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INCOME TAXATION OF THE ECONOMIC BENEFIT OF INTEREST-FREE LOANS

The use of interest-free loans[1] is prevalent in a wide variety of situations, such as from a parent to a child to enable the child to purchase a new home, from a professional athletic club to a star player as compensation, or from a corporation to its majority shareholder for personal expenses. In all of these situations under present case law,[2] the recipient of an interest-free loan need not include the benefit of the use of the money in his gross income, and thus receives what may be a substantial benefit tax-free. The Internal Revenue Service, however, challenges this result.[3]

The use of funds without an obligation to pay interest clearly confers a valuable economic benefit to the borrower and is likely to increase in popularity in response to the dramatic rise in interest rates.[4] In reaching the conclusion that this benefit should be included in gross income, and thus subject to income tax, this comment analyzes: first, the seminal case of *J. Simpson Dean*,[5] in which the Tax Court held that interest-free loans do not result in a taxable gain to the borrower;[6] second, recent Tax Court decisions that, while declining to overturn the *Dean* rationale, have nonetheless limited its holding; and third, possible adverse tax consequences under current case law arising from the excessive use of interest-free loans. Finally, legislation is proposed that would require taxation of the benefit of an interest-free loan when the loan could be characterized as compensation and included in income as a fringe benefit, or when the loan is between a controlling shareholder and his corporation and results in a distortion of income.

I. *J. Simpson Dean*: When An Economic Benefit Is Not Included In Gross Income

The determination of a taxpayer's gross income forms the basis of

1. This comment's discussion of interest-free loans is equally applicable to low-interest loans.
2. *See* notes 20-26 *infra* and accompanying text.
3. The Commissioner has not issued an acquiescence in the cases discussed in Part II, *infra*, and maintains his position that the leading case in this area, *J. Simpson Dean*, 35 T.C. 1083 (1961), was wrongly decided.
4. *See* Wall St. J., Mar. 19, 1980, at 2, col. 2 (prime rate raised to 19% by several major banks; analysts predict 20% or higher rate possible).
5. 35 T.C. 1083 (1961).
6. *Id.* at 1090.

his tax liability.[7] Gross income is defined broadly in section 61[8] of the Internal Revenue Code as "all income from whatever source derived."[9] The United States Supreme Court has consistently upheld decisions that give an all-inclusive scope to what may be included in gross income and thus subject to income tax.[10] Despite this background of taxing economic benefits received regardless of their form, there has been a judicial reluctance to impose either gift or income tax consequences on the benefit of either making or receiving interest-free loans.[11]

J. Simpson Dean[12] was the first case in which the Tax Court considered whether the benefit received from an interest-free loan should

7. For a comprehensive analysis of the concept of gross income, see Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151 (1964).

8. I.R.C. § 61 corresponds to § 39.22(a) of the 1939 Code. *See* Int. Rev. Code of 1939, ch. 1, § 39.22(a), 53 Stat. 457. The legislative history of § 61 indicates that while its language has been simplified, the new section is as broad as the former. H.R. REP. No. 1337, 83d Cong., 2d Sess. A18 (1954). *See* also S. REP. No. 1622, 83d Cong., 2d Sess. 168 (1954).

Citations to code sections are to the Internal Revenue Code of 1954 unless otherwise noted.

9. I.R.C. § 61(a).

10. In Commissioner v. Smith, 324 U.S. 177 (1945), the benefit derived from the bargain purchase of stock through an employee stock option plan was held to be taxable income. *Id.* at 181-82. In reaching its decision, the Court concluded that § 22(a) of the 1939 Code was "broad enough to include in taxable income *any economic or financial benefit* conferred on the employee as compensation, *whatever the form* or mode by which it is effected." *Id.* at 181 (emphasis added).

In deciding whether money received as exemplary damages in a fraud action or as punitive damages in an antitrust action is gross income, the Supreme Court in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) recognized the "intention of Congress to tax all gains except those specifically exempted," *id.* at 430, and held that money received from the award of punitive or exemplary damages is taxable as income. *Id.* at 430-31.

11. In Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966), the court found that the benefit from parents' interest-free loans to their children was not subject to the gift tax. *Id.* at 77. The court stated that such interest-free loans did not defeat the purpose of the gift tax laws, reasoning that the loans did not reduce the parents' estate because the parents had no obligation to invest their money profitably. *Id.*

More recently, in Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978), *aff'g* 67 T.C. 1060 (1977), a partnership controlled by the taxpayer and his two brothers made loans totaling approximately 18 million dollars to a series of 24 trusts established for the partners' children and other relatives. The court held that the making of an interest-free loan repayable on demand was not a transfer of property within the meaning of the gift tax statute because the borrower had no legally protected right against the lender and the borrower's use of the money was not an interest with an exchangeable value in that it could be recalled at any time. *Id.* at 239-40. The court indicated that a different result could occur if the loans were for a fixed term and the foregone interest could be readily ascertained. *Id.* at 241.

For a further analysis of the gift tax aspects of inter-family interest-free loans, see Edwards, *Tax Planning Possibilities of* Crown, 50 J. TAX. 168 (1979); Note, *Interest-Free Loans and the Gift Tax:* Crown v. Commissioner, 38 OHIO ST. L.J. 903 (1977); Comment, *Gift Taxation of Interest-Free Loans*, 19 STAN. L. REV. 870 (1967).

