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THE TAX CONSEQUENCES OF INTEREST-FREE LOANS FROM CORPORATIONS TO SHAREHOLDERS AND FROM EMPLOYERS TO EMPLOYEES

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INTRODUCTION

Between corporations and shareholders, as between employers and employees, interest-free¹ loans are commonplace.² Economically, their effect is identical to that of a loan on which interest is charged, accompanied by an increase in either dividend or compensation, in an amount equal to the charged interest.³ That is, the two-payment transaction is economically indistinguishable from the interest-free loan. And yet, under present law, the tax consequences are quite different.

This observation may be illustrated by an example.⁴ Corporation X makes an interest-free loan of \$1,000 to its sole shareholder for twelve

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¹ While this article speaks only of loans without interest, its reasoning applies equally to loans which carry an interest rate lower than that which would have been imposed in an arm's length transaction.

² This is particularly true of interest-free loans from employers to employees. In 1974, *Business Week* reported that "more and more companies now grant low or no-interest loans to attract middle and upper-management executives." *Business Week*, Nov. 9, 1974, at 162. It also has been reported that many professional athletes are demanding "interest-free loans from their employers as part of their compensation package." Duhl & Fine, *New Case Allowing Interest Deduction Calls for Reappraisal of No-Interest Loans*, 44 J. TAX. 34, 34 (1976).

³ It is assumed throughout this article that the described interest-free loan creates a bona fide obligation on the part of the shareholder or employee to repay the principal. If no bona fide obligation exists, the entire amount of the loan principal could be treated as a dividend or compensation distribution. *Livornois Trust v. Comm'r*, 433 F.2d 879, 883 (6th Cir. 1970). See BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.05, at 7-26 (3d ed. 1971). While one test of a bona fide debt is a provision for interest on the loan, e.g., *Berthold v. Comm'r*, 404 F.2d 119, 122 (6th Cir. 1968), the failure to charge interest, standing alone, is not dispositive. See, e.g., *J. Simpson Dean*, 35 T.C. 1083, 1087-90 (1961).

⁴ See, e.g., Sneed, *Unlabeled Income and Section 483*, 1965 SO. CAL. TAX INST. 643, 652-53.

months. Assume that the prevailing market interest rate for such a loan is eight percent.⁵ The two-payment transaction which would yield the same economic effect as the no-interest loan is this:

Payment 1 — Corporation pays shareholder an \$80 cash dividend.

Payment 2 — Shareholder pays corporation \$80 cash as interest on a \$1,000 loan over a twelve month period at eight percent.

The tax consequences of the two-payment transaction are as follows: the corporation-lender would have \$80 interest income⁶ from Payment 2 and no offsetting deduction from the payment of the dividend (Payment 1);⁷ the shareholder-borrower would have dividend income of \$80 from Payment 1⁸ and an offsetting interest deduction in the same amount from Payment 2.⁹ The interest-free loan, by contrast, yields a different tax consequence under present law: the corporation making the loan realizes no interest income¹⁰ and the shareholder receiving it has neither dividend income¹¹ nor a deductible interest payment.¹² The law's current approach to the interest-free loan may be labeled the "no income, no deduction" approach.

In this article, it is argued that the failure of our taxing system to treat the interest-free loan in conformity with its analogous two-payment

⁵ For a discussion of the problems involved in determining the appropriate interest rate, see text at notes 131-35 *infra*.

⁶ I.R.C. § 61(a)(4). The \$80 income item will also increase corporate earnings and profits by \$80. See Treas. Reg. § 1.312-6(b) (1960). See also B. BITTKER & J. EUSTICE, *supra* note 3, at ¶ 7.03, at 7-13-14.

⁷ However, corporate earnings and profits would be reduced by the \$80 cash dividend paid. I.R.C. § 312(a)(1).

⁸ Corporate distributions to shareholders out of current or accumulated earnings and profits are taxable as ordinary income to the recipient. I.R.C. §§ 61(a)(7); 301(c)(1); 316(a). I.R.C. § 116(a) excludes the first \$100 of dividends received by an individual shareholder and the first \$200 on a joint return. Treas. Reg. § 1.116-1(b) (1960). A corporate distributee has available an 85% dividends received deduction. I.R.C. § 243.

⁹ This assumes that the taxpayer either itemizes his deductions or applies the principal for a business purpose. I.R.C. § 163 permits an itemized deduction for "all interest paid or accrued within the taxable year on indebtedness." An interest deduction is proper whether the debt arises from a personal or a business obligation. If, however, the interest is a business expense, or is attributable to property held for the production of rents or royalties, it is deductible from gross income in arriving at adjusted gross income, see I.R.C. § 62(a); *F.R. Ingram v. Comm'r*, 20 T.C.M. (CCH) 1447, 1464-65 (1961), and so is available to taxpayers who do not itemize. Interest on funds borrowed to purchase other investments is deductible only from adjusted gross income. *Id.* There are, however, a number of limitations on a taxpayer's right to claim an interest deduction. See text at notes 32-35 *infra*.

