# RECENT DEVELOPMENTS

FEDERAL TAX LAW—TAXATION OF INTEREST-FREE LOANS—MAJORITY SHAREHOLDER REALIZES INCOME BY RECEIVING INTEREST-FREE LOANS FROM CLOSELY-HELD CORPORATION. *Hardee v. United States*, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,656 (Ct. Cl. Tr. Div. July 6, 1982). The taxpayer maintained interest-free credit lines with his closely-held corporation, providing promissory notes as evidence of the loan transactions.[1] The Commissioner notified the taxpayer of deficiencies resulting from the taxpayer's failure to report the economic benefit derived from the free use of corporate funds.[2] Following payment, the taxpayer applied for a refund of the deficiencies.[3] The Court of Claims denied the refund[4] and *held*: a shareholder recognizes income from the interest-free use of corporate funds and may not claim

1. Hardee v. United States, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,656 (Ct. Cl. Tr. Div. July 6, 1982). The plaintiff, William Hardee, began interest-free borrowing from his closely held Florida corporation, Sea Garden Sales Company, Inc., in the 1950s. During the tax years in dispute, 1973 and 1974, the balance of Hardee's credit lines fluctuated. On December 31, 1972, he owed Sea Garden approximately $503,000. On December 31, 1974, his indebtedness to Sea Garden totaled approximately $474,000. *Id.* at 84,656.

2. The Commissioner assessed the values of the economic benefits derived from the interest-free loans by increasing Hardee's income by seven percent of the amount Hardee owed Sea Garden. Using this formula and applying the marginal tax rate corresponding to Hardee's income, the Commissioner determined the income and tax deficiencies for the two years. The Commissioner contended that in 1973 the economic benefit of the loans totaled $38,745, and that Hardee owed additional income taxes of $24,926. In 1974 a tax deficiency of $24,675 resulted from the $37,775 economic benefit of interest-free loans. *Id.* at 84,657 n.2.

3. *Id.* at 84,657. A taxpayer notified of a deficiency faces five alternatives. First, he may willingly pay the tax. Second, he may ignore the deficiency notice. If ignored too long, the Internal Revenue Service will begin collection proceedings. I.R.C. §§ 6301-6365 (1976 & Supp. 1980). Third, he may petition the Tax Court for a redetermination of the deficiency. I.R.C. § 6214 (1976 & Supp. 1980). Fourth, he may pay the deficiency and, following a denial of a refund from the Internal Revenue Service, bring suit in federal district court for a refund. 28 U.S.C. § 1346 (1976 & Supp. 1980). Finally, he may pay the deficiency and, following a denial of a refund from the Internal Revenue Service, bring suit for a refund in the Court of Claims. 28 U.S.C. § 1491 (1976 & Supp. 1980). *See also* 28 U.S.C. § 1346 (1976 & Supp. 1980). *See generally* Ponder, *Trial Court Litigation—Tax Court, Court of Claims, and District Court: A Practicing Lawyer's Views*, 21 MAJOR TAX PLAN. 117 (1969).

The structure of the Court of Claims has recently changed by passage of the Federal Courts Improvement Act of 1982. *See* 28 U.S.C.A. § 2501 (West Supp. 1982). Under the New Act, effective October 1, 1982, the Trial Division of the Court of Claims is now the United States Claims Court. 28 U.S.C.A. § 2501 (West Supp. 1982).

4. 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,656, 84,659.

an imputed interest deduction.[5]

Section 61 of the Internal Revenue Code defines gross income as "all income from whatever source derived."[6] Courts, liberally interpreting the section,[7] have included a variety of benefits in the gross incomes of taxpayers.[8] Although nonmonetary compensation[9] and the free use of many corporate assets[10] result in income recognition to an employee or

5. *Id.*

6. I.R.C. § 61 (1976 & Supp. 1980).

7. In Commissioner v. Jacobson, 336 U.S. 28 (1949), the Supreme Court stated that courts should liberally construe section 61. Additionally, the Court has held that the broad language of section 61 indicates that Congress intended to "tax all gains except those specifically exempted." James v. United States, 366 U.S. 213, 219 (1961); Commissioner v. LoBue, 351 U.S. 243, 246 (1956); Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955). The Court has also stated that section 61 is "broad enough to include in taxable income any economic benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." Commissioner v. Smith, 324 U.S. 177, 181 (1945).