12. 35 T.C. 1083 (1961).

be taxed as income. During a two year period, Dean and his wife received in excess of two million dollars in interest-free loans from the Nemours Corporation, of which they were virtually the sole shareholders. The Commissioner contended that the Deans realized a taxable economic benefit from these loans, equal to the interest they would have paid had they borrowed the money in an arms-length transaction.[13] This contention was premised upon an analogy to several cases in which courts had held that a stockholder's rent-free use of corporate property may result in a taxable benefit.[14] The Tax Court rejected this analogy and distinguished the situations by noting that had the user of rent-free corporate property rented the property instead, his expense in so doing would not have been deductible. On the other hand, had the stockholder borrowed the money in an arms-length transaction, his interest payments would have been deductible.[15] Thus, under the court's reasoning, the determination of whether an economic benefit should be included in gross income is dependent upon the availability of a deduction offsetting the benefit received.

The Commissioner did not appeal the *Dean* decision. Although commentators have criticized *Dean*'s holding as being overbroad,[16] little judicial discussion regarding the tax consequences of interest-free loans followed after *Dean* was decided.[17] Relying on *Dean*, tax planners utilized interest-free loans to transfer economic benefits without a corresponding recognition of income on the transfer. It was not until twelve years later, in 1973, that the Commissioner issued a non-acquiescence to *Dean*,[18] thereby giving notice of its intention to challenge the case's holding. Accordingly, cases involving interest-free loans are now coming before the Tax Court, and in a series of opinions the court has

13. *Id.* at 1087.

14. *Id.* at 1089. *E.g.*, Dean v. Commissioner, 187 F.2d 1019 (3d Cir. 1951) (rental value of corporation's house included as part of stockholder's gross income); Rodgers Dairy Co., 14 T.C. 66 (1950) (rental value of corporation's automobile included as part of stockholder's gross income); Paulina DuPont Dean, 9 T.C. 256 (1947) (rental value of corporation's house included as part of stockholder's gross income).

15. *Id.*

16. *See* authorities listed in Herman M. Greenspun, 72 T.C. 931, 948 n.19 (1979).

17. Prior to the four cases discussed in Part II *infra*, the Tax Court most recently considered the tax implications of interest-free loans to majority shareholders in Albert Suttle, 37 T.C.M. (CCH) 1638 (1978). In *Suttle*, the owner of an automobile dealership over a 35 year period borrowed money interest-free from the dealership. When the Commissioner attempted to increase the taxpayer's income by an amount measured by the prime interest rate, the Tax Court summarily followed *Dean* and excluded this amount from gross income. *Id.* at 1639.

18. 1973-2 C.B. 4.

reconsidered and narrowed its decision in *Dean*.[19]

II. Recent Tax Court Decisions Focus on the Issues

The Tax Court has recently rendered decisions evidencing its concern for the potential abuse of interest-free loans. In *Herman M. Greenspun*,[20] Howard Hughes gave low-interest loans to a Las Vegas newspaper publisher in return for favorable press coverage.[21] In the most recent case, *Charles E. Marsh II*,[22] an interest-free loan was given as consideration for part of a purchase agreement for an oil and gas contract.[23] Both *Max Zager*[24] and *Joseph Creel*[25] involved the classic *Dean* situation in which controlling shareholders obtained interest-free loans from their corporations.[26]

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19. Charles E. Marsh II, 73 T.C. 317 (1979); Joseph Creel, 72 T.C. 1173 (1979); Max Zager, 72 T.C. 1009 (1979); Herman M. Greenspun, 72 T.C. 931 (1979).

20. 72 T.C. 931 (1979). Judge Fay wrote the majority opinion. Judges Dawson and Goffe filed concurring opinions. Judge Nims dissented.

21. The loans amounted to four million dollars at an interest rate of 3% per annum for an eight year term. The term was later extended to 35 years. The court held that granting the loan at a preferential interest rate represented consideration given by Hughes in exchange for favorable press coverage from Greenspun. *Id.* at 943. In accordance with *Dean*, the court held that the petitioner realized no taxable income from the receipt of the loan. *Id.* at 945. The court recognized that not all interest is deductible and limited its endorsement of *Dean* to only those situations in which there is an offsetting interest deduction. *Id.* at 950.

22. 73 T.C. 317 (1979).

23. In *Marsh* the petitioners, who owned oil and gas leases and had completed successful test drilling, needed funds to finance construction of a treatment facility and to drill wells. When they were unable to obtain financing, they entered into a purchase agreement with a public utility company that provided the necessary funds. The purchase contract provided that the gas company would buy all gas produced at set prices for 20 years. Simultaneously, the gas company agreed to loan petitioners up to 12.8 million dollars, advanced in installments, to enable the necessary construction to take place. The loan was to be repaid without interest in 54 monthly installments starting six months after deliveries of gas began. If the purchase agreement were terminated, petitioners agreed to repay the loan in 36 monthly installments with interest added at the prime commercial rate.

The Commissioner argued that petitioners clearly received an economic benefit that was includable in gross income. However, the court noted the similarity to the factual situation in *Greenspun*, in which an interest-free loan was given to a party unrelated to the lender as additional consideration for entering into a commercial transaction, and the *Marsh* court reached its decision in an attempt to create tax parity. *Id.* at 326. The court, however, did not merely reaffirm *Dean*; it supported *Dean*'s holding with three new arguments: (1) although the owner of capital is entitled to demand interest, he does not have to invest his capital in an income-producing activity; (2) in a business transaction arrived at by arms-length bargaining between unrelated parties, tax implications should be determined from the parties' agreement; and (3) an economic benefit is not considered income until it is realized. *Id.* at 327-28.

