free loan, or the *Greenspun* "substituted standard," to review the *Dean* holding of no income. *See Martin*, 649 F.2d 1133, 1137-38 n.12 (Goldberg, J., dissenting).

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EFFECTIVE COST ANALYSIS

For purposes of this effective cost analysis, assume a cash-basis taxpayer-shareholder received an interest-free loan of $10,000 from XYZ Corporation, the current market rate of interest is 10%, and the taxpayer is in the 40% marginal tax bracket.* Under this effective cost analysis, the tax effects of the *Dean* "no income-no deduction" interest-free loan transaction (IFLT) (A), the *Greenspun* "substituted standard" loan transaction (true economic character of the interest-free loan) (B), the *Dean* standard of the marketplace loan transaction (C), and the *Greenspun* "income-implied interest deduction" (IID) interest-free loan transaction (the proper tax treatment of the interest-free loan transaction) (D), would be:

	A	B	C	D
	Dean Holding IFLT	*Greenspun* Substituted Standard Loan Trans.	*Dean* Standard Marketplace Loan Trans.	*Greenspun* IID IFLT
	(No Income; No Deduction)	(Additional Income; Deduction)	(Deduction)	(Recognized Income; IID)
Recognized income of $1000 (interest value of loan); Net tax effect ($1000 x 40%)	0	-	-	(400)
Additional cash given by corp.	-	1000	-	-
Income from receipt of cash of $1000; net tax effect. ($1000 x 40%)	-	(400)**	-	-
Interest paid to corp./bank (out-of-pocket expense)	-	(1000)	(1000)	-
Deduction for interest paid of $1000; Net tax effect ($1000 x 40%)	-	400	400	-
Implied interest deduction of $1000; Net tax effect ($1000 x 40%)	0	-	-	400
Effective Cost	0	0	(600)	0

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"equalize the tax treatment of the two loan transactions."[31]

The *Greenspun* court came close to the proper tax treatment of the true economic character of the interest-free loan transaction in *dicta* where it argued the implied interest deduction, but, instead, the court used this analysis to support its own, and effectively *Dean's*, holding of no income.[32] The court stated that "if petitioner were required to include as income the economic benefit associated with the loan, he would be deemed to have simultaneously paid an amount of interest equal to the income so reported."[33] In apparent conflict with the gen-

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* The marginal tax bracket or rate (MTR) is that rate which is applied to the taxpayer's highest portion of income. The MTR works to show the amount of actual tax that would be paid on marginal or successive increases in income or the actual tax saved from marginal reductions of income, say, from a deduction. If our hypothetical taxpayer reported additional income of $4000, the cost in taxes to the taxpayer on that increase in income would be $1600 ($4000 x 40%). Similarly, if the taxpayer was allowed a deduction of $4000, the savings in taxes to the taxpayer on this reduction of income would be $1600 ($4000 x 40%). Under this effective cost analysis, the MTR aids in calculating the actual cost of each transactional part to determine the total effective cost to the taxpayer under each rationale or standard. The conclusions of this analysis would not change with different marginal tax rates because each taxpayer, having the same MTR, would be affected proportionately.

** The bracketed amounts represent a cost to the taxpayer — that is, money, either in taxes or in personal expenditures — leaving the taxpayer's hands. Conversely, the non-bracketed amounts represent a monetary benefit received — namely, money, either in additional income or in decrease of taxes resulting from a deduction — coming into the taxpayer's hands.

With an effective cost of $600, the *Dean* standard of the marketplace loan transaction (C) does not "wash" as *Dean* thought. Having paid $1000 out-of-pocket expense to pay for the interest, the marketplace borrower is entitled to an interest deduction. This deduction, however, offsets the $1000 out-of-pocket expense only by $400 ($1000 deduction x 40% MTR) and thus yields the effective cost of the transaction of $600 ($1000 out-of-pocket expense minus $400 deduction benefit). The *Dean* interest-free loan borrower (A), without having to recognize income and not given the implied interest deduction, has an effective cost, of course, of $0. The *Greenspun* "substituted standard" borrower (B), however, or the true economic "two-payment" character of the interest-free loan transaction, does have the "wash" effect intended by *Dean*. The *Greenspun* "substituted standard" borrower, who receives additional cash from the corporation in an amount equal to cover the cost of the loan, receives cash of $1000, incurs increased taxes of $400 on the inclusion of that cash into income ($1000 cash x 40% MTR), then pays the $1000 back to the corporation as interest thus entitling him to an interest deduction which, like the marketplace borrower, would reduce his taxes by $400. Altogether, this "substituted standard" results in a $0 effective cost or "wash" and thereby supports the *Dean* holding of no income.

31. 72 T.C. at 948.

32. The court stated "[i]n the circumstances of the present case, however, whether or not we rest our conclusion on *Dean*, our decision of no deficiency would be the same." *Id.* at 950. The court then proceeded with its discussion of the implied interest deduction.

33. *Id.* The court also stated that "such interest would in turn have been fully deductible under section 163, the same as if it actually had been charged and paid." *Id.* In support of this result, the court relied on Rev. Rul. 73-13, 1973-1 C.B. 42, where a corporate executive was allowed a deduction under I.R.C. § 212 (1976) after being required to report income from the receipt of personal financial advice paid for by his employer. 72 T.C. at 952. The court noted that the "deduction was permitted even though the executive neither 'paid' nor incurred any financial counseling expense." *Id.* Consistent with its previous analysis, the court stated that "the result can be justified by reasoning that the transaction in question was in substance the same as if the

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eral rule of the deductibility of interest[34] and the cases cited by *Dean* denying an interest deduction to the borrower of an interest-free loan,[35] the *Greenspun* court stated that "none of the cases which have applied the general rule have dealt with the precise question of whether a taxpayer who must report as income the economic benefit associated with a low- or no-interest loan is entitled to claim an offsetting interest deduction."[36] The court concluded that "[i]n such a case, we think an exception to the general rule of deductibility is both appropriate and necessary to give recognition to the economic realities of the transaction."[37] Rather than relying on this analysis to properly tax the interest-free loan, the court reverted to its focus on the tax effects of the approach which, being the proper tax treatment of the interest-free loan under the "two-payment" analysis,[38] would result in a zero effective cost[39] and thereby support the holding of no income from interest-free loans.[40]

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corporation had increased the salary of its executive with the increase being used by the executive to purchase the financial advice." *Id.* For the discussion of the statutory analysis supporting the implied interest deduction neither noted by *Greenspun* nor the Revenue Ruling, see *infra* notes 112-16 and accompanying text.

34. 72 T.C. at 951 (citing Christensen v. Commissioner, 40 T.C. 563, 577-78 (1963)).

35. 72 T.C. at 951 (citing Loveman & Son Export Corp. v. Commissioner, 34 T.C. 776, 805-06 (1960), *aff'd*, 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 (1962)).

36. 72 T.C. at 951.

37. *Id.*

38. *See supra* notes 11-14 and accompanying text. The court noted that had the parties structured the loan as an interest-bearing loan accompanied by an increase in cash, "petitioner would have compensation income *and* an offsetting interest deduction." 72 T.C. at 951. The court justified its result of no income by stating that "the parties have [merely] eliminated the formalistic step of Hughes' paying petitioner cash . . . which petitioner would then repay to Hughes." *Id.* at 951-52.