8. *See* cases cited *infra* notes 9 & 10 and accompanying text.

9. For cases in which the Court has found nonmonetary compensation taxable income to the taxpayer, see Commissioner v. LoBue, 351 U.S. 243 (1956) (difference in cost of participation in stock option plan and value of the stock at the time of purchase); Old Colony Trust Co. v. Commissioner, 279 U.S. 719 (1929) (payment of corporate officer's tax liability); Dolese v. United States, 605 F.2d 1146 (10th Cir. 1979) (payment of shareholder's litigation expenses); Commissioner v. Riss, 374 F.2d 161 (8th Cir. 1967) (automobile); United Anilene Co. v. Commissioner, 316 F.2d 701 (1st Cir. 1963) (yacht expenses); Rudolph v. United States, 291 F.2d 841 (5th Cir. 1961) (vacation), *cert. dismissed,* 370 U.S. 269 (1962); Patterson v. Thomas, 289 F.2d 108 (5th Cir. 1961) (vacation); Silverman v. Commissioner, 253 F.2d 849 (8th Cir. 1958) (vacation); Greenspun v. Commissioner, 229 F.2d 947 (8th Cir. 1956) (farm expenses); Chester Distrib. Co. v. Commissioner, 184 F.2d 514 (3rd Cir. 1950) (entertainment expenses); Oberwinder v. Commissioner, 147 F.2d 255 (8th Cir. 1945) (annuity contracts); Commissioner v. Bonwit, 87 F.2d 764 (2d Cir. 1937) (life insurance); Canady v. Guitteau, 86 F.2d 303 (6th Cir. 1936) (same); Yuengling v. Commissioner, 69 F.2d 971 (3d Cir. 1934) (same); Campbell Sash Works, Inc. v. United States, 217 F. Supp. 74 (N.D. Ohio 1963) (vacation); Creel v. Commissioner, 72 T.C. 1173 (1979) (interest obligations), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Hanhauser v. Commissioner, 37 T.C.M. (CCH) 1851-67 (1976) (maintenance of shareholder's mistress); Genshaft v. Commissioner, 64 T.C. 282 (1975) (life insurance); Champion Trophy Mfg. Corp. v. Commissioner, 31 T.C.M. (CCH) 1236 (1972) (personal expenses); Conole v. Commissioner, 30 T.C.M. (CCH) 467 (1971) (vacation), *aff'd,* 473 F.2d 1037 (5th Cir. 1973); Cambridge Hotels, Inc. v. Commissioner, 27 T.C.M. (CCH) 1411 (1968) (personal expenses); Hornung v. Commissioner, 47 T.C. 428 (1967) (automobile); Adams v. Commissioner, 18 B.T.A. 381 (1929) (life insurance).

Similarly, the Treasury Regulations provide that if services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. Treas. Reg. § 1.61-2(d) (1981).

10. *See, e.g.,* Gardner v. Commissioner, 613 F.2d 160 (6th Cir. 1980) (automobile); Commissioner v. Anderson, 371 F.2d 59 (6th Cir. 1966) (house); Walker v. Commissioner, 362 F.2d 140 (7th Cir. 1966) (same); Dole v. Commissioner, 351 F.2d 308 (1st Cir. 1965) (same); Atlanta Biltmore Hotel Corp. v. Commissioner, 349 F.2d 677 (5th Cir. 1965) (same); United Aniline Co. v. Commissioner, 316 F.2d 701 (1st Cir. 1963) (yacht); Dean v. Commissioner, 187 F.2d 1019 (3d Cir. 1951) (house); Finney v. Commissioner, 39 T.C.M. (CCH) 938 (1980) (houseboat); Harbor

shareholder, the benefit received from the free use of corporate funds has historically escaped taxation.[11]

