GIFT TAX INAPPLICABLE TO INTEREST-FREE, INTRA-FAMILY DEMAND LOANS

Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978)

In *Crown v. Commissioner*[1] the United States Court of Appeals for the Seventh Circuit admitted that the economic reality of not imposing gift tax liability for interest-free, intra-family demand loans opens a significant loophole in the tax statutes, but found that practical and theoretical valuation problems preclude taxation under the present gift tax statutes.[2]

The taxpayer in *Crown* was one of three brothers who had equal interests in a general partnership. Prior to and during 1967 the partnership made a series of interest-free demand loans[3] to twenty-four trusts for the partners' relatives.[4] The total amount of the loans outstanding on the books of the partnership on December 31, 1967, was approximately $18 million.[5] The Commissioner assessed a deficiency of $362,135.92 on the taxpayer's gift tax return for 1967, consisting of one-third of the amount of the partnership's gift allegedly made by virtue of the loans,[6] and valued the deficiency by computing the amount of interest a party bargaining at arm's length would have charged.[7] The Seventh Circuit affirmed the Tax Court[8] and *held:* Intra-family,[9] interest-free demand loans do not subject the lender to federal gift tax liability on the transfer of the right to the use of the loaned funds.[10]

Section 2501 of the Internal Revenue Code (I.R.C.) provides for a

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1. 585 F.2d 234 (7th Cir. 1978).

2. *Id.*

3. Thirteen percent of the indebtedness was represented by notes payable on demand and 87% consisted of loans on open account. *Id.* at 235. Both the open account loans and demand notes were considered to be loans payable on demand, equivalent for tax purposes. *Id.* at 237 n.9. The demand notes provided for interest payable at 6% per annum *after* demand; the open account loans had no interest provisions. Crown v. Commissioner, 67 T.C. 1060, 1061 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978).

4. 585 F.2d at 235.

5. *Id.*

6. 67 T.C. at 1061.

7. The Commissioner determined a reasonable rate of interest to be 6% per annum and applied that rate on a daily basis to the outstanding balance. *Id.* During 1967 the market prime rate of interest ranged between 5.5% and 6%, averaging 5.63%. *Id.*

8. 585 F.2d 234.

9. Gifts made to a trust are treated as gifts to the beneficiaries of the trust and not as gifts to the trustee or to the trust as a legal entity. Helvering v. Hutchings, 312 U.S. 393 (1941).

10. 585 F.2d at 235.

tax on "the transfer of property by gift."[11] I.R.C. section 2511(a) elaborates that "the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." Property transferred directly is taxed on its value at the time of the transfer;[12] property transferred by exchange is taxed on the excess of its value over the consideration received by the donor.[13] The legislative history indicates Congress intended these provisions to be broadly construed,[14] and the regulations[15] and case law[16] support the expansive applicability of the general language of the gift tax statutes to specific transfers of varied interests and forms.[17]

The two main purposes of the gift tax are to prevent avoidance of higher income tax rates through income-splitting and to prevent avoid-

11. I.R.C. § 2501.

12. I.R.C. § 2512(a) provides: "if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."

13. I.R.C. § 2512(b) provides:

> Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar quarter.

Id.

14. The terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense; the term "property" reaching every species of right or interest protected by law and having an exchangeable value.

> The words "transfer . . . by gift" and "whether . . . direct or indirect" are designed to cover and comprehend all transactions (subject to certain express conditions and limitations) whereby, and to the extent . . . that, property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment.

H.R. REP. No. 708, 72d Cong., 1st Sess. 27-28 (1932); S. REP. No. 665, 72d Cong., 1st Sess. 39 (1932).

15. Treas. Reg. § 25.2511-1(a) (1958) provides in pertinent part:

> The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. For example, a taxable transfer may be effected by the creation of a trust, the forgiving of a debt, the assignment of a judgment, the assignment of the benefits of an insurance policy, or the transfer of cash, certificates of deposit, or Federal, State or municipal bonds.

Id.

16. *See, e.g.*, Commissioner v. Wemyss, 324 U.S. 303 (1945); Smith v. Shaughnessy, 318 U.S. 176 (1943); Keinath v. Commissioner, 480 F.2d 57 (8th Cir. 1973). For examples of interests defined as "property" for gift tax purposes, see Talge v. United States, 229 F. Supp. 836 (W.D. Mo. 1964) (patents and patent applications); Rollman v. United States, 342 F.2d 62 (Ct. Cl. 1965) (assignment of rents).

17. *See, e.g.*, Helvering v. Clifford, 309 U.S. 331 (1940); Gregory v. Helvering, 293 U.S. 465 (1935).

ance of estate taxes through depletion of the taxpayer's estate.[18] Accordingly, income derived from the use of loaned funds is taxable to the borrower,[19] and the lender pays no gift tax on the transfer of the principal.[20] If, however, the lender invests the funds himself and transfers the income derived therefrom to the recipient, instead of making a loan, the lender will be subject to an income tax on the receipt of income[21] as well as a gift tax on the transfer of the income.[22] Thus, the use of an interest-free loan can result in tax savings to the lender by splitting his income to avoid the gift tax.[23] To prevent the use of trusts to split income and avoid taxes, the regulations order treatment of income payments to revocable trusts[24] as gifts from the settlor to the beneficiary during the calendar years in which the payments are made.[25]

An interest-free loan depletes the lender's estate only to the extent of the uncompensated deprivation of the use of the loaned money prior to repayment.[26] The general rule for valuation of taxable property is the "fair market value" rule.[27] The present fair market value of the prom-

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18. The gift tax will supplement both the estate tax and the income tax. It will tend to reduce the incentive to make gifts in order that distribution of future income from the donated property may be to a number of persons, with the result that taxes imposed by the higher brackets of income tax are avoided.