39. Under the effective cost analysis, the implied interest deduction borrower (D), actually the interest-free borrower who is properly treated under the "two-payment" analysis, would accordingly have the "wash" or $0 effective cost effect as the two-payment structured loan transaction (B). The income required to be recognized of $1000 (measured by the interest value of the loan) would result in increased taxes of $400 ($1000 recognized income x 40% MTR). This increase in taxes would be completely offset by the $400 savings in taxes resulting from the $1000 implied interest deduction ($1000 implied interest deduction x 40% MTR) and result in a $0 effective cost.

40. This effective cost analysis and *Greenspun's* own "wash" example illustrates the court's focus and reliance on the "wash" effect of the true economic "two-payment" character of the interest-free loan transaction to support *Dean's* holding of no income. *Greenspun's* failure to give its own characterization of the interest-free loan the proper tax treatment — namely, the recognition of income and the allowance of an implied interest deduction — has served to perpetuate the flaws of *Dean* in that it violates the structure of the separateness of income and deductions and allows for potential disparate tax effects on itemized deductions. For discussion of these flaws, see *supra* notes 15-21 and accompanying text. For discussion and critical commentary of the *Greenspun* opinion in general, see Jacobs, *supra* note 30, at 285-91; Joyce & Del Cotto, *supra* note 10, at 472-89, 501-08; Comment, *A New Look*, *supra* note 21, at 503-08.

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In *Creel v. Commissioner*,[41] the Tax Court again followed *Dean*.[42] However, on a factual distinction from *Dean* with respect to some of the interest-free loans,[43] the court held for the recognition of income and an implied interest deduction. The court reasoned that the corporation's payments of interest to third-party creditors while carrying interest-free loans to the taxpayers were "actually a discharge . . . of petitioners' own obligations."[44] Accordingly, the court held that "[t]o 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."[45] The Fifth Circuit Court of Appeals, in affirming *Creel*, along with *Martin v. Commissioner*[46] and *Zager v. Commissioner*,[47] did not discuss this exception to *Dean* nor the allowance of an implied interest deduction. Instead, the court simply upheld the decision's following of *Dean*.[48]

Since *Greenspun* and *Creel*, the Commissioner has consistently, though unsuccessfully, attempted in both the Tax Court and the circuit courts of appeal to have *Dean* overruled.[49] The circuit courts, in affirming *Dean*, have chosen not to further reexamine the merits of the *Dean* rationale nor the ramifications of its result.[50] Instead, these courts have chosen to rely on the principle of *stare decisis*[51] and to leave any

41. 72 T.C. 1173 (1979). During the taxable years 1973 and 1974, taxpayer-shareholders Creel and Parkinson had open account interest-free loans from their three corporations with the bulk of the loan money issued by Gulf Paving, Inc. *Id.* at 1175-76.

42. *Id.* at 1179.

43. As a factual and legal exception to *Dean*, the Commissioner showed that at the same time Gulf Paving, Inc. carried interest-free loans for the taxpayers, the corporation carried interest-bearing obligations to banks and finance companies, personally guaranteed by the taxpayers. *Id.* at 1177-78. The Commissioner argued that under these circumstances the interest-free loans "constituted an actual transfer of value taxable to petitioners as ordinary income . . . . " *Id.* at 1178. The court accepted the Commissioner's argument and concluded that "Gulf Paving, Inc., 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." *Id.* at 1179.

44. *Id.* at 1180.

45. *Id.* Consistent with *Dean*, the court also concluded that the interest-free loans to petitioners which did not require the corporations to carry interest-bearing obligations to third parties would have no direct tax effect. *Id.*

46. 39 T.C.M. (CCH) 531 (1979).

47. 72 T.C. 1009 (1979).

48. 649 F.2d 1133 (5th Cir. 1981).

49. For the line of cases following *Dean*, see *supra* note 2. Six circuits (First, Second, Fourth, Fifth, Sixth and Ninth) have affirmed the Tax Court's following of *Dean*.

50. The Ninth Circuit Court of Appeals in *Greenspun*, one of the last circuits to affirm *Dean*, stated that "[t]oo much water has passed under the bridge to warrant judicial reexamination of the principles underlying the decision or the problems generated by it." 670 F.2d at 125-26.

51. Though acknowledging the logical assailability of the *Dean* rationale and its far-reaching implications, the circuit courts of appeal have founded their affirmation of *Dean* on *stare decisis* principles. The circuit courts have noted that *Dean* has simply given judicial effect to (1)

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action to Congress.[52] Thus, without a congressional response,[53] the Tax Court's position of no income or deduction from interest-free loans has endured.

This note will discuss *Hardee v. United States*,[54] a Court of Claims[55] recommended opinion[56] which reevaluated the correctness of

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an administrative practice existing for some 48 years; (2) the reliance of taxpayers on *Dean* for some 20 years, and have concluded that the benefits of an alternative solution would not outweigh the loss of the uniform application of our tax laws. *See, e.g., Parks*, 686 F.2d at 409; *Baker*, 677 F.2d at 12; *Greenspun*, 670 F.2d at 125; *Beaton*, 664 F.2d at 317; *Martin*, 649 F.2d at 1133-34.

52. In affirming *Dean*, the circuits have stated that the Commissioner should turn to Congress and not the courts to modify the taxation of interest-free loans. The circuits noted the Supreme Court's view of *stare decisis* and deference to congressional expertise in the area of tax law in United States v. Byrum, 408 U.S. 125, 135 (1972):

> Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

Id. See, e.g., Parks, 686 F.2d at 409; *Baker*, 677 F.2d at 12-13; *Greenspun*, 670 F.2d at 126; *Beaton*, 664 F.2d at 317. Note that now after 20 years of reliance on *Dean*, the *Dean* rationale is not necessarily being supported by correct statutory or legal interpretation, but, rather, by *stare decisis*.

53. Congress has not passed any new statutory guidelines affecting interest-free loans since its 1965 passage of I.R.C. § 482 (1976), which has been used to tax interest-free loans between related organizations. *See supra* note 14. In 1975, the Commissioner approached Congress with a discussion draft of proposed regulations to tax other fringe benefits but the draft was withdrawn in 1976. In 1977, however, Congress began to review the tax treatment of fringe benefits. When it became pressed for time, Congress created a task force in the House Committee on Ways and Means to study the area of fringe benefits and instructed the Commissioner not to issue any new regulations under § 61 governing fringe benefits until the end of 1983. *See* Pub. L. No. 95-427, § 1, 92 Stat. 996 (1978), extended by Pub. L. No. 96-167, § 1, 93 Stat. 1275 (1979), and by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 801, 95 Stat. 172. *See also Baker*, 677 F.2d at 12; *Zager*, 72 T.C. at 1014; *Greenspun*, 72 T.C. at 955 (Goffe, J., concurring). Congress has, however, passed legislation affecting employee fringe benefits in two recent tax acts. *See* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 235-50, 96 Stat. 324 (pension plans); §§ 331-339 (employee stock ownership provisions); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 251, 95 Stat. 172 (stock options); § 252 (property transferred to employees subject to certain restrictions).