¹⁰ See, e.g., *Brandtjen & Kluge, Inc.*, 34 T.C. 416, 447 (1960); *Society Brand Clothes*, 18 T.C. 304, 320-21 (1952). See text at notes 71-103 *infra*. Presumably, because the corporation realizes no income, the interest-free loan neither increases nor decreases corporate earnings and profits. This is because earnings and profits are computed by reference to income. See Treas. Reg. 1.312-6(b) (1960); B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 7.03, at 7-13 - 7-14.

¹¹ *J. Simpson Dean*, 35 T.C. 1083, 1090 (1961). See text at notes 13-23 *infra*.

¹² See *Howell Turpentine Co.*, 6 T.C. 364, 393-94 (1946), *rev'd on other grounds*, 162 F.2d 316 (5th Cir. 1947); *Rainbow Gasoline Corp.*, 31 B.T.A. 1050, 1059-60 (1935). See text at notes 55-70 *infra*.

transaction cannot be justified. Instead, the interest-free loan should be treated identically with its two payment counterpart, by employing a "two-payment transaction analysis." Under this analysis, the interest-free loan is resolved into its hypothetical components. Thus the lender is deemed to transfer to the borrower not only the principal of the loan but also an amount sufficient to cover a reasonable interest charge. This interest amount is later deemed repaid to the lender. Part I of this article examines the interest-free loan from corporation to shareholder and discusses three questions: first, whether the shareholder-borrower realizes dividend income from the free use of the borrowed money; second, whether the shareholder-borrower is entitled to an interest deduction; and third, whether the corporation-lender realizes interest income. Part II of the article applies the corresponding questions to the situation of the interest-free loan from employer to employee and poses a further question: whether the employer-lender is entitled to a business expense deduction for compensation paid.

Part III, concerning timing and valuation questions, discusses first, the appropriate interest rate to be applied to the interest-free loan assuming that income is realized; and second, the peculiar timing problems of taxpayers reporting income and taking deductions arising from an interest-free loan transaction. The different issues raised by demand loans and loans with a fixed repayment date are separately considered in this section.

Part IV considers the tax consequences of bargain sales of property by an employer or corporation to an employee or shareholder in exchange for the latter's non-interest bearing promissory note. The section examines the overlap between section 483 of the Internal Revenue Code (Code), a section which permits the imputation of interest in certain transactions, and the recommended analysis of taxing the interest-free loan as a two-payment transaction.

Finally, Part V of this article examines the applicability of section 482 of the Code to interest-free loans from corporations to shareholders where the corporate lender and the shareholding borrower are not commonly controlled corporations.

I. THE INTEREST-FREE LOAN FROM CORPORATION TO SHAREHOLDER

A. *Does the Shareholder-Borrower Realize Dividend Income?*

The first question raised concerning the interest-free loan from corporation to shareholder involves the income consequences to the shareholder. At first glance, these consequences would appear obvious. The shareholder should report dividend income equal to the economic benefit derived from the interest-free loan¹³—i.e., a sum equal to a reasonable in-

¹³ This assumes that the corporation has sufficient earnings and profits to support the dividend. If the economic benefit exceeds corporate earnings and profits, the excess should reduce the shareholder's basis in his stock to the extent thereof, I.R.C. § 301(c)(2), with any additional amount being treated as gain from the sale or exchange of the shareholder's stock, I.R.C. § 301(c)(3).

interest rate on the loan. Under section 61 of the Code, gross income is defined as "all income from, whatever source derived" unless excluded by other provisions of the Code. It is clear that items of gross income need not be in the form of cash;¹⁴ all economic benefits are taxed, whether such benefits take the form of title to property, free services, or the rent-free use of corporate owned property.¹⁵ Since the use of money seems no different from the use of tangible property,¹⁶ the economic benefits derived from such use should be taxed. Yet, in the only case to decide the income issue, the Tax Court, in *J. Simpson Dean*,¹⁷ held that a stockholder realizes no income from his interest-free use of a corporation's money.¹⁸

In *Dean*, a corporation had made interest-free loans in excess of two million dollars to its controlling shareholders. Relying on the long series of cases holding that the rent-free use of corporate property by a stockholder or officer results in the realization of income,¹⁹ the Commissioner asserted that the shareholders "realized income to the extent of the economic benefit derived from the free use of borrowed funds from [the corporation]."²⁰