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Medical Corp. v. Commissioner, 38 T.C.M. (CCH) 1144 (1979) (airplane); Stephans v. Commissioner, 35 T.C.M. (CCH) 39 (1976) (residence); Holland v. Commissioner, 33 T.C.M. (CCH) 611 (1974) (automobile); Rethorst v. Commissioner, 31 T.C.M. (CCH) 1101 (1972) (house); Nichols, North, Buse Co. v. Commissioner, 56 T.C. 1225 (1971) (yacht); Challenge Mfg. Co. v. Commissioner, 37 T.C. 650 (1962) (boat); Heyward v. Commissioner, 36 T.C. 739 (1961) (houses), *aff'd,* 301 F.2d 307 (4th Cir. 1962); Reynard Corp. v. Commissioner, 30 B.T.A. 451 (1934) (house); Frueauff v. Commissioner, 30 B.T.A. 449 (1934) (apartment).

11. Parks v. Commissioner, 686 F.2d 408 (6th Cir. 1982); Baker v. Commissioner, 677 F.2d 11 (2d Cir. 1982); Commissioner v. Greenspun, 670 F.2d 123 (9th Cir. 1982); Beaton v. Commissioner, 664 F.2d 315 (1st Cir. 1981); Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Suttle v. Commissioner, 625 F.2d 1127 (4th Cir. 1980); Ruwe v. Commissioner, 41 T.C.M. (CCH) 1458 (1981); Trowbridge v. Commissioner, 41 T.C.M. (CCH) 1302 (1981); Estate of Liechtung v. Commissioner, 40 T.C.M. (CCH) 1118 (1980); Marsh v. Commissioner, 73 T.C. 317 (1979); Dean v. Commissioner, 35 T.C. 1083 (1961). *See generally* Duhl & Fine, *Interest-Free Loans and The Tax Court: Is* Dean *Weakening Under IRS Attacks?,* 51 J. TAX'N 322 (1979); Duhl & Fine, *New Case Allowing Interest Deduction Calls for Reappraisal of No-Interest Loans,* 44 J. TAX'N 34 (1976); Jacobs, *Of No Interest: Truth, Substance, and Bargain Borrowing,* 9 FLA. ST. U.L. REV. 261 (1981); Livsey, *Tax Aspects of Interest-Free Loans,* 31 MAJOR TAX PLAN. 35 (1979); Pulliam, *Income and Gift Tax Implications of Nonbusiness Interest-Free Loans: Looking a Gift Horse In the Mouth,* 58 TAXES 675 (1980); Roth, *Can Lender Be Charged With Receiving Taxable Income As A Result of an Interest-Free Loan,* 52 J. TAX'N 136 (1980); Schlifke, *Taxation as Income the Receipt of Interest-Free Loans,* 33 U. CHI. L. REV. 346 (1965); Wilkes, *Tax Court Holds Interest-Free Loan to Shareholder Creates No Taxable Income,* 14 J. TAX'N 351 (1961); Note, *I.R.C. § 61 and Low-Interest Loans:* Dean, Greenspun, *and the Convolution Continues,* 23 ARIZ. L. REV. 1147 (1981); Comment, *Tax Consequences of an Interest-Free Loan,* 24 LOY. L. REV. 33 (1978).

Conversely, interest-free loans between businesses create income for the borrowing corporation. *See* Fitzgerald Motor Co. v. Commissioner, 508 F.2d 1096 (5th Cir. 1975); Kerry Inv. Co. v. Commissioner, 500 F.2d 108 (9th Cir. 1974); Kahler Corp. v. Commissioner, 486 F.2d 1 (8th Cir. 1973); B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir.), *cert. denied,* 407 U.S. 934 (1972); Latham Park Manor, Inc. v. Commissioner, 69 T.C. 199 (1977). *See also* Treas. Reg. § 1.482-1(d)(4) (1962). *See generally* Sneed, *Unlabeled Income and Section 483,* 17 MAJOR TAX PLAN. 643 (1965).