54. 82-2 U.S. Tax Cas. (CCH) ¶ 9459 (Ct. Cl. Trial Div. July 6, 1982), *appeal docketed*, No. 84-79 (F. Cir. Feb. 7, 1983).

55. Effective October 1, 1982, the Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, 96 Stat. 25, replaced the trial function of the United States Court of Claims with the new and independent United States Claims Court. The Claims Court will assume jurisdiction, nearly identical to that of its predecessor, of any claim against the government based on the Constitution, any act of Congress, or any regulation of an executive department. *Id.* § 133. Accordingly, the court will maintain its nationwide, limited subject matter jurisdiction and will continue to be a forum for tax litigation. It shares this particular function with the Tax Court and the district courts. The Claims Court was created under Article I of the Constitution and its judges will be appointed by the President, subject to the advice and consent of the Senate. *Id.* § 105. As a new and independent court, the judges of the Claims Court will have, unlike the trial Commissioners

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the Tax Court's *Dean* and *Greenspun* rationales and the economic propriety of their result.

II. Facts and Holding

W. L. Hardee and his wife were principal shareholders of Sea Garden Sales Company.[57] In the 1950's, Hardee had established a practice of borrowing money, interest-free, from the company.[58] By the end of 1972 and 1974, his indebtedness to Sea Garden had reached approximately $503,000 and $474,000, respectively.[59] During those same years, Hardee held tax-exempt municipal bonds valued at more than $500,000.[60]

The Commissioner asserted that Hardee realized a taxable economic benefit from the loans measured by the interest he would have been required to pay had he obtained the loans in an arms-length transaction.[61] Accordingly, the Commissioner increased Hardee's in-

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of the Court of Claims, the power to enter dispositive orders and make final decisions. S. Rep. No. 275, 97th Cong., 2d Sess. (1982), *reprinted in* 1982 U.S. Code Cong. & Ad. News 18 [hereinafter cited as S. Rep. No. 275].

Similar to the Tax Court, the court will designate a Chief Judge. Decisions of the Claims Court will be subject to the review of the United States Court of Appeals for the Federal Circuit.

The United States Court of Appeals for the Federal Circuit was created by a merger of the Court of Claims and the Court of Customs and Patent Appeals and will inherit substantially all the appellate jurisdiction of the two courts abolished in the merger. S. Rep. No. 275, at 12-13. Although on the same level as the other Circuit Courts of Appeal, the jurisdiction of this thirteenth circuit will be defined in terms of subject matter, rather than geography. S. Rep. No. 275, at 12-13. The Federal Circuit was also given exclusive, nationwide jurisdiction over patent appeals. *Id.* at 14. Proposals to create a similar, centralized national court of tax appeals, having exclusive jurisdiction over tax decisions of the Tax Court, Claims Court, and the district courts, were not enacted. *See* Jones & Singer, *Changes in Procedure, Strategy Due in New Federal Circuit and Revamped Claims Court*, 57 J. Tax'n 136, 136-37 (1982) [hereinafter cited as Jones & Singer].

56. The Court of Claims Trial Commissioner's recommended opinion (absent a recommended judgment) in Hardee v. United States, 82-2 U.S. Tax Cas. (CCH) ¶ 9459 (Ct. Cl. Trial Div. July 6, 1982), was, for purposes of appeal, converted to a final judgment of the Claims Court by order of the Court of Appeals for the Federal Circuit and is currently on appeal in the Court of Appeals for the Federal Circuit, *appeal docketed*, No. 84-79 (Feb. 7, 1983).

57. *Id.* at 84,656. W. L. Hardee was president and majority shareholder of Sea Garden Sales Company, Inc. *Id.* Together he and his wife owned approximately 94% of the company's stock. *Id.* at n.1. Sea Garden was engaged in several business activities including marine, industrial, and municipal supplies, farming and ranching, and the operation of a fleet of deep sea shrimp trawlers. *Id.* at 84,656.

58. *Id.*

59. *Id.* The indebtedness was evidenced by promissory notes and Mr. Hardee was not obligated to pay, nor did he pay, interest on the borrowings. *Id.*

60. *Id.*

61. *Id.* at 84,656-57. "In calculating the value of the interest-free loans, the Government computed the daily balance of plaintiff's indebtedness to Sea Garden and applied a 7 percent interest factor to derive an interest-not-charged figure. . . . As a result, plaintiff's gross income was increased by $38,745.13 for 1973 and $37,775.70 for 1974." *Id.* at 84,657 n.2.

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come and assessed deficiencies for the years 1973 and 1974.[62] Hardee paid the deficiencies and then commenced suit in the Court of Claims for the recovery of these payments.[63]

Court of Claims Trial Judge Wiese denied Hardee's recovery. With facts nearly identical to *Dean*,[64] the court rejected the Tax Court's *Dean-Greenspun* rationale. The court held that an interest-free loan from a corporation to its shareholder results in a taxable economic benefit to the shareholder which is includible in the shareholder's gross income as dividend income and is measured by the fair market value of the economic benefit.[65] The court also held that the borrower of an interest-free loan is not entitled to an interest deduction.[66]

III. ANALYSIS

The Court of Claims opinion in *Hardee v. United States*[67] answered the call of many commentators to reconsider the Tax Court's position regarding interest-free loans.[68] Although the opinion properly views the income and deduction issues separately,[69] Judge Wiese's analysis fails to give effect to the true economic or "two-payment" character of the interest-free loan transaction.[70]

Judge Wiese began his discussion by summarizing the *Dean* and *Greenspun* rationales.[71] He aptly explained that it was the presence of a deduction in the marketplace loan transaction, but not in the personal use of other asset transactions (e.g., rental of a home), and the resulting differences in their real costs,[72] that motivated the *Dean* court to

62. *Id.* at 84,657. The amounts of the assessed deficiencies were $24,926.61 for 1973 and $24,675.02 for 1974. *Id.*

63. *Id.*

64. The only relevant distinction between the facts of *Dean* and *Hardee* is Hardee's apparent use of the loan proceeds to carry tax-exempt municipal bonds. The cost of the bonds, $500,000, nearly equalled the amount of the outstanding loan balances, $503,000 and $474,000. For Judge Wiese's discussion of the relevance of Hardee's holding of tax-exempt securities, see *infra* notes 75 & 76 and accompanying text.

65. 82-2 U.S. Tax Cas. (CCH) at 84,659. The court reserved judgment on the amount due the Government. *Id.*

66. Id. at 84,658-59.

67. 82-2 U.S. Tax. Cas. (CCH) ¶ 9459 (Ct. Cl. Trial Div. July 6, 1982).

68. *See, e.g.*, Joyce & Del Cotto, *supra* note 10.

69. For a discussion of the Tax Court's failure to properly view the income and deduction issues separately, see *supra* notes 15-17 and accompanying text.

70. For the initial discussion of this "two-payment" analysis and Judge Wiese's failure to give effect to such analysis, see *supra* notes 11-14; *infra* notes 98-108 and accompanying text.