24. 72 T.C. 1009 (1979).

25. 72 T.C. 1173 (1979).

26. In Max Zager, 72 T.C. 1009 (1979), Judge Raum, writing for the court, followed *Dean* and held that the dominant stockholders of a corporation did not realize income when

While all four cases followed *Dean*, the court seemed uncomfortable endorsing a loophole that avoids the taxation of the receipt of an economic benefit. When reconsidering its decision in *Dean*, the Tax Court faces the following questions that must be resolved in order to reach a fair solution to the problem of taxing interest-free loans: (1) Does the recipient of an interest-free loan realize an economic benefit? (2) If the economic benefit of an interest-free loan is included in gross income, should the taxpayer be allowed an offsetting interest deduction? (3) If the recipient of an interest-free loan is deemed to have received interest income and may deduct that interest, should the fiction be extended to impute interest income to the lending corporation? (4) What value should be placed on the benefit received from the interest-free loan, and when does the recipient of the loan receive that benefit?

A. The Economic Benefit Realized from Interest-Free Loans

When attempting to assign income to the recipient of an interest-free loan, the Commissioner has consistently argued that the economic benefit derived from the free use of money is the same as that derived from the rent-free use of other corporate assets, such as a house or a boat, which benefits have been held to be includable in gross income.[27] Judge Fay, writing for the majority in *Greenspun*, conceded that the "use of funds absent a corresponding obligation to pay interest, or to

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receiving interest-free corporate loans. Relying on the strong policy of stare decisis, the court overturned the Commissioner's determination that the economic benefit of the free use of $88,988.30 in corporate funds should be measured by the prime rate charged by area banks and taxed accordingly. *Id.* at 1014. In Joseph Creel, 72 T.C. 1173 (1979), the taxpayers were the sole shareholders, officers and salaried employees of three corporations. Petitioner Creel borrowed funds to pay personal obligations through open accounts, with monthly balances in 1973 and 1974 ranging from $158,312 to $81,538. Petitioner Parkinson also borrowed extensively from the three corporations, with balances ranging from a high of $119,974 to a low of $28,377. Neither petitioner paid interest for the use of these funds. Judge Sterrett, writing for the court, recognized that there would have been an offsetting interest deduction had petitioners procured interest-bearing loans. The court therefore refused to hold that "the mere loan of money interest free creates income to the borrower. . . ." *Id.* at 1179. The court, however, noted that during the same period that petitioners received their loans, one of the lending corporations owed third-party creditors large sums of money that were personally guaranteed by the petitioners. The court concluded that the corporation was in effect borrowing funds and paying interest as petitioners' agent. *Id.* The court held that to the extent the corporation borrowed money and paid interest on petitioners' behalf, petitioners received dividend income and were deemed to have paid interest. *Id.* at 1180.

27. *See* International Artists, Ltd., 55 T.C. 94 (1970) (rent-free use of corporate house); Challenge Mfg. Co., 37 T.C. 650 (1962) (rent-free use of corporate boat); Rodgers Dairy Co., 14 T.C. 66 (1950) (rent-free use of corporate automobile).

pay interest only at a preferential rate, . . . constitutes as valuable an economic benefit as would any rent-free use of a residence, automobile, or boat."[28]

A recent decision by the Seventh Circuit, *Mason v. United States*,[29] supports the view that an interest-free loan gives rise to a taxable benefit. In *Mason* the taxpayer sold property at its fair market value to a charity. The charity paid a small amount of cash and executed a long term promissory note for the balance. The interest on the note was set at a low rate, causing the fair market value of the note to be substantially lower than its face amount. The court held that the taxpayer had made a tax deductible gift of the value of the interest that the taxpayer had foregone, measured by the difference between the fair market value of the property sold and the fair market value of the note and cash received.[30]

However, in *Marsh*,[31] the court was not willing to concede that the petitioners had received an economic benefit includable in gross income when they received an interest-free loan of 12.8 million dollars, and stated that "[a]n economic benefit is not usually considered income until it is *realized*."[32] The opinion passed quickly over leading cases that have interpreted gross income to mean all benefits received regardless of form, unless specifically excluded,[33] and instead focused on the realization of the benefit. The court concluded that "[h]ere there is no gain resulting from an exchange of property, payment of indebtedness, relief from liability, or other profit realized from the completion of a transaction."[34]

While affirming *Dean*, the court seemed to recognize the potential weakness in its rationale. After noting that the case may be appealed,[35] the court attempted to base its position on more fundamental arguments.[36] While *Crown v. Commissioner*[37] was not cited, the court's analysis rested heavily on the underlying assumption of that case that a person is not required to use his capital in any income-producing activity.[38] However, this argument is more persuasive when an interest-free

28. 72 T.C. at 947.
29. 513 F.2d 25 (7th Cir. 1975).
30. *Id.* at 30.
31. 73 T.C. 317 (1979).
32. *Id.* at 328 (emphasis added).
33. *See* note 10 *supra.*
34. 73 T.C. at 328.
35. *Id.* at 327.
36. *See* note 23 *supra.*
37. 585 F.2d 234 (7th Cir. 1978), *aff'g* 67 T.C. 1060 (1977).
38. *See* note 11 *supra.*

loan is made as a gift within a family than in a business transaction conducted for profit.