The Commissioner also has argued that low interest loans constitute a gift, the value of which equals the difference between the market rate of money and the actual interest rate of the loan multiplied by the amount of the loan. The Commissioner's efforts have produced mixed results. *Compare* Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978) (demand loan creates no taxable gift) *and* Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966) (same) *with* Estate of Berkman v. Commissioner, 38 T.C.M. (CCH) 183 (1979) (term loan results in taxable gift). *See generally* Edwards, *What planning opportunities does CA-7's no-gift-tax holding in* Crown *open up?,* 50 J. TAX'N 168 (1979); Joyce & Del Cotto, *Interest-Free Loans: The Odyssey of a Misnomer,* 35 TAX L. REV. 459 (1980); O'Hare, *The Taxation of Interest-Free Loans,* 27 VAND. L. REV. 1085 (1974); Pulliam, *supra* note 11; Taylor & Schnee, *Interest-Free Loans: A Need for Caution,* 58 TAXES 263 (1980); Note, *Gift Tax Implications of an Interest-Free Loan,* 42 ALB. L. REV. 471 (1978); Note, *The Value of the Use of Money Loaned by Taxpayers to Their Children Without Interest Does Not Constitute a Gift,* 5 HOUS. L. REV. 138 (1967); Note, *Gift and Income Tax Consequences of Interest-Free Demand Loans,* 1979 U. ILL. L.F. 643; Comment, *An Interest-Free Borrower or Lender Be:*

In *Dean v. Commissioner*,[12] the Commissioner relied on cases holding that rent-free use of corporate property confers a taxable benefit on the user[13] and argued that interest-free loans from a corporation to a shareholder result in income to the shareholder.[14] The Tax Court rejected this argument by differentiating between rent-free use of corporate property and interest-free loans. The court examined the dissimilar treatment of rent and interest payment deductibility, and noted that although rent would not be deductible, borrowers of corporate funds are entitled to a full deduction for interest payments.[15]

In *Greenspun v. Commissioner*,[16] the Tax Court elaborated on the rationale used in its earlier *Dean* decision.[17] The court stated that *Dean* attempted to make the tax effects of a shareholder interest-free loan identical to the tax consequences of increasing the shareholder's dividends by an amount equal to the interest charges on a market-rate

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*Gift Tax Implications of Interest-Free Loans,* 53 N.Y.U. L. REV. 941 (1978); 19 STAN. L. REV. 870 (1967); 23 VILL. L. REV. 625 (1977-78).

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

13. *Id.* at 1089. *See supra* note 10 and accompanying text.

14. 35 T.C. at 1087.

15. *Id.* at 1090. I.R.C. § 163(a) (1976 & Supp. 1980) allows interest payments to be deducted from income. The deduction, however, arises only if the taxpayer itemizes deductions, I.R.C. § 163(d) (1976 & Supp. 1980), and the use of the borrowed funds does not generate tax-free income. I.R.C. § 265(2) (1976 & Supp. 1980).

The Commissioner's efforts to tax the benefits of interest-free loans increased as interest rates escalated. The average prime rate charged by banks rose from less than five percent in 1961 to twelve percent in 1974. The prime rate settled to less than seven percent in 1977 before rising to over twenty percent in 1981. BUREAU OF ECONOMIC ANALYSIS, U.S. DEPT. OF COMMERCE, 22 BUSINESS CONDITIONS DIGEST 35 (May 1982).