71. 82-2 U.S. Tax. Cas. (CCH) at 84,657.

72. By giving the taxpayer a reduction in taxes, a deduction serves to reduce or offset a portion of the initial cost of a transaction. Thus, a transaction that yields a deduction, such as a marketplace borrowing, has a lower real cost by virtue of the deduction than a transaction that does not yield a deduction, such as the rental of a house. For a discussion of the effective cost analysis, see *supra* note 30.

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make a corresponding distinction when measuring the taxable gain from the free use of the same assets.[73] Judge Wiese summed up his discussion of the two rationales with the conclusion that "[f]or both decisions then, the linchpin was the idea that interest-free borrowings should stand on a parity, economically speaking, with borrowings in the marketplace."[74]

In view of his noncompliance with *Dean*, Judge Wiese understandably relegated discussion of Mr. Hardee's coincident investment in tax-exempt bonds as a possible grounds for his decision to a footnote at the outset of the opinion.[75] He stated that this question was rendered moot in light of his conclusion that "income must be recognized for all interest-free borrowings regardless of the purpose to which the funds are applied."[76]

It is important to note that the Court of Claims was not bound to follow the Tax Court's *Dean* and *Greenspun* decisions.[77] Faced with rendering the first opinion in over twenty years to break from *Dean*,[78] Judge Wiese expressed his concern over the principle of *stare decisis* stating that "over two decades of precedent should not lightly be cast aside or rendered uncertain by the loose expression of competing

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73. 82-2 U.S. Tax Cas. (CCH) at 84,657.

74. *Id.* With this conclusion, Judge Wiese apparently missed *Greenspun's* substitution of the *Dean* marketplace loan standard with the "two-payment" loan transaction standard. *See supra* note 29 and accompanying text. Judge Wiese did use, however, the *Greenspun* "substituted standard" loan transaction later in his opinion to analyze the economic effects of his approach. 82-2 U.S. Tax Cas. (CCH) at 84,658-59.

75. *Id.* at 84,656 n.**. For the discussion of the *Dean* rationale concerning the denial of an interest deduction under § 265(2) or by some other section, see *supra* note 25.

76. 82-2 U.S. Tax Cas. (CCH) at 84,656 n.**.

77. The Court of Claims, an independent tax forum with its decisions subject to review solely by the Supreme Court, was outside the jurisdiction of the circuit courts of appeal and thus not bound to follow the Tax Court's *Dean* and *Greenspun* decisions. Similarly, under the Federal Courts Improvement Act of 1982, the Claims Court will only be bound to follow the decisions of the Court of Appeals for the Federal Circuit. *See supra* note 55. "Neither [the Claims Court nor Federal Circuit] should see the [Federal Courts Improvement] Act as an invitation to follow the law of the taxpayer's home circuit in the manner of the *Golsen* rule." Jones & Singer, *supra* note 55, at 136 (citing Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd,* 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1972)).

78. The Court of Claims has been known to disregard technical tax rules, ignore precedent of other federal courts, and to view "more favorably than the Tax Court or district courts an argument based on equity, even if it offends a literal reading of the Code or Regulations." Jones & Singer, *supra* note 55, at 136. With this independent approach to deciding cases, it is not surprising that the Court of Claims rendered the first opinion that refused to follow *Dean.* It is surprising, however, that the Court of Claims failed to stay true to its reputation by placing such a strict meaning on the word "paid" in § 163(a). The court did not give effect to the equity of the transaction, unless, of course, the court viewed its denial of the interest deduction as the "fair" result. For Judge Wiese's analysis of the deduction issue and his failure to acknowledge the economic substance of the transaction, see *infra* notes 98-108 and accompanying text.

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thought."[79]

Stare decisis "is a principle of policy and not a mechanical formula of adherence,"[80] and accordingly, is designed to balance the competing concerns of certainty in the law with the need for reaching correct results. Where a legislative remedy is available, as in the tax law, *stare decisis* has swung toward the side of certainty of the law even where, as Justice Brandeis has said, "the error is a matter of serious concern."[81] The more recent elucidation of the Supreme Court concerning *stare decisis* in the tax law in *United States v. Byrum*,[82] cited by the circuit courts in affirming *Dean*,[83] also seems to support the stricter adherence to *stare decisis* when a legislative remedy is at hand.

Despite strong arguments in favor of following *stare decisis* and for remaining committed to *Dean* until Congress has the opportunity to address the situation,[84] Judge Wiese stated that "this court [is] not bound to honor existing views that it considers to be wrong."[85] He also stated that "[w]e depart from those views here only after much deliberation of the matter in issue and the inability . . . to become honestly convinced that the *Dean-Greenspun* rationale is correct either in reasoning or result."[86]

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79. 82-2 U.S. Tax. Cas. (CCH) at 84,658. Judge Wiese also expressed his view of *stare decisis* as "expressing as much the law's awareness of the need for predictability in everyday affairs as it does the need to achieve judicial economy by letting matters once settled remain at rest." *Id.*

80. Helvering v. Hallock, 309 U.S. 106, 119 (1940).

81. Burnet v. Coronado Oil & Gas. Co., 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting). Justice Brandeis, albeit in dissent, stated:

> *Stare decisis* is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right. This is commonly true even where the error is a matter of serious concern, provided correction can be had by legislation.

Id. (footnote & citation omitted).

82. 408 U.S. 125, 135 (1972).

83. *See supra* note 52. For other *stare decisis* principles relied upon by the circuits in affirming *Dean*, see *supra* note 51.

84. For Congress' decision to defer attention to fringe benefits, which may include interest-free loans, until 1984, see *supra* note 53.

85. 82-2 U.S. Tax Cas. (CCH) at 84,658. In support of this statement, Judge Wiese analogized that "even as correct interpretation of the tax laws requires that the Commissioner . . . not be precluded from taking a position contrary to what his office may earlier have espoused . . . so also is this court not bound to honor existing views that it considers to be wrong." *Id.* (citing Dixon v. United States, 381 U.S. 68, 72-73 (1965)). The Eleventh Circuit Court of Appeals also relied on *Dixon* to justify its breaking away from the existing precedent of *Crown* in the gift tax area of interest-free loans. Dickman v. Commissioner, 690 F.2d 812, 818 (11th Cir. 1982).

86. 82-2 U.S. Tax Cas. (CCH) at 84,658.

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A. Gross Income and Section 61(a): Interest-Free Loans Confer a Taxable Economic Benefit

Judge Wiese properly analyzed the issue of the taxability of the economic benefit conferred by an interest-free loan solely within the confines of section 61(a). Accordingly, he did not consider the deduction nature of the transaction in his inquiry into the income issue.