H R. REP. No. 708, 72d Cong., 1st Sess. 28 (1932); S. REP. No. 665, 72d Cong., 1st Sess. 40 (1932). *E g.*, Harris v. Commissioner, 340 U.S. 106, 107 (1950); Smith v. Shaughnessy, 318 U.S. 176, 179 n 1 (1943).

19. I.R.C. § 61(a).

20. A gift is incomplete in every instance in which the donor reserves the power to revest the beneficial title to the property in himself. Treas. Reg. § 25.2511-2(c) (1958).

21. I.R.C. § 61(a).

22. I.R.C. § 2501. *See* Treas. Reg. § 25.2511-1(a) (1958); notes 15-16 *supra* and accompanying text.

23. *See* Burke, *Interest-Free Loans—A Valuable Family Tax Planning Tool?*, 48 TAXES 137, 137-38 (1970); O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. L. REV. 1085, 1093 (1974); Comment, *Tax Consequences of an Interest Free Loan*, 24 LOY. L. REV. 33, 34 (1978); 38 OHIO ST. L J. 903, 909 (1977).

24. Irrevocable, short term trusts receive tax treatment similar to that of revocable trusts. Helvering v. Clifford, 309 U.S. 331, 335 (1940).

25. Treas. Reg. § 25.2511-2(f) (1958) provides in pertinent part:

> The receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary . . . during the interim between the making of the initial transfer and the relinquishment or termination of the power operates to free such income or other enjoyment from the power, and constitutes a gift of such income.

Id. *See* Helvering v. Horst, 311 U.S. 112 (1940) (trust income is taxable to donor retaining control of trust though income is paid to donee-beneficiary); Burnet v. Guggenheim, 288 U.S. 280 (1933) (upholding predecessor of Treas. Reg. § 25.2511-2(f) (1958)).

26. The loan principal is included in the lender's estate. Treas. Reg. § 20.2031-4 (1958).

27. Treas. Reg. § 20.2031-1(b) (1958). "Fair market value" is defined as "the price at which

ise to repay a term loan is the present discounted value of the loan.[28] The present value of the promise to repay a demand loan, however, is incapable of determination because the duration of the loan is by definition uncertain and unknown.[29]

In business settings, courts have held that the right to use interest-free funds is not taxable as a receipt of income[30] or as a constructive dividend,[31] absent specific statutory and regulatory authority permitting taxation of imputed interest.[32] In a variety of nonbusiness transac-

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the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." *Id.* The same language is found under the gift tax regulations. *See* Treas. Reg. § 25.2512-1 (1965).

28. Treas. Reg. § 20.2031-7(d) (1958) (valuation of remainders or reversionary interests); Treas. Reg. § 25.2512-5(d) (1958) (same).

29. To be able to determine the present value of a promise to repay a loan, the length of the period during which the loaned property is to be held must be known. *See* Treas. Reg. § 20.2031-7(d) (1958); Treas. Reg. § 25.2512-5 (d) (1958).

30. *See* Saunders v. United States, 294 F. Supp. 1276 (D. Hawaii 1968) (net amount derived from use of interest-free loans not taxable as ordinary income but rather as capital under circumstances of transaction), *rev'd on other grounds*, 450 F.2d 1047 (9th Cir. 1971); Dean v. Commissioner, 35 T.C. 1083, 1089 (1961) (imputed income to taxpayer as result of receiving interest-free loan held to be unrealized income because it would be offset by deduction for interest expense). For the view that the right to the use of money should be taxed as income to the borrower, see Comment, *Income and Gift Tax Implications of Interest-Free Loans Between Relatives*, 1978 B.Y.L. REV. 155; Comment, *Taxing as Income the Receipt of Interest-Free Loans*, 33 U. CHI. L. REV. 346 (1966), *reprinted in* 44 TAXES 544 (1966). *See also* Treas. Reg. § 25.2511-2(a) (1958).

31. *See* Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862, 868 (3d Cir. 1974) (economic benefit of funds loaned interest-free insufficient to give rise to constructive dividend because treated by both parties as corporate obligation).

32. An obvious method which can be used to milk one commonly controlled organization for the benefit of another is the making of interest free loans. Under this method, the lending entity, by not reporting interest on the loans, has lower earnings and, consequently, lower taxes. By not paying interest, the borrowing entity, if it has no net taxable income, merely eliminates a deduction which otherwise, would increase its losses. As a group the commonly controlled organizations pay less income tax than they would if they had dealt at arm's length and charged interest on the loans.

Latham Park Manor, Inc. v. Commissioner, 69 T.C. 199, 212 (1977). I.R.C. § 482 now authorizes the Commissioner to allocate income and deductions among businesses controlled by the same interests if necessary to prevent evasion of taxes or to clearly reflect the income of such organizations. The regulations contain a "safe haven" provision that indicates to the taxpayer a range of interest rates that will not result in imputation of interest income and tax liability thereon. Treas. Reg. § 1.482-2(a)(2) (1975). Otherwise, the Commissioner can successfully impute and allocate income under § 482 through the application of a fixed percentage without regard to whether interest income was actually generated. Kahler Corp. v. Commissioner, 486 F.2d 1, 5 (8th Cir. 1973) (whether borrowed funds produced income to borrowing corporations was "of no importance"); B. Forman. Co. v. Commissioner, 453 F.2d 1144, 1156 (2d Cir.) (allocation to the taxpayers of interest income at 5% on their loans to a corporation that they had formed was proper even though the taxpayers had waived the right to interest on the loan), *cert. denied*, 407 U.S. 934 (1972); Latham Park Manor, Inc. v. Commissioner, 69 T.C. 199 (1977) (§ 482 authorizes the Commis-

tions, however, courts have held taxable the transfer of the right to use money: a district court held forgiveness of interest due to be a taxable transfer under section 2501;[33] the Tax Court held a gift of bonds to be a taxable gift of the interest and bonds even when the interest has not matured;[34] and the difference between a below-market interest rate charged and the usual rate of interest is a taxable gift.[35] Further, the Seventh Circuit recently held the gratuitous transfer to a charitable organization of the right to use money is deductible as a gift.[36]

The initial judicial consideration of the gift tax treatment of intra-

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sioner to impute interest on noninterest bearing loans between parent and subsidiary corporations even if income is not produced by the proceeds), *rev'g* PPG Industries, Inc. v. Commissioner, 55 T.C. 928 (1970). *See* Crawford, *Are the Courts Expanding the Scope of Code Section 482?*, 36 J. TAX. 150 (1972).