The Commissioner filed his nonaquiescence to *Dean* in 1973. 1973-2 C.B. 4. Recently, the Commissioner extensively pursued the interest-free loan issue at the court of appeals level. *See* Parks v. Commissioner, 686 F.2d 408 (6th Cir. 1982); Baker v. Commissioner, 677 F.2d 11 (2d Cir. 1982); Commissioner v. Greenspun, 670 F.2d 123 (9th Cir. 1982); Beaton v. Commissioner, 664 F.2d 315 (1st Cir. 1981); Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Suttle v. Commissioner, 625 F.2d 1127 (4th Cir. 1980).

16. 72 T.C. 931 (1979), *aff'd,* 670 F.2d 123 (9th Cir. 1982).

17. Five criticisms of the *Dean* rule have emerged. First, allowing the free use of money to escape taxation is inconsistent with taxing the free use of other corporate assets. *See supra* notes 9 & 10 and accompanying text.

Second, I.R.C. § 163(a) (1976 & Supp. 1980) authorizes interest deductions only to borrowers who actually pay or accrue interest. Hardee v. United States, 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,658 (Ct. Cl. Tr. Div. July 6, 1982); Christensen v. Commissioner, 40 T.C. 563, 577-78 (1963); D. 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); Howell Turpentine Co. v. Commissioner, 6 T.C. 364 (1946), *rev'd on other grounds sub nom.* Howell v. Commissioner, 162 F.2d 316 (5th Cir. 1947).

loan.[18] The court conceded that in situations where interest charges are not fully deductible,[19] the *Dean* rule would give an unfair advantage to the taxpayer.[20] Until presented with such a case, the *Greenspun* court decided to postpone modification of the *Dean* rule.[21]

After *Greenspun*, courts criticized the holding of *Dean*,[22] yet continued to follow the *Dean* rule that interest-free loans do not provide income to shareholder-borrowers.[23] Courts refused to overturn *Dean* for

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Interest-free borrowers pay no interest. If they recognize income they would not, therefore, as the *Dean* court stated, receive an interest deduction.

Third, the interest-free borrower who recognizes income and qualifies for a deduction is in a better after-tax situation than the market-rate borrower. *See infra* notes 18 & 40.

Fourth, even if the interest-free borrower recognizes income and becomes entitled to interest deductions, other provisions might limit the deduction. *See supra* note 15.

Fifth, even if fully deductible, the increase in gross income might create different tax results because gross income frequently determines the amount of other deductions. I.R.C. § 1348 (1976) (repealed 1981) subjected different types of income to different marginal tax rates. Deductions were allocated to the different incomes according to a ratio determined from gross income. Consequently, if interest-free loan benefits increased gross income and a corresponding interest deduction was allowed, the ratio changed, the tax due on the different income changed, and, thus, the total tax bill changed. *See* Jacobs, *supra* note 11, at 284 n.91. Similarly, gross income determines the amount of medical and charitable deductions. *See* I.R.C. § 213 (1976) (medical deductions); I.R.C. § 170 (1976 & Supp. 1980) (charitable deductions).

18. 72 T.C. at 948. The court stated:

> 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.*

In the two hypotheticals, *A*, the borrower, assumes equal tax liability. Yet, *X*, the lender, pays less tax when making an interest-free loan than when making a market-rate loan, receiving interest income and paying nondeductible dividends. *See* Jacobs, *supra* note 11, at 288.

In addition, the taxable income in each hypothetical is equal, but the after tax position is not. *See infra* note 40. In the first situation, the interest-free loan would leave *A* with $1,000. The second, because of the interest payment, would leave him with $0.

19. 72 T.C. 931, 949 n.20 (1979). *See also supra* note 15.

20. 72 T.C. at 949.

21. *Id.* at 950.

22. *See, e.g.,* Beaton v. Commissioner, 664 F.2d 315, 317 (1st Cir. 1981); Martin v. Commissioner, 649 F.2d 1133, 1135 (1981) (Goldberg, J., dissenting).