Judge Wiese began his analysis with an examination of two settled principles of interpretation utilized in construing the concept of gross income within section 61(a).[87] First, gross income is to be broadly construed to "tax all gains except those specifically exempted."[88] Second, this definition is to include the value of in-kind benefits as well as cash.[89] These two principles, he noted, have resulted in the established rule that "the economic benefit realized through the free use of corporate assets compels the recognition of income to the extent of the market value of that use."[90]

Judge Wiese saw no distinguishable difference between the free use of corporate funds and the free use of other corporate assets with respect to the realization of a taxable economic benefit. He stated that "[u]ndeniably . . . the use of a corporate asset without a corresponding obligation to pay is a [taxable] economic benefit,"[91] and reasoned that the interest-free use of corporate funds "is certainly no less an economic enrichment of the borrower than, say, the rent-free use of a company-owned home or boat."[92] Thus, the "same result" of the realization of income from the rent-free use of corporate property "must apply" to the interest-free use of corporate funds.[93]

A potential argument for the taxability of the economic benefit

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87. *Id.*

88. *Id.* (quoting Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955)).

89. 82-2 U.S. Tax Cas. (CCH) at 84,658 (citing Commissioner v. Smith, 324 U.S. 177, 181 (1945)). *See* Treas. Reg. § 1.61-1(a) (1953).

90. 82-2 U.S. Tax Cas. (CCH) at 84,658 (citing Gardner v. Commissioner, 613 F.2d 160 (6th Cir. 1980) (income recognized in the free use of a company-owned automobile); Chandler v. Commissioner, 119 F.2d 623 (3d Cir. 1941) (income recognized in the free use of a corporation-owned residence); Challenge Mfg. Co. v. Commissioner, 37 T.C. 650 (1962) (income recognized in the rent-free use of a company-owned boat); Frueauff v. Commissioner, 30 B.T.A. 449 (1934) (income recognized in the rent-free use of a company-owned apartment)). In further support of the broad construction of gross income, Judge Wiese also cited cases holding for the inclusion of income from payments made by a corporation for a taxpayer's personal expenses. Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) (corporation's payment of employee's taxes is income to the employee); Dolese v. United States, 605 F.2d 1146 (10th Cir. 1979), *cert. denied*, 445 U.S. 961 (1980) (corporation's payment of the shareholder's litigation expense is income to the shareholder). 82-2 U.S. Tax Cas. (CCH) at 84,658.

91. *Id.*

92. *Id.*

93. *Id.*

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conferred by an interest-free loan lies within the cash equivalent concept of Treasury Regulation section 1.61-2(d)(2)(i).[94] Generally stated, the principle of section 1.61-2(d)(2)(i) is that when property is received for less than its fair market value, the difference between the amount paid for the property and its fair market value is the equivalent of the receipt of cash and thus is included in the gross income of the recipient. Assuming the threshold questions concerning its applicability are satisfied,[95] section 1.61-2(d)(2)(i) would result in income being recognized by the borrower of an interest-free loan. Since the borrower has not paid anything for the use of the money, the full fair market value of the use of the money, measured by its interest value, would be included in the borrower's gross income. This examination is consistent with Judge Wiese's analysis of the parallel taxability of the free use of corporate funds and other corporate property. The conclusion of both analyses is that the interest-free borrower, by not having to pay for the use of an asset, has realized a taxable economic benefit equivalent to the receipt of cash.

Judge Wiese stated that the conclusion of the taxability of the economic benefit conferred by an interest-free loan "would seem to be indisputable" and noted that the "Tax Court has never said otherwise."[96]

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94. Treas. Reg. § 1.61-2(d)(2)(i) (1963) reads in part:

> [I]f property is transferred by an employer to an employee or if property is transferred to an independent contractor, as compensation for services for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor.

Id. See also 1958-1 C.B. 173. Consistent with the "two-payment" analysis of in-kind benefits, it is as if the employee or contractor received the equivalent of cash to purchase the property. *See supra* note 11.

95. The first question of the applicability of § 1.61-2(d)(2)(i) is whether an interest-free loan is "compensation for services." The argument that an employee or shareholder would not receive an interest-free loan were it not for their service to or investment in the company, § 1.61-2(d)(2)(i) would clearly apply. *See also supra* note 23 (*Greenspun* Court found the low-interest loan to be made for "friendly press coverage.").

The second question is whether the word "property" of § 1.61-2(d)(2)(i) includes money. Although pertaining to the word "property" in the gift tax statutes, Congress "made it clear that the term 'property' . . . was to have the broadest possible meaning, reaching every species of right or interest protected by law and having an exchangeable value. The word property was to include money." Duhl & Fine, *supra* note 30, at 37 n.26 and accompanying text (citing H.R. Rep. No. 708, 72d Cong., 1st Sess. 27 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 39 (1932); *reprinted in* 1939-1 C.B. (Part 2) 476, 524)).

The third question is whether the word "property" of § 1.61-2(d)(2)(i) includes the "use" of property. To give effect to the broad congressional intent concerning the word "property," courts have interpreted the word to include the right *to use* property. *See* Duhl & Fine, *supra* note 30, at 37 n.27 and accompanying text. The established rule of the realization of income from the rent-free *use* of corporate property also supports this conclusion. *See supra* notes 1 & 90.

96. 82-2 U.S. Tax Cas. (CCH) at 84,658. Judge Wiese is correct with this statement inso-

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He pointed out that "[w]here trouble sets in . . . is with the notion that, because interest obligations incurred in the marketplace give rise to deductions . . . so also then should income-in-kind . . . carry with it the same tax consequences, to wit: a deduction."[97]

B. Dean-Greenspun *Offsetting Interest Deduction Rationale, Section 163(a), and Economic Results*

Judge Wiese found two fundamental problems with the *Dean-Greenspun* rationale permitting the interest-free loan to result in the same tax consequences of a deduction.[98] First and foremost, he noted a lack of statutory authority sanctioning such a result.[99] Second, he charged the *Dean-Greenspun* approach with substituting "one economic dislocation for another."[100]

1. Lack of Statutory Authority for the Interest Deduction?

Judge Wiese's observation of the lack of statutory authority allowing an interest deduction to an interest-free loan transaction is not altogether correct. The allowance of such a deduction can be read within the statutory language of section 163(a). Furthermore, such a deduction is necessary to give effect to the true economic or "two-payment" character of the interest-free loan transaction.

Judge Wiese strictly construed the "paid or accrued" words in section 163(a),[101] to mean that an interest deduction is allowed only when there has been a cost of borrowing to the taxpayer.[102] He also concluded that the *Greenspun* assumption of the corresponding increase in cash compensation to cover the cost of the loan cannot change the fact that there is no cost of borrowing.[103] In support of his strict construction of section 163(a) and that provision's non-attention to ancillary considerations, Judge Wiese quoted the United States Supreme Court

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far that the Tax Court has acknowledged the presence of a valuable economic benefit conferred by an interest-free loan similar to the economic benefit conferred by the rent-free use of corporate property. The Tax Court, however, has not conceded that the interest-free loan's economic benefit is realized and taxable as income. *See supra* note 24.

97. 82-2 U.S. Tax Cas. (CCH) at 84,658.

98. *Id.*

99. *Id.*

100. *Id.* at 84,659.

101. Section 163(a) allows a deduction for "interest *paid or accrued* within the taxable year on indebtedness." *Id.* (emphasis added).

102. 82-2 U.S. Tax Cas. (CCH) at 84,658-59. See the general rule of the deductibility of interest and the cases denying an interest deduction to the borrower of an interest-free loan, *supra* notes 13 & 5.