Latham purports to overrule *Kahler*, but the *Kahler* test was whether the loan from the taxpayer to the controlled group would have been interest-free in an arm's length transaction with an uninterested, uncontrolled party. The question of income was of no importance. Kahler Corp. v. Commissioner, 486 F.2d 1, 5 (8th Cir. 1973).

I.R.C. § 483 requires that interest be imputed as a component of certain deferred payments made in the sale or exchange of property. I.R.C. § 483. This provision was enacted to prevent the practice of hiding interest payments in the selling price of certain property sales. This provision is applicable only to transfers of more than $3,000 for more than one year. I.R.C. § 483(f). As with § 482 transactions, prior to the enactment of § 483, courts refused to impute interest income. *See, e.g.*, Brown v. Commissioner, 37 T.C. 461 (1961), *aff'd*, 325 F.2d 313 (9th Cir. 1963), *aff'd*, 380 U.S. 563 (1965); Pretzer v. United States, 61-1 U.S.T.C. § 9477 (Ariz. 1961).

33. Republic Petroleum Corp. v. United States, 397 F. Supp. 900, 917 (E.D. La. 1975) (parent's cancellation of son's obligation to pay interest on loan was gift of the amount of interest forgiven; distinguished Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966), *see* notes 38-40 *infra* and accompanying text, on ground that there was contractual duty to pay interest). *But cf.* Estate of Lang v. Commissioner, 64 T.C. 404, 413 (1975) (decedent allowed statute of limitations to run on loan to son; Commissioner assessed gift tax on principal only).

34. Affelder v. Commissioner, 7 T.C. 1190 (1946).

For a discussion of the tax consequences of other kinds of property transfers, see Estate of Bell v. Commissioner, 60 T.C. 469 (1973) (stock transfer by parents to children in exchange for annuities was taxable gift of excess of fair market value over discounted value of annuity).

35. Blackburn v. Commissioner, 20 T.C. 204 (1953); *see* notes 42-43 *infra* and accompanying text.

36. Mason v. United States, 513 F.2d 25 (7th Cir. 1975), *noted in* Duhl & Fine, *New Case Allowing Interest Deduction Calls for Reappraisal of No-Interest Loans*, 44 J. TAX. 34 (1976). *See also* Threlfall v. United States, 302 F. Supp. 1114 (W.D. Wis. 1969).

Under the gift tax statute, "[d]onative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor." Treas. Reg. § 25.2511-1(g)(1) (1958). For a charitable deduction under I.R.C. § 170, subjective donative intent is required to establish that a "gift" has been made. Commissioner v. Duberstein, 363 U.S. 278 (1960); *see* Commissioner v. Beck's Estate, 129 F.2d 243, 246 (2d Cir. 1946). The phrase "transfer of property," however, is treated identically under I.R.C. §§ 170 & 2501. Once deemed a gift, the "parties' expectations or hopes as to the tax treat-

family, interest-free demand loans occurred in 1966. In *Johnson v. United States*[37] a federal district court concluded that such loans were not gifts of the use of money within the meaning of section 2501. Because the unpaid amount of the loans was recorded as and includible as an asset in the lender's estate, the loan did not defeat the purpose of the gift tax to protect the estate from depletion by untaxed inter vivos gifts.[38] Furthermore, the lender was under no duty to lend or otherwise invest the money and the recipients were under no express or statutory duty to pay interest.[39] The court suggested that provision for a tax on the value of intra-family loans should come from Congress and not from the courts.[40]

The IRS did not appeal the *Johnson* decision and waited nearly seven years before indicating its non-acquiescence.[41] In 1973 the Commissioner ruled that a parent who made large interest-free loans to his child's wholly owned corporation incurred gift tax liability.[42] In his

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ment of their conduct have nothing to do with the matter." Commissioner v. Duberstein, 363 U.S. 278, 286 (1960).

For a case involving the rent-free use of real property under the charitable gift deduction provision, see Passailaigue v. United States, 224 F. Supp. 682 (M.D. Ga. 1963).

> If the right to use real estate is to be regarded as "merely" an incidental privilege we suppose it might also be said with equal logic that the right to remove the oil from an oil well is "merely" a privilege and that the really important thing is who owns the hole in the ground.

Id. at 686. The same might well be said about the privilege to use money. *See also* Thriftimart, Inc. v. Commissioner, 59 T.C. 598, 615 (1973) (charitable deduction of fair rental value allowed on rent-free, term lease of real property); Allen v. Commissioner, 57 T.C. 12, 13 (1971) (charitable deduction of fair rental value of interest conveyed allowed on rent-free, term lease); Sullivan v. Commissioner, 16 T.C. 228, 231 (1951) (deduction allowed for gift made when taxpayer conveyed property "for duration of war"). *But cf.* Rev. Rul. 70-72, 1970-1 C.B. 15 (tenant farmer earns no income from use of dwelling supplied by landowner). The Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, altered I.R.C. § 170(f)(3) to require that a donor relinquish all rights in property to qualify for the charitable gift deduction. This change reflected a congressional policy decision that the gift of the use of property should not result in a deduction, provided the donor retained a beneficial interest in the property, rather than a denial that the use value of a proprietary interest could never be subject to transfer by gift.