B. The Offsetting Interest Deduction

While the court in *Greenspun* recognized that there is an economic benefit accruing to the recipient of an interest-free loan, it reaffirmed the *Dean* rationale, noting that if the taxpayer had paid interest, he would have had an offsetting interest deduction.[39] The majority reached this result by concluding that an interest-free loan from a corporation to an employee or shareholder is economically speaking no different than the making of a loan on which interest is charged accompanied by an increase in compensation or dividends.[40] Thus, the court justified its conclusion as an attempt to make the tax results for the taxpayer who receives an interest-free loan the same as for the taxpayer who borrows funds in an arms-length transaction, receives additional compensation to cover his expenses and then deducts that interest.[41]

However, when trying to equalize the tax results for the person who receives extra compensation and then is given a deduction for the interest paid, the court may have been focusing on the wrong comparison. In fact, an inequity remains when the tax results for one who receives an interest-free loan are compared with the results for one who must borrow that money in an arms-length transaction.[42]

The majority in *Greenspun*, while resting its decision on an attempt

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39. 72 T.C. at 947.

40. For a discussion of this "two payment transaction," see Keller, *The Tax Consequences of Interest-Free Loans from Corporations to Shareholders and from Employers to Employees*, 19 B.C.L. REV. 231 (1978) [hereinafter cited as Keller].

41. 72 T.C. at 948. The court provided the following example:

> To illustrate this point, assume 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.

42. For example, if A, a cash-basis taxpayer in the 40% tax bracket, borrows $1,000 at 10% for one year, he will pay $100 in interest charges. A will save $40 on his tax bill because of the $100 deduction for interest expense. Therefore, the net cost of the loan to A is $60. If, on the other hand, B borrows $1,000 from his employer at no interest, he will incur no expense under the *Dean* rule. The net benefit of the interest-free loan is $60. In order to place taxpayer A and B in equal positions, the $60 net benefit should be included as income to B.

to achieve tax parity, noted a potential for disparate tax treatment arising because certain calculations for deductions are limited by their relationship to a percentage of the taxpayer's gross income.[43] Under section 213,[44] a taxpayer may deduct medical expenses that exceed three percent of his gross income. Under section 170,[45] charitable deductions cannot exceed a certain percentage of the taxpayer's gross income. The person who receives an interest-free loan without it being reflected in his gross income benefits by having the threshold before which he may take medical deductions lowered. On the other hand, this lower gross income results in a lower maximum charitable deduction. Thus, even in the *Dean* type of situation in which an offsetting interest deduction results in a "wash" in terms of the tax on income, the exclusion of the benefit of the interest-free loan distorts the taxpayer's gross income that forms the basis for other tax calculations.

The court in *Greenspun* cited with approval Judge Opper's concurring opinion and Judge Bruce's dissenting opinion in *Dean*, both of which noted that the statement that "an interest free loan results in no taxable gain to the borrower"[46] is much too broad a generalization because in certain situations interest is not deductible under section 163.[47] Thus, the holding in *Greenspun* is limited to only those situations in which there would be a deduction if interest were paid.[48]

The court further stated in *Greenspun* that if the taxpayer were charged with gross income, he could be entitled to an offsetting deduction under section 163(a), depending on the facts.[49] In reaching the conclusion that an offsetting interest deduction may be appropriate, the court drew an analogy to Revenue Ruling 73-13,[50] which involved an executive who had been provided personal financial advice by his employer. In that ruling, the Service concluded that the executive had received income, to be measured by the value of the professional serv-

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43. 72 T.C. at 949.
44. I.R.C. § 213.
45. I.R.C. § 170.
46. 35 T.C. at 1090-92.
47. Under I.R.C. § 265(2), no deduction is allowed for interest paid on an indebtedness "incurred . . . to purchase or carry obligations the interest on which is wholly exempt from . . . taxes . . . ." I.R.C. § 163(d) limits the amount of interest that is deductible on an indebtedness incurred to purchase property held for investment. I.R.C. § 264(a)(2) denies a deduction for interest paid on an indebtedness used to purchase a single-premium life insurance, endowment, or annuity contract. I.R.C. § 267(a)(2) disallows a deduction for interest paid in certain instances to related taxpayers. In addition, interest deductions are generally not available to a person who chooses not to itemize his deductions.
48. 72 T.C. at 950.
49. *Id.* at 952 (dictum).
50. 1973-1 C.B. 42.

ices received, offset by a deduction under section 212.[51]

It is not clear, however, that the recipient of an interest-free loan should be entitled to an interest deduction for interest that he has not in fact paid. Section 163 allows an interest deduction for "all interest *paid* or *accrued* within the taxable year on indebtedness."[52] The decision in *D. Loveman & Son Export Corp.*[53] supports the position that interest cannot be deducted when it has not in fact been paid.[54] In that case, the court was faced with the issue of whether an interest-free loan could be converted into an interest-bearing loan at a later date by the payment of interest and the taking of an interest deduction. The court held that it could not, and followed the "general rule—that interest may not be accrued where there is no obligation to pay interest. . . ."[55]

C. *Extending the Fiction: Imputing Interest Income to the Corporation*

If the borrower is deemed to have paid interest to the lending corporation when he receives an interest-free loan, then a logical extension of this fiction seems to be that the corporation has received interest income.[56] Judge Goffe, concurring in *Greenspun*, recognized the possibility of this imputing of interest income and concluded that such a change should come from legislative rather than judicial action.[57] There is no precedent for imputing interest income to a corporation that lends money interest free.[58] In cases in which a corporation transferred the rent-free use of property to a stockholder, the stockholder

51. I.R.C. § 212 allows a deduction for all ordinary and necessary expenses paid or incurred for the production of income.