23. Parks v. Commissioner, 686 F.2d 408 (6th Cir. 1982); Baker v. Commissioner, 677 F.2d 408 (6th Cir. 1982); Commissioner v. Greenspun, 670 F.2d 123 (9th Cir. 1982); Beaton v. Commissioner, 664 F.2d 315 (1st Cir. 1981); Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Suttle

several reasons. First, long periods of congressional[24] and administrative[25] acquiescence followed the *Dean* decision. Second, determination of taxable income would involve intricate measurements if interest-free loans were held to create a taxable benefit.[26] Finally, some courts contend that the legislature has responsibility for taxing interest-free loans and formulating tax policy.[27] Accordingly, six circuits have held that a shareholder does not recognize income from the interest-free use of corporate funds.[28]

The Court of Claims, in *Hardee v. United States*,[29] was the first to adopt the Commissioner's argument that a shareholder's interest-free loan results in income, but fails to generate an imputed interest deduction.[30] Two problems with the *Dean* rule influenced the *Hardee* court's determination. First, the *Dean* court's reliance on the deductibility of interest charges to support its holding[31] was misplaced, according to the court in *Hardee*.[32] Criticizing the *Dean* court's economic equivalence rationale[33] as contrary to the Supreme Court's restrictive approach to permitting deductions,[34] the Court of Claims stated that interest deduc-

v. Commissioner, 625 F.2d 1127 (4th Cir. 1980); Ruwe v. Commissioner, 41 T.C.M. (CCH) 1458 (1981); Trowbridge v. Commissioner, 41 T.C.M. (CCH) 1302 (1981); Baker v. Commissioner, 75 T.C. 166 (1980), *aff'd*, 677 F.2d 11 (2d Cir. 1982); Estate of Liechtung v. Commissioner, 40 T.C.M. (CCH) 1118 (1980); Marsh v. Commissioner, 73 T.C. 317 (1979).

24. Congress has not enacted legislation to tax the benefit of interest-free loans. Instead, in a Senate Appropriations Committee report, it has told the Internal Revenue Service that the Commissioner should reduce the amount of time and money channeled into litigation of the interest-free loan issue. S. REP. No. 955, 96th Cong., 2d Sess. 30 (1980).

25. The Commissioner's nonacquiescence did not come until 1973. 1973-2 C.B. 4.

26. *See, e.g.*, Martin v. Commissioner, 649 F.2d 1133, 1134 (5th Cir. 1981).

27. *See, e.g.*, Commissioner v. Greenspun, 670 F.2d 123, 126 (9th Cir. 1982) (quoting United States v. Byrum, 408 U.S. 125, 135 (1972)); Beaton v. Commissioner, 664 F.2d 315, 317 (1st Cir. 1981) (same).

28. *See* Parks v. Commissioner, 686 F.2d 408 (6th Cir. 1982); Baker v. Comissioner, 677 F.2d 11 (2d Cir. 1982); Commissioner v. Greenspun, 670 F.2d 123 (9th Cir. 1982); Beaton v. Commissioner, 664 F.2d 315 (1st Cir. 1981); Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Suttle v. Commissioner, 625 F.2d 1127 (4th Cir. 1980).

29. 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,656 (Ct. Cl. Tr. Div. July 6, 1982).

30. *Id.* at 84,659.

31. *Id.* at 84,658.

32. *Id.* at 84,659.

33. Economic equivalence is used here to mean "wash out" and not the equivalence of the two transactions described in *Greenspun, see supra* note 18 and accompanying text. The terms refer to the needless addition of income when an identical, offsetting interest deduction is present.