103. 82-2 U.S. Tax Cas. (CCH) at 84,658-59. For the true economic character of the interest-free loan transaction, referred to as the *Greenspun* "assumption" by Judge Wiese, see *supra* notes 11 & 29.

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which denied an interest deduction to a taxpayer who incurred no cost of borrowing in *Commissioner v. National Alfalfa Dehydrating & Milling Co.*[104] "The propriety of a deduction does not turn upon general equitable considerations, such as a demonstration of effective economic and practical equivalence. Rather, it depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed."[105]

In further support of his conclusion that the *Greenspun* assumption cannot change the "no deduction" result, Judge Wiese invoked a basic methodology argument stating "[s]ound administration of the tax law demands that tax consequences be determined according to the facts as they stand and not according to the facts as they could have been."[106] Thus, Judge Wiese concluded that here, as in *National Alfalfa*,[107] the relevant consideration is that given the facts as they were, the taxpayer incurred no cost of borrowing and therefore was not entitled to take a deduction.[108]

Although Judge Wiese's strict construction of section 163(a) and his requirement that tax consequences be determined according to the

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104. 417 U.S. 134 (1974). Although the issue of the deductibility of interest in *National Alfalfa* arose in a factually different context than that of an interest-free loan, Judge Wiese noted that the Supreme Court's words "were nevertheless directed to the same core issue: whether under § 163(a) of the Internal Revenue Code of 1954 an interest deduction can be allowed where no cost of borrowing has been incurred." 82-2 U.S. Tax Cas. (CCH) at 84,659.

The specific issue in *National Alfalfa* was the allowability of an interest deduction under § 163(a) for debt discount (i.e., interest) under a plan of exchange of $50 face value debentures for $50 value preferred shares of stock with a market value of $33. The taxpayer attempted to deduct the difference between the $50 face amount of the debentures and the $33 trading price of the debt instruments as interest. The Supreme Court did not allow the deduction because the exchange "did not give rise to any cost of borrowing." *Id.* at 84,659 n.4 (quoting *National Alfalfa*, 417 U.S. at 154).

105. *Id.* at 84,659 (quoting *National Alfalfa*, 417 U.S. at 148-49). *See also* Commissioner v. Tellier, 383 U.S. 687, 693 (1966) (deductions in general are held to be a matter of legislative grace).

106. 82-2 U.S. Tax Cas. (CCH) at 84,659. Accordingly, Judge Wiese stated "[i]t cannot matter, therefore, that had Mr. Hardee's loans been structured differently by giving him first the interest amount in cash and the loans thereafter that he then might have been allowed a deduction." *Id.* Unless he is referring to Mr. Hardee's investment in tax-exempt bonds, Judge Wiese is clearly wrong with this statement. Had the loans been structured in this manner, the payment of interest back to the corporation would have yielded a "cost of borrowing" and a deduction would have been allowed.

107. *Id.* at 84,659 n.4. The taxpayer in *National Alfalfa* made the argument that the exchange was economically equivalent to an open market transaction in which the $50 debentures were sold for $33 in cash and the cash was then used to retire the shares. The Supreme Court deemed the argument irrelevant. "'To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty.'" 417 U.S. at 149 (quoting Founders General Corp. v. Hoey, 300 U.S. 268, 275 (1937)).

108. 82-2 U.S. Tax Cas. (CCH) at 84,659.

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facts as they are is appealing, his analysis ignores the true economic character of the interest-free loan transaction, particularly with respect to the deduction issue. As previously noted, the interest-free loan transaction is, economically speaking, an interest-bearing loan accompanied by an increase in cash equal to the amount of the interest charged.[109] This economic analysis yields the two hypothetical component payments of the interest-free loan and results in the transaction's proper tax treatment.

The first hypothetical component is the payment of cash to the taxpayer. Such a payment yields the recognition of income to the taxpayer of the cash received which is measured by the interest value of the loan. After such payment, the taxpayer's balance sheet shows an increase in assets of the cash received (with the corresponding increase in assets and liabilities (notes payable) of the principal sum of the loan)). The corporation's balance sheet shows a decrease in assets of the cash paid (with the corresponding accounting change in assets of cash to notes receivable).[110] However, this financial position as reflected in the balance sheets of the taxpayer and corporation is not the true financial position of the parties to the actual interest-free loan transaction.

To complete the analysis and to place the parties in the financial position they actually are after the completion of an interest-free loan transaction, it is necessary for the taxpayer to pay back to the corporation the cash received or the interest charged on the loan. Such a payment would give final effect to the true economic character of the transaction and would yield, under normal circumstances, an interest deduction. This logical analysis produces the proper tax treatment of the two component payments of an interest-free loan — namely, the recognition of income and the allowance of an interest deduction.

The logic of this analysis and its resulting tax conclusions is supported by statutory interpretation of the Internal Revenue Code. The recognition of income from an interest-free loan is inescapable under the broad scope of section 61(a) and its traditional construction requiring taxpayers to include all economic benefits in gross income in whatever form received or mode effected.[111] The allowance of an inter-

109. *See supra* note 11 and accompanying text. *See also supra* note 29 (*Greenspun's* identical characterization of the interest-free loan transaction).

110. The assets of the corporation's balance sheet would not be decreased by the amount of the loan along with the payment of cash since the lender is held to retain ownership of the principal sum of the loan.

111. *See supra* note 12. There is one situation where the shareholder-borrower would not have dividend income. If the corporation did not have current or accumulated earnings and profits, any distribution would be treated as a return of capital to the extent of the adjusted basis of the stock. *See* I.R.C. §§ 301(a), (c), 316 (1976 & Supp. IV 1980). *See also generally* B. BITTKER &

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est deduction when interest has not actually been paid but when income has been recognized from the transaction is supported by the way the Code and Regulations treat "basis" or, more specifically, the word "cost" in section 1012.[112] Treasury Regulation section 1.61-2(d)(2)(i) specifically states " 'basis' shall be the amount paid for the property *increased by the amount* of such difference *included in gross income*."[113] Just as the broad, non-literal interpretation of the word "cost" in section 1012 is necessary "to give the statute the quality of rationality,"[114] so too, it is necessary to give the word "paid" of section 163(a) a broad, non-literal interpretation to give effect to the economic substance of the interest-free loan transaction and its rational tax treatment.[115] Thus, just as the taxpayer who is permitted to increase his

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J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 7.01 (4th ed. 1979).

112. I.R.C. § 1012 (1976) reads: "The basis of property shall be the cost of such property. . . . " This analysis is not in any way precluded by the word "property" since, as previously noted, "property" is to include money. *See supra* note 95.

113. Treas. Reg. § 1.61-2(d)(2)(i) (1963) (emphasis added). The reading of the regulation, relevant to this analysis, is:

> In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income.

Id. See also I.R.C. § 301(d)(1) (1976 & Supp. IV 1980) which provides that the basis of property received by a shareholder will be "the fair market value of such property" which is included in the shareholder's income to the extent of earnings and profits. *See also* note 111.

114. E. Brown, *The Growing "Common Law" of Taxation*, 1961 SO. CAL. TAX INST. 1, 8. Professor Keller ccommented on Professor Brown's non-literal interpretation of the word "cost" of § 1012.