52. I.R.C. § 163(a) (emphasis added). *See* O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. L. REV. 1085, 1096 (1974); Sneed, *Unlabeled Income and Section 483*, 17 MAJOR TAX PLAN. 643, 651-53 (1965).

53. 34 T.C. 776 (1960).

54. *See also* Howell Turpentine Co., 6 T.C. 364 (1946), *rev'd on other grounds*, 162 F.2d 516 (5th Cir. 1947).

55. 34 T.C. at 805-06.

56. *See* Keller, *supra* note 40, at 244-50. Keller comments that the result of using a two payment transaction is that a tax is imposed on the corporate lender. Thus, when a corporation pays a shareholder a dividend, and the shareholder pays the corporation interest, the net result is that the shareholder has increased income and an offsetting deduction, while the corporation has interest income with no offsetting deduction for dividends paid.

57. 72 T.C. at 955-56. One should note that adding interest income to the corporation's income may cause it to lose its status as a small business corporation or change its categorization to that of a personal holding company. 72 T.C. at 954. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF SHAREHOLDERS & CORPORATIONS ¶ 8.20 (4th ed. 1979) (personal holding companies) and ¶ 6.01 (Subchapter S corporations) [hereinafter cited as BITTKER & EUSTICE].

58. The court in *Dean* held that interest-free loans result in no interest income to the

was deemed to have additional compensation; however, the rental value of the property was not included as additional income to the corporation.[59]

D. Valuation Problems and the Timing of the Benefit

When valuing the benefit of the low-interest loan that the taxpayer received in *Greenspun*, the Commissioner asserted that the taxpayer realized the total economic benefit for the entire eight-year term of the loan in the year in which the loan was granted.[60] Thus, the Commissioner argued that in 1967 when Greenspun received four million dollars at four percent interest, his income was increased by $701,211 for that year, and in 1969 when the term of the loan was extended to thirty-five years, his income was increased by $1,536,156.[61] This analysis was rejected by the Tax Court, which declared that "any economic benefit which may flow from the favorable interest rate is realized ratably over the term of the loan."[62] The court decided that if the recipient of a low-interest loan were to sell his right to a third party, the sum realized would be subject to full taxation in the year of the sale; however, this is not the usual situation in which an interest charge for the use of money can be allocated to the appropriate years over the term of the loan.[63]

III. TAXING THE BENEFIT OF INTEREST-FREE LOANS UNDER CURRENT CASE LAW

While the Tax Court has consistently followed its decision in *Dean*, it has also suggested that in certain circumstances it might reach a different result. Practitioners seeking to make use of interest-free loans in tax planning should consider the following adverse tax consequences that may arise from the excessive use of interest-free loans: (1) the interest-free loan may be re-characterized as a constructive divi-

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lender. 35 T.C. at 1090 (citing Society Brand Clothers, Inc., 18 T.C. 304 (1962); Brandtjen & Kluge, Inc., 34 T.C. 416 (1960); and Combs Lumber Co., 41 B.T.A. 339 (1940)).

59. *See* Reynard Corp., 37 B.T.A. 552 (1938).

60. 72 T.C. at 950.

61. *Id.*

62. *Id.* at 951.

63. The timing problem also arises in the area of prepaid interest. *See* Andrew A. Sandor, 62 T.C. 469 (1974), *aff'd per curium*, 536 F.2d 874 (9th Cir. 1976), in which a cash basis taxpayer borrowed $100,000 from a bank on a note payable on demand or, if no demand was made, at five years after the date made at 7½% interest. The taxpayer prepaid in one year the entire interest due for the five year term in the amount of $38,041.61 and attempted to deduct the entire sum. The Tax Court disallowed the deduction under § 446, holding that the deduction would have materially distorted the taxpayer's taxable income because the deduction represented approximately 18% of his income for the year.

dend; (2) the corporation may be assessed an accumulated earnings tax; (3) if an offsetting deduction is not allowed under section 163, the benefit of the interest-free loan may be included in gross income; and (4) if the corporation that lends money interest free has large outstanding debts itself, the corporation may be found to be acting as the shareholder's agent in obtaining loans and paying interest, and the benefit of the loan may be considered dividend income to the shareholder.

First, in making excessive use of interest-free loans, the corporation runs the risk of the whole amount of the loan being found to be a constructive dividend.[64] *Dolese v. United States*[65] may indicate a new willingness by the courts to find adverse tax consequences for interest-free loans.[66] Other courts generally have been liberal when shareholders borrow from a controlled corporation and these courts have tolerated shareholders channeling some personal transactions through the corporation. The court in *Dolese*, however, stated:

> [W]hereas withdrawal of reasonable amounts are countenanced as a loan if other loan factors are present, excessive and continuous diversion of corporate funds into the controlling shareholder's pocket takes on a different character. There is a principle of too much; phrased colloquially, when a pig becomes a hog it is slaughtered.[67]

Accordingly, the court held that the entire amount of the interest-free loan was a constructive dividend and was includable in gross income.[68]

Second, if a corporation makes large loans, it may red-flag itself as a likely candidate for the imposition of the accumulated earnings tax,[69] which is imposed on a corporation that accumulates earnings and profits beyond the reasonable needs of the business to avoid income tax.

Third, the *Greenspun* decision specifically limits its holding of no taxable income to situations in which there would be an offsetting deduction allowable if interest were paid.[70] However, in cases in which the imputed interest would not produce an offsetting deduction, such as when the loaned money is used by the taxpayer to purchase tax-exempt

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64. *Cf.* Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862 (3d Cir. 1974).