37. 254 F. Supp. 73 (N.D. Tex. 1966). *See* 5 HOUS. L. REV. 138 (1967); 65 MICH. L. REV. 1014 (1967); 19 STAN. L. REV. 870 (1967).

38. 254 F. Supp. at 77. The court did not discuss the other commonly accepted purpose of the gift tax: the prevention of income tax avoidance through income splitting. *See* note 19 *supra* and accompanying text.

39. *Id.*

40. *Id.*

41. *See* Rev. Rul. 73-61, 1973-1 C.B. 408.

42. *Id.*

ruling, the Commissioner set forth an interpretation of the scope of the gift tax contrary to that in the *Johnson* decision:

> The right to use property, in this case money, is itself an interest in property, the transfer of which is a gift within the purview of section 2501 of the Code unless full and adequate consideration in money or money's worth is received. The tax in the instant case would be imposed on the value of the right to use the money. Such value is usually stated in terms of interest or some other equivalent in money or money's worth. The rate of interest that would represent full and adequate consideration may vary, depending upon the actual circumstances pertaining to the transaction.[43]

In *Crown v. Commissioner*[44] the Seventh Circuit upheld the Tax Court's[45] rejection of the Commissioner's imposition of a gift tax on intra-family, interest-free demand loans. Judge Wood, writing for the court, recognized that the making of an interest-free demand loan

43. *Id.* at 409. For a term loan, "the value of the right to the use of the money loaned is ascertainable by accepted actuarial methods, as of the date the money and note were exchanged, and is, therefore, subject to the gift tax at that time." *Id.* For a demand loan, "[t]he value of the use of the money during the calendar quarter is calculable as of the last day of each calendar quarter during which the corporation granted such use," and the amount of gift should be calculated then rather than at the date of the exchange. *Id.*

The IRS predicted that no tax effect would result in most cases involving small interest-free loans because the $3,000 per donee exclusion would operate as a floor to tax liability. *Id.* I.R.C. § 2503(b) provides for this exclusion:

> In computing taxable gifts for the calendar quarter, in the case of gifts . . . made to any person by the donor during the calendar year 1971 and subsequent calendar years, $3,000 of such gifts to such person less the aggregate of the amounts of such gifts to such person during all preceding calendar quarters of the calendar year shall not . . . be included in the total amount of gifts made during such quarter.

Id. Following the IRS method suggested in Rev. Rul. 73-61, Feinschreiber & Granwell calculated, for loans of varying terms, the amounts required to be transferred to yield a value in excess of the exclusionary floor. Feinschreiber & Granwell, *IRS Imputes Interest on Loans Between Family Members*, 51 TAXES 294 (1973). Their results support the IRS prediction that only large loans would be taxable under this method, assuming, of course, that the benefits of the exclusion were not already depleted by prior gifts. *Id.*

The $30,000 lifetime exemption provision, also cited in the Ruling as a check on the practical impact of the IRS holding, 1973-1 C.B. at 409, was repealed in 1976.

Other provisions not suggested by the IRS, but which might operate as a limit on the applicability of the tax are: I.R.C. § 2513(a)(1), which provides that: "A gift made by one spouse to any other person other than his spouse shall . . . be considered as made one-half by him and one-half by his spouse" and I.R.C. § 2503(c), which excludes certain transfers for the benefit of minors.

44. 585 F.2d 234 (7th Cir. 1978).

45. Crown v. Commissioner, 67 T.C. 1060 (1977). The Tax Court opinion was commented upon extensively: 42 ALB. L. REV. 471 (1978); 19 B.C.L. REV. 359 (1978); 24 LOY. L. REV. 33 (1978); 38 OHIO ST. L.J. 903 (1977); 9 RUT.-CAM. L.J. 579 (1978); 23 VILL. L. REV. 625 (1978); 14 WAKE FOREST L. REV. 150 (1977).

would result in an economic benefit to the borrower,[46] leaving the lender poorer by the amount of interest foregone or by his inability to use the loaned funds to otherwise increase his net worth.[47] The court acknowledged that interest-free loans facilitated income-splitting in contravention of one of the purposes of the gift tax.[48]

The court, however, following the reasoning of the *Johnson* court and the Tax Court in *Crown*, refuted the Commissioner's two theories, which postulated that failure to subject interest-free demand loans to gift tax treatment would allow evasion of the estate tax.[49] First, unlike term loans,[50] there is no reason to expect that the value of the promise to repay a demand loan is substantially less than the face value of the loan, because the lender may demand payment at any time. Thus, the court rejected the argument that because of the time-value of money, the estate is depleted by the difference between the amount of money loaned and the present value of the promise to repay.[51] The court also rejected the Commissioner's second argument that the lender's estate will be depleted by the "opportunity cost," the amount of income the loaned funds may generate. Judge Wood noted that a taxpayer was not duty bound "to cultivate the fruits of his capital . . . and will not be

46. The court looked directly at the economic consequences of the loan transaction. 585 F.2d at 235. The *Johnson* decision, 254 F. Supp. 73 (N.D. Tex. 1966), and the Tax Court majority in *Crown* were heavily criticized for failing to consider the "economic realities" of the interest-free loan. 585 F.2d, at 236; Crown v. Commissioner, 67 T.C. 1060, 1065 (1977) (J. Simpson, dissenting); *see* secondary sources cited in note 45 *supra.*

47. This missed chance to increase wealth is termed the "opportunity cost" of the loan. 585 F.2d at 235. The court went further to note that it was not necessary that the interest rate be set at zero for the economic benefits to be transferred to the recipient; the interest rate need only be less than the appropriate market rate of interest. *Id.*

48. *Id.* at 236. The *Johnson* decision, 254 F. Supp. 73, and the Tax Court in *Crown* both failed to consider the income splitting issue though the facts in *Crown* suggest precisely this intended result: $16,000,000 of the funds were lent for the purpose of investment in a partnership known as Henry Crown & Co., 67 T.C. at 1061. The name of the partnership suggests that it comprised family members in whom the taxpayer sought to invest his money with the investment benefits to pass to low income family members without taxation in his income brackets. *See* note 18 *supra* and accompanying text on the income-splitting issue and the gift tax statute. The court rejected petitioner's argument that protection of the income tax is only a "natural consequence" of the gift tax rather than one of its purposes. 585 F.2d at 235 n.2.