> Professor Brown hypothesizes the case of a taxpayer who receives an automobile valued at $5000 as a bonus from his employer or as a prize in a lottery. The taxpayer reports the automobile's value as income, and soon thereafter decides to sell it for cash.
>
>> Its value, let us say $5,000, is clearly income to him when received. He reports it as such and pays the appropriate tax. But he decides that such a car is beyond his needs and style and sells it for cash. What is the tax result? What is his basis? Search the statute as we will, all we can find is "cost." And what is cost? Literally in the case of the lottery prize, it is the price of the ticket. But we should all be startled if our taxpayer were required to pay a tax on the value of the car when he received it and another tax on all, or almost all, of the proceeds of the sale. *So we should, I am sure, stretch the word "cost" almost out of recognizable shape to make it mean the amount at which the car was taken into income, and we should feel justified in doing so in order to give the statute the quality of rationality.*

Keller, *supra* note 11, at 241-42 (quoting Brown, *supra* at 7-8)(footnote omitted). Judge Goldberg also cited to Professor Brown in support of his position that an implied interest deduction should be allowed. *See Martin*, 649 F.2d 1133, 1143 n.17 (Goldberg, J., dissenting).

115. The logic of a broad, non-literal interpretation of the terms "paid or accrued" has found support in a number of Tax Court concurring and dissenting opinions. For example, Judge Opper, in his concurring opinion in *Dean*, hypothesized the situation where a shareholder-officer who received the free use of corporate property, which he then rented to another, would realize gross income equal to the fair rental value of the property, and would also be able to "presumably deduct as a business or nonbusiness expense the hypothetical rental value theoretically paid by

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basis ("cost") by the recognition of income within section 1012, so too, an interest-free borrower should be permitted to have "paid" interest from the recognition of income from an interest-free loan within section 163(a).[116]

This statutory analogy of the non-literal interpretation of the word "cost" of section 1012 to the word "paid" of section 163(a) serves only to loosen or free the word "paid" from the irrational effects of a strict construction; it does not provide for the unqualified grant of an interest deduction. Although the recognition of income would be the necessary prerequisite to the implied interest deduction, the hypothetical payment of interest to the corporation would be subject to all the limitations on the deductibility of interest had the interest actually been paid.[117] Thus, despite Mr. Hardee's recognition of income of the interest value of the loan and his hypothetical payment of interest to the corporation, his use of the loan proceeds to invest in tax-exempt bonds would deny him an interest deduction for interest actually paid and, so too, for any implied interest deduction under section 265(2).

There appears to be no authority specifically rejecting this non-literal interpretation of "paid or accrued" of section 163(a) when income is recognized from an interest-free loan. *Dean* cited cases supporting the denial of an interest deduction to the borrower of an interest-free loan.[118] In its discussion of the implied interest deduction, the Tax Court in *Greenspun* correctly pointed out that "none of the cases which applied the general rule dealt with the precise question of whether a taxpayer who must report as income the economic benefit

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him to the corporation [under] § 212. . . . " 35 T.C. at 1091. (Opper, J., concurring). Judge Opper's non-literal interpretation of the words "paid or incurred" found in §§ 212 and 162 would also seem to apply to the words "paid or accrued" found in § 163(a).

Judge Dawson, in his concurring opinion in *Greenspun*, stated that the taxpayer would be "entitled to an offsetting deduction under § 163(a), notwithstanding the rather unequivocal language of that section." 72 T.C. at 953 (Dawson, J., concurring).

Judge Goldberg, in his dissenting opinion in *Martin*, referred to this strict construction of § 163(a) and stated that "[t]his illogical and unjust result is neither required by nor even permitted under a fair and proper application of the Internal Revenue Code." 649 F.2d at 1137 (Goldberg, J., dissenting). *See also Greenspun's* discussion and endorsement of the implied interest deduction but refusal to hold for such a deduction *supra* note 32-38 and accompanying text (citing Rev. Rul. 73-13, 1973-1 C.B. 42).

116. One writer, though agreeing with the *Dean-Greenspun* rationale, notes this treatment of "basis" by the Internal Revenue Code and criticizes *Hardee* in the following way:

> It is submitted that this basis write-off represents the tax cost of the expiration of the right to use the funds interest-free and is the tax equivalent of a direct cost of borrowing. The failure to take into account this loss of basis leads to the inequitable result of the *Hardee* decision.

Coleman, *I.R.S. Victory on Interest-Free Loans*, N.Y.L.J., Aug. 16, 1982, at 4, col. 4.

117. For some of the limitations on the deductibility of interest, see *supra* note 25.

118. *See supra* note 5.

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associated with a low- or no-interest loan is entitled to claim an offsetting interest deduction."[119] Similarly, the Supreme Court in *National Alfalfa*, relied upon by Judge Wiese in his analysis of the deduction issue,[120] did not address this particular issue.[121] *Greenspun* properly concluded that "an exception to the general rule of deductibility is both appropriate and necessary to give recognition to the economic realities of the transaction."[122]

Additionally, the analysis of the implied interest deduction does not impair the separate nature of income and deductions.[123] Although the permissibility of an implied interest deduction is conditioned on the recognition of income from an interest-free loan, such a result is sanctioned by valid statutory interpretation of the Internal Revenue Code. The Tax Court, on the other hand, allows a deduction (and its resulting tax effects) to eliminate the existence of income, a result clearly not sanctioned by the Internal Revenue Code. The implied interest deduction, an issue decided after the recognition of income has been established and still subject to the limitations on the deductibility of interest, would not allow the presence of a deduction or the lack thereof to negate the realization of income. Furthermore, despite its probable "wash" effect,[124] the "two-payment" analysis would still provide for both the recognition of income and the allowance of a deduction. Accordingly, the taxpayer's "true gross income" would be reached and the disparate effects caused by the exclusion of income approach would be eliminated.[125]

This "two-payment" analysis of in-kind benefits and its resulting tax treatment would also provide for and support the policy of consistency in our tax system. Congress, for whatever particular social or economic concern, has designated certain payments or transactions as

119. 72 T.C. at 951. Professor Keller concurs in this finding. The cases cited by *Dean* focused on the issue of whether interest-free loans could be converted retroactively by the taxpayer-borrower into interest-bearing loans for purposes of obtaining an interest deduction. Keller, *supra* note 11, at 243.

120. *See supra* notes 104-08 and accompanying text.

121. There was no income issue in *National Alfalfa*. There is properly no taxable economic benefit arising from a mere shifting of a corporation's capital from one account (preferred stock) of the corporation to another (debentures). Accordingly, the issue of whether the recognition of income from a transaction would then allow a deduction to be taken was not even noted or discussed. For the specific issue in *National Alfalfa* noted by Judge Wiese, see *supra* note 104.

122. 72 T.C. at 951.

123. For the Tax Court's violation of the separateness of income and deductions under the Internal Revenue Code, see *supra* notes 15-17 and accompanying text.

124. For discussion of the tax effects of the "two-payment" analysis, see *supra* notes 30 & 39.

125. For the discussion of the disparate tax effects on itemized deductions caused by the Tax Court's exclusion of income approach, see *supra* notes 18-21 and accompanying text.