65. 605 F.2d 1146 (10th Cir. 1979).

66. In *Dolese*, a taxpayer took advances in the form of interest-free loans for personal living expenses in the amount of $1,817,133 over a period of 16 years. While the taxpayer's gross income was $125,000 annually, the court noted that interest on the outstanding loan would be $72,000 a year (figured at a modest 4%). *Id.* at 1153.

67. *Id.* at 1154.

68. *Id.*

69. I.R.C. §§ 531-537. *See* BITTKER & EUSTICE, *supra* note 57, at ¶ 8.01.

70. 72 T.C. at 950.

bonds, single premium life insurance, an annuity contract, or property held for investment,[71] the benefit received from the free use of money may be included in gross income.

Finally, if the corporation that makes loans to its shareholders is itself heavily indebted to third-party creditors, the court may look to the substance of the transaction and conclude that the corporation was borrowing money and paying interest as the shareholder's agent. In *Creel*, a case involving shareholders who received interest-free loans from their wholly-owned corporations, the court distinguished the loans made by one corporation when that corporation owed large amounts of money to third party creditors and the debt was personally guaranteed by the shareholders.[72] The shareholders were deemed to have received dividend income and paid interest to the extent that the indebted corporation made such interest payments on behalf of the shareholders.[73] While the court found no net tax result from this dividend income,[74] the decision still evidences the court's willingness to look through the form of the interest-free loan transaction and conclude that the shareholder received dividend income when he received an interest-free loan.

IV. A LEGISLATIVE PROPOSAL

While courts may begin to scrutinize interest-free loans under the analysis discussed above, it is unlikely that *Dean* will be specifically overruled. The Tax Court has consistently maintained its position that an interest-free loan results in no income tax consequences on the basis of a policy determination to follow a 60-year span of judicial precedent.[75] Several opinions have recently suggested that if a change is

71. *See* note 47 *supra*.

72. 72 T.C. at 1179. On December 31, 1973, Gulf Paving, Inc. owed $748,487 to creditors and had outstanding loans to its shareholders of $86,284. On December 31, 1974, Gulf Paving, Inc. owed $826,418 to creditors and had outstanding loans to its shareholders of $51,136. *Id.* at 1175-77.

73. *Id.* at 1180.

74. *Id.*

75. The interest-free loan used in *Dean* reflected a practice that had been unchallenged from the beginning of our modern income tax law in 1913 to 1961 when the question was first raised as an "afterthought." The issue of taxing the benefit from the interest-free loan as income was not raised in the original deficiency. It was raised in an amended answer and appeared to be in response to a memorandum opinion of the Tax Court involving the same taxpayers. The court stated: "Viewed realistically, the lending of over two million dollars to petitioners without interest might be looked upon as a means of passing on earnings (certainly potential earnings) of Nemours in lieu of dividends, to the extent of a reasonable interest on such loans . . . ." Pauline DuPont Dean, 19 T.C.M. (CCH) 281, 288 (1960). Indeed, even after the adverse decision in *Dean*, the Government did not appeal the result,

necessary it should come from Congress rather than through unnecessarily broad judicial interpretation.[76]

When formulating a legislative proposal to determine the income tax consequences of an interest-free loan to the recipient, an appropriate starting point is to examine the relationship between the lender and the borrower. An interest-free loan from one family member to another will not be a taxable event for the recipient because of the exclusion of gifts from income tax.[77] However, the donor may be subject to gift tax on the value of the use of the money when the loan is for a fixed term.[78] Outside the family context, where receipt of an interest-free loan cannot usually be classified as a gift,[79] the benefit derived from the use of the interest-free loan should be subject to taxation as income. This comment suggests two legislative proposals that focus on the relationship of the lender and the borrower. First, section 482 should be extended to individuals who are found to "control" their corporations to cover shareholders who receive loans from their corporations and use such loans to distort their income. Second, the receipt of compensation in the form of a loan from an employer to an employee should be taxed under the criteria established for taxing fringe benefits.

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and it was not until 1973 that the Commissioner announced his non-acquiescence. 1973-2 C.B. 4.

76. Given the long-standing precedent of *Dean*, Judge Raum, writing for the court in *Max Zager*, concluded that if a change is necessary it should be accomplished by the legislature rather than the judiciary. 72 T.C. at 1014.

This call for a legislative solution was echoed in Judge Goffe's concurring opinion in *Greenspun*, in which he found support from Justice Powell's opinion in United States v. Byrum:

> 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.

72 T.C. at 955-56 (quoting United States v. Byrum, 408 U.S. 125, 135 (1972)).

77. I.R.C. § 102(a) provides: "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

78. *See* Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978) (taxpayer who loaned money to family members as demand notes, in interest-free loans and payable accounts, not required to include the value of foregone interest in taxable gift computation). *See* note 11 *supra*.

79. *See* Commissioner v. Duberstein, 363 U.S. 278, 285 (1960) (characterization of gift as motivated by "detached and disinterested generosity").

A. The Controlling Shareholder: Reallocation of Income and Deductions under Section 482

Almost from the inception of our modern tax system, Congress has recognized the potential problems created by interest-free loans and has attempted to prevent related taxpayers from reducing their combined taxes by arbitrarily shifting elements affecting taxes among themselves.[80] Section 482 authorizes the Commissioner to allocate gross income and deductions among two or more commonly owned or controlled entities if such allocation is necessary either to prevent an evasion of taxes or to reflect income clearly.[81] Thus, the use of section 482 has three conditions: (1) the taxpayer entities must be organizations, trades, or businesses; (2) the operation of these entities must be controlled by the same interests; and (3) the reallocation must be necessary to prevent tax evasion or to reflect income accurately.[82]

While it is clear that by its terms, section 482 is not generally applicable to dealings between a corporation and an individual shareholder, some courts have been willing to stretch its language to reach the individual, when the section's purposes would thereby be served.[83] However, the better approach would be for the legislature to expand the scope of section 482 to reach individuals by its terms.