34. *See* Commissioner v. National Alfalfa Dehydrating, 417 U.S. 134 (1974); Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943); Deputy v. duPont, 308 U.S. 488 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). In *National Alfalfa*, the Court stated: "The

tions are not granted on interest-free loans because the borrower fails to pay or accrue interest costs.[35]

The Court of Claims in *Hardee* also reasoned that the denial of an interest deduction placed the interest-free borrower in a poorer after-tax position than a market-rate borrower with a similar income who gains an interest deduction.[36] The court further suggested that the *Dean* court overcompensated for this discrepancy by allowing the interest-free borrower to escape income recognition.[37] The *Dean* rule enabled the interest-free borrower to receive credit at no cost while the market-rate borrower, although receiving an interest deduction, still incurred interest costs.[38] Unable to ignore the inconsistencies of *Dean* after separate examinations of interest deductions and income recognition, the Court of Claims rejected this economic equivalence approach to the taxation of interest-free loans.[39]

In *Hardee*, the court incorrectly reasoned that denial of an interest deduction placed the interest-free borrower in a worse after-tax situation than a market-rate borrower with a similar income who receives an interest deduction. The interest-free borrower's tax liability might be greater, but his after-tax position is clearly better.[40] Because the

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propriety of a deduction does not turn upon general equitable consideration, such as a demonstration of effective economic and practical equivalence." 417 U.S. at 148-49.

35. 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,658. The code limits deductions to those "paid or accrued." I.R.C. § 163(a) (1976).

36. 82-2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,656, 84,659.

37. Judge Wiese wrote:

> Aside from the statutory impediment that the court sees in the notion of an imputed or implicit deduction, the second problem that we have with the *Dean-Greenspun* analysis is the result that it accomplishes: it substitutes one economic dislocation for another. To explain: for the interest-free borrower, an obligation to recognize additional income . . . coupled with the absence of an offsetting deduction, leaves that individual in a less favorable after tax position than his counterpart, *i.e.*, the individual with income in like amount . . . whose borrowing cost generates a tax deduction. Yet, under the *Dean-Greenspun* analysis, the effort to eliminate this imbalance yields the equally disproportionate result of permitting the interest-free borrower to enjoy the benefit of a loan without any adverse economic consequences whatsoever.

*Id.*

38. *Id.*

39. *Id.*

40. *Id.* Although the tax liability of an interest-free borrower is greater than a market-rate borrower with a similar income, the interest-free borrower's after-tax situation is clearly better. For example, assume that two taxpayers (*I-F* and *M-R*) have incomes of $100,000. Further assume the interest-free borrower (*I-F*) recognizes income from compensation totaling $90,000 and a $10,000 benefit from an interest-free loan, while the market-rate borrower (*M-R*) recognizes income of $100,000 from compensation and pays $10,000 in interest charges. *I-F* must pay tax on $100,000. *M-R*, after taking a $10,000 interest deduction pays tax on $90,000. Yet *M-R* pays tax

same forum that established the *Dean* rule later considered the doctrine "too sweeping,"[41] the *Hardee* court's criticisms of *Dean* remain persuasive. The determination of the interest-free loan issue, however, depends less on the continuing validity of *Dean* than on the approval of the Commissioner's use of the courts to formulate tax policy.[42]

Interest-free borrowers should take special notice of the *Hardee* decision. Until the interest-free loan issue is resolved, either by Congress or the judiciary, the procedural aspects[43] of *Hardee* encourage taxpayers to petition for an income tax redetermination in the Tax Court, where they will probably receive more favorable treatment.[44] Borrowers who pay the deficiencies related to interest-free loans and subsequently seek a refund may avoid the Claims Court by bringing suit in federal district court.[45]

*B.L.T.*

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and interest while *I-F* pays only tax. Only if *I-F*'s tax is greater than *M-R*'s tax and interest will *I-F* be left with fewer dollars than *M-R*. Such a situation will occur only if the marginal tax rate on the additional $10,000 is greater than 100%. Consequently, *I-F* might pay more tax, but his after-tax situation is still better. *See also supra* note 18 and accompanying text.

41. *See* Zager v. Commissioner, 72 T.C. 1009, 1012 (1979), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981).

42. *See supra* note 27 and accompanying text.

43. *See supra* note 3.

44. *See* Creel v. Commissioner, 72 T.C. 1173 (1979), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Zager v. Commissioner, 72 T.C. 1009 (1979), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981). *See also* cases cited *supra* note 23.

45. *See supra* note 3.