49. 585 F.2d at 236.

50. The dissent in the Tax Court in *Crown* apparently did not find controlling the difference between a term loan and a demand loan in calculating the depletion of the taxpayer's estate. 67 T.C. at 1069-70.

51. 585 F.2d at 236. The Commissioner offered no evidence showing that demand notes systematically trade in the market place at a significant discount from face value, *id.* at 238, or even that the right to use funds loaned on demand has an exchangeable value. *Id.* at 239.

taxed as if he had when he hasn't," but conceded that "[p]ermitting others to enjoy the economic benefits of an asset can be seen as one means of exerting control over the asset's economic potential."[52] This was not determinative, however, because there was no evidence that Congress, in protecting the estate tax, "was concerned with the use of gifts to diminish a taxpayer's potential estate as well as his actual one."[53]

The court agreed with the Commissioner that there are good policy reasons for taxing interest-free loans because nontaxation would result in different tax consequences for economically similar transactions, for example, for loans to irrevocable trusts or the establishment of revocable trusts.[54] The court, expressly reserving decision on the issue, noted that the differential between the present discounted value and face amount of interest-free term loans might be taxable as a gift.[55] Policy reasons, however, were insufficient to support a finding of taxability because the scope of the gift tax statute was simply not broad enough to

52. 585 F.2d at 236-37. The court noted that this might serve as a theoretical basis for distinguishing gifts, similar to those in *Crown*, from other situations in which the taxpayer lets his productive property lie totally fallow. *Id.* at 237. *See* R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 10-11 to 10-12 (4th ed. 1978).

The court's approach is similar to that set forth in Treas. Reg. § 25.2511-2(f) (1958), requiring income payments paid to revocable trusts to be taxed to the settlor as gifts because of his retained control over the trust corpus. *See also* Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

53. 585 F.2d at 237.

54. *Id.* If the taxpayer contributes the money to an irrevocable trust, a gift of the discounted value of the income of the trust for the trust term will result at the time of the trust's creation; but no further gifts will occur if the income actually paid to the beneficiary is in excess of this amount. *Id.* The court viewed the revocable trust as even more analogous to a demand loan, but noted the important distinction that a trust beneficiary is given income already produced by the capital, while the borrower in a demand loan is given only the opportunity to use the principal productively. *Id.* at 237 n.8.

55. *Id.* at 237 n.7, (citing Mason v. United States, 513 F.2d 25 (7th Cir. 1975), and Blackburn v. Commissioner, 20 T.C. 204 (1953)). *See* notes 35-36 *supra* and accompanying text.

At oral argument the taxpayer conceded that the present discounted value of a no-interest, term loan would be less than its face amount. This led the court to suggest that a gift might be found under section 2512(b), referring to *Mason* and *Blackburn*. The IRS relied on *Blackburn* in Rev. Rul. 73-61, as did Judge Simpson in his dissent from the Tax Court majority in *Crown*, 67 T.C. at 1068 (Simpson, J., dissenting), in reasoning for a finding of taxability of demand loans. Neither distinguished *Blackburn* on the ground that it involved a term loan rather than a demand loan. Although both the IRS and Judge Simpson noted that some interest had been charged in *Blackburn* rather than none, as in the *Johnson* and *Crown* cases, neither felt this distinction was material. 67 T.C. at 1068 (Simpson, J., dissenting); Rev. Rul. 73-61, 1973-1 C.B. 408, 409. *See* note 47 *supra*.

apply to a *demand* loan transaction.[56]

The court also rejected the Commissioner's statutory arguments for taxing demand loans. The Commissioner first argued that the interest-free demand loan was an "unequal exchange" under section 2512(b),[57] because at the time of the loan the lender transferred to the borrower an asset worth more than the promise for repayment received as consideration. The court noted that although this argument might be sound in the abstract, it was flawed in application because of the impossibility of instantaneous repayment.[58] The value of the right to repayment is both unknown, because the Commissioner offered no evidence "showing that demand notes systematically trade at a significant discount from face value in the marketplace,"[59] and unknowable, because no present discount formula can be applied in the absence of knowledge of when the loan will be repaid.[60] The Commissioner's attempt at valuation by assessing the tax once a taxing quarter has passed[61] was inaccurate as well as theoretically inconsistent with the proffered theory of taxation because it compared values at two points in time,[62] could have resulted in a tax on more than the face amount of the loan,[63] and was based on the unfounded assumption that when

56. 585 F.2d at 237. The court reviewed the extremely expansive application of the gift tax. *Id.* at 237-38.

57. *Id.* at 238. *See* note 13 *supra* for text of this provision.

58. 585 F.2d at 238.

59. *Id.*

60. *Id.* The court noted:

> The most that can be said is that the eventual value of the notes expressed in terms of a present discounted value as of the time of the loan will range somewhere between zero and the face amount of the notes. The reason that the value at the time of the loan cannot be determined with greater certainty is that the transfer of the economic benefit is incomplete at that point, being yet totally dependent on the lender's continued willingness to refrain from demanding repayment.