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80. The forerunner of I.R.C. § 482 was § 240(d) of the Revenue Act of 1921, which authorized the Commissioner to consolidate the accounts of related trades or businesses in order to accurately reflect their income. I.R.C. § 482 is substantially the same as § 45 of the Internal Revenue Code of 1939.

For a brief legislative history of § 482, see Hewitt, *Section 482—Allocation of Income and Deductions Among Related Taxpayers*, 20 N.Y.U. INST. FED. TAX 463 (1962).

81. I.R.C. § 482 states:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

82. *Id.*

83. In Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), a professional entertainer was the sole owner of a corporation that conducted a poultry business at a loss. He contracted with the corporation to perform entertainment services for five years at a salary of $50,000 per year. In this manner, the corporation offset the poultry losses against the high entertainment profits. The Tax Court upheld under section 482 the allocation to the entertainer of a portion of compensation received by the corporation for entertainment services performed by Borge. The Second Circuit affirmed, holding that for purposes of I.R.C. § 482, Borge controlled two businesses, an entertainment business and a poultry business, and the income of Borge's two businesses had been distorted when "the sole purpose of the arrangement was to permit [the corporation] to offset losses from the poultry business with income from the entertainment business." *Id.* at 677.

If the Commissioner may allocate income to individuals as well as organizations, trades, or businesses under section 482, two critical issues that arise in each situation are whether interest-free loans have been used to distort income and avoid taxation, and whether the individual shareholder who receives such a loan has a controlling interest in a corporation. When the shareholder has a controlling interest, he can manipulate funds to divert the interest-free use of money to his personal use. If this interest-free loan distorts the income of the individual shareholder *or* evades taxes, the rationale of section 482 requires a reallocation of this interest as income.[84] The criterion for determining sufficient control by a shareholder to satisfy the section has been left intentionally vague to allow the Commissioner greater flexibility of administration;[85] however, a majority shareholder who receives an interest-free loan would certainly be found to have sufficient control of that corporation.

While the Tax Court has attempted to limit the scope of section 482, circuits that have considered the issue have supported the Commissioner's broad power to allocate income as long as correlative adjustments are made.[86] However, it must be noted that the imposition of

84. The legislative history indicates that Congress passed § 482 in order to prevent the tax evasions that occurred by shifting profits, making fictitious sales or using other methods frequently adopted for "milking." S. REP. No. 960, 70th Cong., 1st Sess. 24 (1928).

85. *See* Plumb & Kapp, *Reallocation of Income and Deductions under § 482*, 41 TAXES 809, 811 (1963).

86. While any detailed analysis of § 482 is beyond the scope of this article, it is helpful to note how the courts have dealt with the problem of imputing interest among commonly controlled corporations. Early attempts at allocating income under § 482 were frustrated because courts narrowly construed the section's application. In Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940), one corporation allowed a related corporation to use equipment rent-free. The Commissioner increased the income of the corporation whose equipment had been used by the amount of rent it would have received in an arms-length agreement, but did not reduce the other corporation's income by the amount of rent that would have been paid. The Sixth Circuit held that the Commissioner had exceeded his authority under § 482, and "set up income where none existed." *Id.* at 510. *See also* Smith-Bridgman & Co., 16 T.C. 287 (1951), *acq.* 1951-1 C.B. 3.

In B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972), two competing department stores set up a third corporation for the purpose of building a shopping mall to connect the two stores. Each store owned 50% of the stock of the "mall" corporation, and each made a loan of one million dollars to the controlled corporation interest-free. Pursuant to § 482, the Commissioner increased the income of each store by five percent to reflect interest income. The Tax Court disallowed the application of § 482, based on a determination that neither corporation had control of the third corporation. *Id.* at 1150. The Second Circuit reversed, holding that § 482 should be broadly construed and that interest should be imputed in order to comport with "economic reality." *Id.* at 1156. Responding to the reasoning in *Tennessee-Arkansas Gravel* and a number of other cases, the court stated: "Those cases may be correct from a pure accounting standpoint. Nevertheless, interest income may be added to taxpayers' incomes, as long as correlative adjustment is

the effects of section 482 may be a severe sanction and the Commissioner's power should be narrowly drawn to permit such action only in those situations in which it is clear that such an allocation is necessary to prevent evasion of taxes or to reflect income clearly.