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deductible, resulting in a tax benefit for taxpayers. Judge Wiese's income only approach, however, improperly places in-kind transactions such as the interest-free loan, which would normally be allowed a deduction if the payment of interest actually was made, on an equal tax footing with in-kind transactions such as the rent-free use of a home for personal use, which would not be allowed a deduction under any circumstances. To permit an interest-free loan transaction to result in a deduction would give effect to congressional intent of providing preferential tax treatment, by means of a deduction, to certain payments and transactions. Judge Wiese's rigid construction of section 163(a) failed to give the interest-free loan transaction the deduction necessary to give effect to the true economic substance or hypothetical "two-payment" character of the interest-free loan.

2. *Economic Analysis: Form over Substance?*

Judge Wiese began his economic analysis with the charge that the *Dean-Greenspun* rationale "substitutes one economic dislocation for another."[126] Although he initially stated that the *Dean* and *Greenspun* opinions attempted to equate the tax effects of an interest-free loan to a marketplace loan,[127] he realigned himself by using the two-payment structured loan transaction to evaluate the economic effects of his approach.[128]

Judge Wiese correctly concluded that under his "income-no deduction" approach, the interest-free borrower is in a less favorable after-tax position than his counterpart two-payment structured borrower, who receives additional cash and then is allowed a deduction for the interest paid to the corporation.[129] Judge Wiese explained that the *Dean-Greenspun* "no-income" approach, in an attempt to eliminate the imbalance between the two taxpayers, yields "the equally disproportionate result of permitting the interest-free borrower to enjoy the benefit of the loan without any adverse consequences whatsoever."[130] He concluded that to the interest-free borrower under *Dean* and *Green-*

126. 82-2 U.S. Tax Cas. (CCH) at 84,659.

127. *See* text accompanying *supra* note 74.

128. *See* 82-2 U.S. Tax Cas. (CCH) at 84,659.

129. 82-2 U.S. Tax Cas. (CCH) at 84,659. For the effective cost analysis, see *supra* note 30. Under the facts of the effective cost analysis, the *Hardee* "income only" borrower-taxpayer, who is required to recognize income of $1000, incurs an actual cost of $400 in increased taxes and, not permitted an implied interest deduction, would thus have an effective cost of the transaction of $400. The structured two-payment borrower-taxpayer (B), who has an effective cost of the transaction of $0, would be, as Judge Wiese concluded, in a better after-tax position.

130. 82-2 U.S. Tax Cas. (CCH) at 84,659. Judge Wiese noted that there are no "up-front" borrowing costs nor, under *Dean* and *Greenspun*, any tax consequences occasioned by the borrowing. *Id.*

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spun, the borrowing is truly "free."[131]

In the final paragraph of his economic analysis, Judge Wiese advocated viewing tax treatment of interest-free loans and other in-kind transactions according to their form and not their substance.

> So viewed, the result seems even more out-of-joint, economically speaking, than the [natural] *discrepancy it means to overcome, namely, that differing tax consequences should attend two transactions* [interest-free loan and structured two-payment loan] *that may be functionally identical but cast in dissimilar forms.* Thus, even if this court could somehow sidestep the statutory requirement limiting an interest deduction to interest "paid or accrued," we would *still remain unpersuaded that, as a matter of fact and economic reality, it would make sense to do so.* In a word, the court *cannot endorse the conceptual inversion that results when payments in-kind are equated, tax wise, with actual expenditures (and their related deductions).* The former is income—and that only.[132]

Judge Wiese's restricted analysis of the true economic substance or "two-payment" character of in-kind benefit transactions fails to give proper tax treatment to those transactions. With such an analysis, the concept of form-over-substance reigns. Under Judge Wiese's income only approach, taxpayers, knowing that income will be recognized whether they structure their loan as a conventional interest-free loan or as an interest-bearing loan accompanied by a corresponding increase in cash, will almost always opt for the latter two-payment form to receive the benefit of the interest deduction. Since the interest-free loan is, by its nature, a two-payment loan transaction, Judge Wiese's approach would cause tax consequences to truly depend on the form of the transaction and not on its economic substance.

The tax effects of the "two-payment" analysis of the interest-free loan transaction, would, assuming the interest deduction would have been allowed had interest actually been paid,[133] result in a "wash" or no net cost effect to the transaction.[134] Such a result is consistent with the economic reality of the transaction and is supported by valid statutory interpretation.[135] Although this "two-payment" analysis would, in most cases, result in the same "wash" effect of the Tax Court's no income approach in *Dean*, it, unlike *Dean*, is consistent with the separateness of income and deduction concepts in the Internal Revenue

131. *Id.*

132. *Id.* (emphasis added).

133. For discussion of the limitations on the deductibility of interest and the "two-payment" analysis, see *supra* text accompanying note 117.

134. For the illustration of the tax effects of the implied interest deduction, see the effective cost analysis table, *supra* note 30 & 39.

135. *See generally supra* notes 111-16 and accompanying text.

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Code.[136] It would also solve the disparate tax effects caused by *Dean*, particularly with itemized deductions.[137]

IV. Conclusion

Judge Wiese's opinion in *Hardee* bears the important distinction of being the first interest-free loan opinion to properly view the income and deduction issues separately. With this methodology, the *Hardee* opinion does not fall into *Dean's* seductive analysis of permitting a deduction and its resulting tax effects to dictate the realization of income. However, the *Hardee* court's failure to recognize the true economic substance or "two-payment" character of the interest-free loan transaction will produce inequitable tax results with respect to interest deductions. Although an implied interest deduction under the "two-payment" analysis would not be allowed in Mr. Hardee's case, Judge Wiese's analysis would in all cases not allow for such a deduction. As previously demonstrated the allowance of an interest deduction when income is recognized from an interest-free loan is necessary to give effect to the economic substance of the transaction and is supported by valid statutory interpretation, not specifically in conflict with any authority and consistent with the separate nature of income and deduction concepts in the Internal Revenue Code. Such a practice is also strengthened by policy considerations, and buttressed by the essential tax objective of taxing the *substance*, and not the form, of the transaction.

Judge Wiese's opinion bears the equally important distinction of being the first interest-free loan opinion in over twenty years to break from *Dean*. The greater deference given to the policy of *stare decisis* and certainty of the law when a legislative remedy is available seems to support adherence to the *Dean* result, at least until Congress has the opportunity to act. With six circuit courts of appeal firmly committed to *Dean*, it is unlikely a noticeable change will result from Judge Wiese's opinion alone. However, should the newly created Court of Appeals for the Federal Circuit decide to affirm or modify his opinion in a manner inconsistent with the Tax Court, a clear conflict would exist in the courts and the Supreme Court would likely grant certiorari to resolve the issue. A change in the taxation of interest-free loans may also occur when Congress addresses the area of fringe benefits in the beginning of 1984. In the meantime, the proper tax treatment of the interest-free loan transaction will continue to be an unsettled issue.

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136. *See supra* notes 15-17 and accompanying text.

137. *See supra* notes 18-21 and accompanying text.

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