Id. See note 29 *supra.*

61. This is the method suggested in Rev. Rul. 73-61. *See* note 43 *supra.*

62. The court noted "the 'unequal exchange' approach of Section 2512(b) implicitly assumes that the values being compared will be measured at the same point in time, just as Section 2512(a) requires that an outright gift of property be valued at the date of the gift." 585 F.2d at 239.

63. The failure to discount the interest imputed in subsequent periods back to the time of the loan leads to the seeming paradox that if the lender were to permit the interest-free loan to remain outstanding for a sufficiently long period before demanding repayment, he would end up paying more in gift taxes than he would have had he made an outright gift of the loan principle.

Id. at 239. The court gave an example of this paradox, but then qualified its importance:

> For example, if a lender makes a $1,000 no-interest loan and the "proper" interest rate is 10%, under the IRS formula he would be treated as having made a gift of $100 in each year the loan remains outstanding. Thus, if the loan remains outstanding for 20 years,

making the loan the borrower and lender predetermined that the loan would be outstanding for the period during which the Commissioner sought to apply the tax.[64]

The Commissioner alternatively argued that under section 2512(b) the right to use money loaned on demand is a discrete proprietary interest gratuitously transferred, analogous to the right to use property in a tenancy at will.[65] The court rejected this argument because the right to use money lacks the necessary attributes of a property interest. The right is not "protected by law" and has no "exchangeable value."[66] A recipient of a demand loan does not have a legally protected interest *vis-a-vis* the lender,[67] and even if the theoretical existence of an exchangeable value is conceded,[68] the Commissioner's method of measuring that value is "seriously deficient."[69]

The court then rejected the Commissioner's variation of his arguments—that the gift is completed when and to the extent the lender

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he will be treated as having made gifts totaling $2,000, whereas he would only have been taxed on $1,000 if he had made a gift of the principal in the first place. However, the paradox is one of nominal rather than real values. In the case of the outright gift the tax is paid immediately, while under the loan the tax is paid at various points in the future. Because of the time-value of money, the present value of the two alternatives may be about the same.

Id. at 239 n.14.

64. *Id.* at 239. As suggested earlier, *see* note 55 *supra* and accompanying text, courts are likely to subject interest-free, term loans to gift taxation under the present gift tax laws because of the absence of the valuation problems associated with demand loans.

65. 585 F.2d at 239.

66. *Id.* These attributes are apparently drawn from the language of the congressional reports. *See* note 14 *supra.*

67. 585 F.2d at 239.

68. The court carefully distinguished the conceptual difference between the right to use money and money itself. While money itself, of course, has an exchangeable value, the Commissioner offered no evidence showing that the borrower's "at will" interest had an exchangeable value. *Id.* One should further distinguish between interest and the right to use money. The two are tied together because the amount of interest demanded usually correlates with the value of the use rights transferred by a loan, how much money is transferred and for how long, and any other limitations on use. The precise problem here is that while the right to use money has been transferred, it is difficult to estimate a correlating interest rate that ordinarily would have been demanded.

69. *Id.* The court distinguished cases, such as Galt v. Commissioner, 216 F.2d 41 (7th Cir. 1954), *cert. denied,* 348 U.S. 951 (1955), in which the court rejected an IRS attempt to tax as a gift a series of payments received by virtue of an earlier transferred right, in favor of a single tax on the right at the time of transfer, because in this case the right transferred was revocable. 585 F.2d at 239 n.16. *See* notes 21-25 *supra* and accompanying text. *See also* Putoma Corp. v. Commissioner, 66 T.C. 652 (1976) (court refused to treat shareholder's cancellation of debt of the corporation as an assignment of income to the corporation).

refrains from demanding repayment—because it would require stretching the gift tax concept of what constitutes a property right.[70] This "cancellation of the indebtedness" argument rests on the unsupported premises that the borrower is under a legal obligation to pay for the right to use money (interest), and that the lender subsequently and continuously forgave the obligation.[71]

Judge Wood further noted that judicial broadening of the scope of the gift tax to cover demand loans would be without precedent[72] and contrary to the proper role of the judiciary.[73] It would involve the courts in the difficult task of determining an appropriate interest rate for imputation without statutory or regulatory guidelines,[74] and the tax would reach other currently untaxed exchanges of economic benefit.[75] Furthermore, the equities were with the taxpayer, who made the loans seven years before the publication of the Commissioner's nonacquiescence in the *Johnson* decision.[76] The court pointedly left undecided the

70. 585 F.2d at 240.

71. *Id.*

72. The court characterized Mason v. United States, 513 F.2d 25 (7th Cir. 1975), Commissioner v. Edwards, 135 F.2d 574 (7th Cir. 1943), and Blackburn v. Commissioner, 20 T.C. 204 (1953), as indirect support for the "unequal exchange" approach under § 2512(b). 585 F.2d at 240. Like the Tax Court below, the *Crown* court pointed to the courts' consistent rejection of the IRS attempt to impute taxable income to the recipients of interest-free loans. *Id.* (citing Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862 (3d Cir. 1974); Saunders v. United States, 294 F. Supp. 1276 (D. Hawaii 1968), *rev'd on other grounds*, 450 F.2d 1047 (9th Cir. 1971); and Dean v. Commissioner, 35 T.C. 1083 (1961)). *See* notes 30-31 *supra* for a summary of the holdings of these cases.

73. 585 F.2d at 241.

74. *Id.* at 240-41.

75. *Id.* at 241. The Johnson court, 254 F. Supp. at 77, and the Tax Court below, 67 T.C. at 1065, seemed primarily concerned with situations involving the gratuitous use or sharing of real or personal property among relatives. The Seventh Circuit went further and suggested the principle of taxability might be extended to an office worker lending $10 until the next payday, a neighbor borrowing a lawnmower, or out-of-town guests who are provided free lodging with friends instead of staying at a hotel. 585 F.2d at 241.