B. Employee Compensation: Taxing the Interest-Free Loan as a Fringe Benefit

The taxation of the benefit of an interest-free loan given to an employee[87] should be governed by the criteria set forth for the taxation of other fringe benefits. Congress is currently reviewing the tax treatment of fringe benefits,[88] and it is appropriate that Congress review the treatment of interest-free loans as fringe benefits at the same time. On February 15, 1979, the Task Force on Employee Fringe Benefits of the House Ways and Means Committee submitted its discussion draft bill and report.[89] The Task Force emphasized general concepts and issues

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made to . . . [the recipient of the loan], for then the true taxable income of all involved will be properly reflected." *Id.*

In Latham Park Manor, Inc., 69 T.C. 199 (1977), the Tax Court reconsidered its earlier position that interest income may not be allocated to the lending corporation when the borrowed funds do not generate income. *See* Kerry Investment Co., 58 T.C. 479 (1972), *aff'd in part & rev'd in part*, 500 F.2d 108 (9th Cir. 1974); Kahler Corp., 58 T.C. 496 (1972), *rev'd*, 486 F.2d 1 (8th Cir. 1973). In *Latham*, two subsidiaries borrowed 2.1 million dollars from a third party at 10% per annum, and then made interest-free loans to the parent corporation totaling $625,982.64. These loans were used primarily by the parent corporation to resolve a legal suit and were not used to generate income. In holding that § 482 permits the allocation of interest income even though the parent corporation did not use the loan to produce income, the Tax Court found Treas. Regs. §§ 1.482-1(d)(4) and 1.482-2(a)(1) (1968) to be controlling. *Id.* at 215-16. Thus, these recent decisions indicate a broader application of § 482 by the Tax Court.

87. Whenever an interest-free loan is determined to have been given as compensation, even if no formal employer-employee relationship exists, the benefit of that loan should be taxed as a fringe benefit. Under this reasoning, the benefit of the loan given in *Greenspun* would be taxed as a fringe benefit, since it was determined to have been given as compensation.

88. In 1975, the Treasury Department issued a discussion draft of proposed regulations for the tax treatment of fringe benefits. Opponents to the draft argued that the policy regarding fringe benefits was of such long standing duration that it had achieved the force of law, and any policy changes should be made instead by the Legislature. The discussion draft was withdrawn on December 28, 1976. In 1977, Congress began considering the taxation of fringe benefits. A bill was passed that prevented the issuance of new regulations relating to fringe benefits prior to July 1, 1978. This date has been extended twice, and current law prohibits the promulgation of fringe benefit regulations before June 1, 1981. Act of Dec. 28, 1979, PUB. L. No. 96-167, § 1, 93 Stat. 1275 (1979).

For a general discussion of fringe benefits and the discussion draft of treasury regulations that was withdrawn, see Warble, *Taxation of Fringe Benefits and Perquisites*, 36 N.Y.U. INST. FED. TAX 693 (1978); Comment, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141 (1976).

89. TASK FORCE ON EMPLOYEE FRINGE BENEFITS, HOUSE WAYS & MEANS COMM.,

rather than attempting to prescribe the tax treatment for every specific type of fringe benefit. The discussion draft bill provides five alternative tests by which a fringe benefit may be excluded from gross income: (1) a general guidelines test, (2) a convenience-of-the-employer test,[90] (3) a de minimus test, (4) any other existing statutory provision applicable to fringe benefits, or (5) future regulations prescribed by the Secretary of the Treasury.[91]

It is doubtful that interest-free loans would be excludable from gross income under any of the tests outlined in the discussion draft bill, except that very small loans could be excludable under the de minimus test. Under the general guidelines test, the benefit would have to be made available to employees generally, provided at no incremental cost to the employer, *and* the benefit could not be substantial in either absolute terms or in comparison to the employee's total compensation.[92] The interest-free loan that is typically made to the high-level executive seems to be exactly the type of exclusive benefit that the bill is aimed at taxing.[93]

While the Treasury would be given authority to promulgate new regulations that provide tax exempt status for fringe benefits consistent with the purposes of this bill,[94] it seems likely that interest-free loans would not fall in the category of socially desirable benefits exempted from taxation under existing statutory provisions, such as qualified pension plans, group term life insurance, or medical benefits,[95] scholarships,[96] and group legal services.[97] Therefore, the benefit of the interest-free loan given to an employee as a fringe benefit should be includable in his gross income as compensation and subject to taxation.

96TH CONG., 1ST SESS., DISCUSSION DRAFT BILL & REPORT ON EMPLOYEE FRINGE BENEFITS (Comm. Print 1979), *reprinted in* [1979] STAND. FED. TAX. REP. (CCH) ¶ 6156.

90. The convenience-of-the-employer test would not be appropriate for excluding the benefit of interest-free loans. This exclusion is for a benefit which is made available primarily for the purpose of facilitating the employee's performance of services for the employer, and may include such benefits as office equipment, secretarial support, and a company car used strictly for business. *Id.* at 9-10.

91. *Id.* at 15-18.

92. *Id.*

93. While no direct reference is made to interest-free loans, it should be noted that in its conclusion, the report notes that transitional relief should be considered when there has been a reasonable reliance upon favorable decisions or rulings. *Id.* at 14.

94. *Id.* at 11.

95. I.R.C. § 106.

96. *Id.* § 117.

97. *Id.* § 120.

V. CONCLUSION

Recent case law has indicated that the Tax Court is unwilling to move quickly to change the favorable tax treatment given to interest-free loans. There is, however, a growing concern within the judiciary when excessively large loans escape taxation, as evidenced by Justice Van Pelt's dissenting opinion in *Crown v. Commissioner*,[98] in which no gift tax consequences were applied to an 18 million dollar interest-free loan. Justice Van Pelt concluded simply that it "just ain't right."[99] To correct the inequity created when large interest-free loans transfer the beneficial use of money without taxation, Congress should specifically include such loans when it acts on fringe benefits. Moreover, Congress should expand section 482 to bring individuals within its coverage, and thus allow the Commissioner to allocate income and deductions between an individual shareholder and his controlled corporation when such loans create a distortion of income or are used to evade taxes.

Jan Elizabeth Eakins

98. 585 F.2d 234, 241 (7th Cir. 1978).
99. *Id.* at 242.