76. *Johnson* was decided in 1966; the *Crown* loan transactions took place in 1967; Rev. Rul. 73-61 was issued in 1973; the Commissioner first assessed the gift tax deficiency for the *Crown* transaction in 1973. The IRS did not argue that the loans were within the coverage of section 2512(b) until argument before the Seventh Circuit. 585 F.2d at 241 n.19.

The Tax Court in *Crown* saw the IRS assertion of taxability long after the basic statute had been enacted as the "crux of the matter," but the dissent correctly noted the established tax principle that recent adoption of a position does not render it invalid, provided the Commissioner is acting within his authority, and he may, even retroactively, change an incorrect interpretation of the law as previously applied by him. 67 T.C. at 1070 (Simpson, J., dissenting) (citing Dixon v. United States, 381 U.S. 68 (1965), and Auto Club of Mich. v. Commissioner, 353 U.S. 180 (1957)). *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976); Morton v. Ruiz, 415 U.S. 199, 232

possible validity of a prospective regulation making such loans taxable absent specific statutory authority.[77]

Judge Van Pelt, in dissent, argued that the gift tax statutes are broad enough to encompass the gratuitous transfer of a proprietary interest such as the right to use money, even though not specifically enumerated in the statute or regulations; therefore no judicial stretching is required to tax the lender.[78]

The *Crown* case is an example of how concepts of valuation become intertwined with analysis of the basic definition of a taxable gift. The

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(1974); Manhattan Gen. Equip. Co. v. Commissioner, 297 U.S. 129, 134 (1936); Anderson, Clayton & Co. v. United States, 562 F.2d 972, 979 (5th Cir. 1977); Dobbs v. Costle, 559 F.2d 946, 948-49 (5th Cir. 1977); Burck v. Commissioner, 533 F.2d 768, 774 (2d Cir. 1976); Quinn v. Commissioner, 524 F.2d 617, 622 (7th Cir. 1975); Matson Navigation v. Commissioner, 68 T.C. 847, 852 (1977); I.R.C. § 7805(a) & (b).

Suggested factors to be used in reviewing the Commissioner's exercise of his discretionary powers to adopt retroactive regulations are:

> (1) whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters the law; (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative re-enactment of the pertinent Code provisions; (3) whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether according retroactive effect would produce an inordinately harsh result.

Anderson, Clayton & Co. v. United States, 562 F.2d 972, 981 (5th Cir. 1977). Judge Learned Hand's comments on paying taxes are apposite: "Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." Commissioner v. Newman, 159 F.2d 848, 851 (2d Cir.), *cert. denied*, 331 U.S. 859 (1947).

The dissent in the Tax Court below noted:

> [E]ven though the discounted value of a demand note cannot be ascertained, the privilege of using the borrowed funds interest free is nonetheless valuable. The difference in facts means merely that we must find a different means for measuring the value of such privilege, and we are satisfied that the method used by the Commissioner is reasonable. Instead of valuing the obligation for repayment at the time of its creation, we wait until the money has been used for some period of time and then measure the value of such use.

67 T.C. at 1069 (Simpson, J., dissenting). "Reasonableness" and whether the Commissioner considered "all relevant factors" is the standard of review over the Commissioner's determination of the value of transferred property that has no comparable counterpart. *See* Commissioner v. Edwards, 135 F.2d 574 (7th Cir. 1943); notes 27-29 *supra*.

77. 585 F.2d at 241. A prospective regulation could alleviate many of the theoretical and practical problems Judge Wood saw in taxing demand loans under the present statutory and regulatory framework. For example, the IRS could set a reasonable interest imputation rate. By so doing, both the taxpayer and the Commissioner would know in advance whether a loan was a gift and, if so, the amount of the gift. This approach could limit the potentially broad reach of the principle, *see* note 75 *supra* and accompanying text, eliminate its troublesome retroactive application, and most importantly, solve valuation problems.

78. 585 F.2d at 241-42 (Van Pelt, J., dissenting).

usual gift tax analysis requires an initial determination of whether there has been (1) a transfer (2) of property (3) by gift,[79] and then a determination of the value of the property so transferred.[80] In contrast, the *Crown* majority's reasoning is grounded in practical valuation considerations. There is no "gift" because it would be impossible to demonstrate that the exchange was unequal, since no evidence established that the value of the promise to repay on demand was worth less than the principal amount of the loan.[81] Alternatively, there is no "property" because the right to use funds loaned on demand has no fixed exchangeable value.[82] The Commissioner's attempt to value the economic benefit as a continuous gift is based on unfounded assumptions.[83]

The court decided the unequal exchange issue persuasively: there is no reasonable way to estimate in money's worth the value of a promise to repay a loan on demand either at or after the time of making the loan.[84] The court's determination that a lack of exchangeable value renders the right to use funds not a taxable property interest is less

79. I.R.C. § 2501(a). *See* C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 24 (3d ed. 1974).

80. I.R.C. § 2512. *See* notes 12-13 *supra* for text of this section.

81. *See* notes 57-64 *supra* and accompanying text.

82. *See* notes 66-69 *supra* and accompanying text. The court's alternate point—that there is no authority establishing that a recipient of a demand loan has a legally protected interest *vis-a-vis* the lender—is at best flimsy support in the face of strong authority to the effect that tenants at will have legally recognized contract rights against third parties. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 129, at 932 (4th ed. 1971), and cases cited therein. Surely, a recipient of a demand loan has contract rights protectible against third parties' interference during the period the loan is lawfully outstanding. It is unlikely that the court intended this to be a real basis for the finding of no property interest and, consequently, no gift tax liability.

83. *See* notes 70-71 *supra* and accompanying text.

84. The Commissioner's method involves repeatedly applying a tax rate assessed on a future value (dependent on how long the loan is outstanding) to a past, one-time loan transaction. Some courts have held a court cannot consider facts arising after the date of the gift in determining the value of the gift as of that date. *See* Lockard v. Commissioner, 166 F.2d 409 (1st Cir. 1949). However, facts that could reasonably have been anticipated as of the date of the gift may be shown to corroborate a valuation as of the date of the gift. Hyman v. Nunan, 143 F.2d 425 (2d Cir. 1944); Beck v. Commissioner, 15 T.C. 642 (1950), *aff'd*, 194 F.2d 537 (2d Cir.), *cert. denied*, 344 U.S. 821 (1952). *See* notes 60 & 62 *supra* and accompanying text.

The court's parallel analysis of the Commissioner's "frustration of estate tax" argument—no evidence of actual substantial market value of promise to repay as less than the face value of the note; thus no evidence of impairment of the estate tax—is likewise persuasive. *See* note 50-51 *supra* and accompanying text. Note, however, that demolishing one policy argument in favor of taxation alone does not strengthen the court's argument, but merely weakens the Commissioner's position.

persuasive in light of its similarity to the situation in which the property interest is merely difficult to value because of the absence of a "market" or comparable transfers.[85] If the concern centered on the inaccuracy[86] or theoretical imperfection[87] of the Commissioner's method of valuation, the court could have found that the Commissioner acted unreasonably in setting a value for the right to use funds loaned by the taxpayer, and thus could have reached the same result on narrower grounds.[88] This approach would have met the dissent's strong argument that the gift tax is broad enough to encompass the transfer of economic benefits by interest-free demand loans,[89] avoided a harsh tax result in the *Crown* case in which other equitable considerations fa-

85. In the absence of a "fair market value," or specific regulatory guidance, the Commissioner is required to consider "all relevant factors" in determining a value. *See* notes 27-29 *supra* and accompanying text. The absence of a ready market or price does not prevent the valuation of property. Guggenheim v. Rasquin, 312 U.S. 254 (1941). *See generally* Annot., 60 A.L.R.2d 1304 (1958). Moreover, the court's argument seems to be circular: there is no property interest because it cannot be valued; because the interest cannot be valued, it is not "property."

86. *See* note 69 *supra* and accompanying text.

87. *See* notes 70-71 *supra* and accompanying text.

88. The Commissioner must act reasonably in determining value. Commissioner v. Edwards, 135 F.2d 574 (7th Cir. 1943). In *Crown* the Commissioner followed the method outlined in Rev. Rul. 73-61 to value the right to use funds, retroactively applying the rate of interest parties at arms' length would have charged for the right to use the loaned funds. The Commissioner's use of a market interest rate can be semantically confusing. The IRS is not seeking to impute interest income as it does under I.R.C. §§ 482 & 483. *See* note 32 *supra*. The interest rate is used as an estimate of value. The actual amount of interest or investment income generated by the use of funds by the borrower is irrelevant in determining gift tax liability of the lender, which is at issue in the *Crown* case; the income potential from use of the loaned funds is relevant only as one factor indicating the value of the right to use funds.

Applying the rate of interest that parties at arms' length would have charged for the period determined by the length of time the lender forebears from recalling the loan probably is not an accurate estimate of the value for intra-family demand loans. A person may have sought a loan from a relative because of a higher-than-average commercial interest rate, scarcity of funds, or the availability of lower (perhaps even zero) interest rates. Thus, the characteristics of each transaction may have to be examined in closer detail to determine more accurately the value of the right transferred, rather than applying a commercial average and assuming an arms' length bargain. On the other hand, the average or prime rate certainly is a starting point, and the rate determined by the Commissioner in the *Crown* case was arguably a reasonable estimate of the value of the right to use funds because it was the same as the rate the borrower would have charged had repayment been demanded and because it was within the current market rates. *See* note 7 *supra*. *See generally* R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 4 (4th ed. 1978). Other methods of valuation, such as those found in the regulations under I.R.C. § 482, *see* note 32 *supra*, while not insuring complete accuracy, have the virtue of predictability and uniformity. *See* Duhl & Fine, *New Case Allowing Deduction Calls for Reappraisal of Interest Free Loans*, 44 J. TAX. 34, 37 (1976).

89. *See* notes 14-17 *supra* and accompanying text.

vored the taxpayer,[90] and permitted the IRS to issue prospective regulations to close the tax loophole.[91] This narrower holding would also better correlate with the court's strong dicta suggesting the IRS has the authority to tax the right to use funds transferred by interest-free term loans, which are more susceptible to valuation than the right to use funds transferred by demand loans.[92] If the Commissioner is able to show that the right to use funds loaned on demand has an exchangeable value or is worth less than the promise to repay, it may be possible in future cases to limit *Crown* to its facts.

In sum, although the Seventh Circuit sustained the taxpayer's position in *Crown*, the potential for change through legislative or administrative action should serve as a warning to tax planners who seek to use interest-free demand loans to secure tax advantages.[93]

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90. *See* note 76 *supra* and accompanying text.

91. The court closed the opinion with the cryptic remark that it would not pass on the validity of prospective regulation providing for taxation. *See* note 77 *supra* . However, this is inconsistent with the court's determination that there is no statutory authority for the taxation of demand loans. 585 F.2d at 241.

92. *See* notes 50 & 55 *supra* and accompanying text.

93. In the interim, however, a tax planner may find demand loans useful for splitting income. *See* ESTATE PLANNING IDEAS (IBP) (Oct. 1978); FED. EST. & GIFT TAX. REP. (CCH) ¶ 12,192.