¹⁴ Treas. Reg. 1.61-1(a) (1960). See B. BITTKER & L. STONE, *FEDERAL INCOME ESTATE AND GIFT TAXATION* 44 (4th ed. 1972). If the rule were otherwise, "[t]ax burdens would fall in an irrational manner depending upon the fortuitous circumstance of the practicality of compensation in kind." *Id.*

¹⁵ Treas. Reg. 1.61-1(a) (1960). See, e.g., Charles A. Frueauff, 30 B.T.A. 449, 450 (1934) (shareholder taxed on fair rental value of corporate-owned apartment which he occupied rent-free). In *Commissioner v. Smith*, 324 U.S. 177 (1945), the Supreme Court stated that section 61's predecessor 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. See also STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, *EXAMINATION OF PRESIDENT NIXON'S TAX RETURNS FOR 1969-1972*, at 158-61 (Comm. Print. 1974) (free use of government transportation on personal business constitutes "income").

¹⁶ See STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, *supra* note 15, at 171 n.6.

¹⁷ 35 T.C. 1083 (1961).

¹⁸ *Id.* at 1090. In *Saunders v. United States*, 294 F. Supp. 1276, 1282 (D. Hawaii 1968), *rev'd on other grounds*, 450 F.2d 1047 (9th Cir. 1971), the district court held, without discussion, that an interest-free loan did not constitute compensation to an employee. Cf. *Joseph Lupowitz Sons, Inc. v. Commissioner*, 497 F.2d 862, 868 (3d Cir. 1974) (no constructive dividend to common shareholders on interest-free loans between related corporations).

The Tax Court has dodged opportunities to review its *Dean* decision. See *Claude J. Lisle*, 35 T.C.M. (CCH) 627, 640 (1976); *Arthur Genshaft*, 64 T.C. 282, 291 (1976). But in *Lester Crown*, 67 T.C. 1060 (1977), a recent case in the related area of the gift tax consequences of interest-free loans, the Tax Court appeared to reaffirm its no-income decision in *Dean*. The Tax Court in *Crown* stated that, "[t]he courts have uniformly rejected every attempt by the Internal Revenue Service to subject the making of non-interest bearing loans to income or gift taxes." *Id.* at 1064. On the gift tax question before it, the Tax Court in *Crown* held that an interest-free loan did not constitute the transfer of an interest in property, and was therefore not a taxable gift. *Id.* at 1062. *Accord*, *Johnson v. United States*, 254 F. Supp. 73, 77 (N.D. Tex. 1966). *Contra*, Rev. Rul. 73-61, 1973-1 C.B. 408; *Gertrude H. Blackburn*, 20 T.C. 204, 207 (1953). The Tax Court majority in *Crown* failed to refer to its seemingly contrary decision in *Blackburn*. For a description of the *Blackburn* case see text at notes 153-56 *infra*. *Crown* is noted *infra* at p.359.

¹⁹ E.g., *Rodgers Dairy Co.*, 14 T.C. 66, 73-74 (1950) (rent-free use of a corporate automobile); *Percy M. Chandler*, 41 B.T.A. 165, 178 (1940), *aff'd*, 119 F.2d 623 (3d Cir. 1941) (rent-free use of corporation's apartment and lodge); Charles A. Frueauff, 30 B.T.A. 449, 451 (1934) (rent-free use of corporation's apartment). For a recent compilation of other similar cases, see STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, *supra* note 15, at 158-160.

²⁰ 35 T.C. at 1087.

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Judge Raum, speaking for the majority of the Tax Court, however, held that the interest-free loan resulted in no income to the stockholder-borrower, noting that the cases involving rent-free use of corporate property had only a "superficial resemblance" to the interest-free loan situation. The characteristic distinguishing the interest-free loan from the rent-free transfer of property, according to Judge Raum, was the fact that, in the interest-free loan situation, had the recipient of the interest-free loan actually paid interest, that interest would have been fully deductible under section 163.²¹ For this reason, Judge Raum declared the line of cases involving the rent-free transfer of corporate property to a stockholder or officer "not in point," saying of the rent-free cases:

In each of them a benefit was conferred upon the stockholder or officer in circumstances such that had the stockholder or officer undertaken to procure the same benefit by an expenditure of money such expenditure would not have been deductible by him. Here, on the other hand, had petitioners borrowed the funds in question on interest-bearing notes, their payment of interest would have been fully deductible by them under Section 163, I.R.C. 1954.²²

Accordingly, since the inclusion in income of the benefit of the interest-free loan would have been balanced by an equivalent deduction, Judge Raum decided that the same result could be achieved more easily by recognizing neither income nor a deduction.²³

The court's analysis in *Dean* is flawed in several respects. First, even where an interest-free loan would, if treated identically with the equivalent two-payment transaction, produce both income and an equivalent deduction, the inclusion in income nonetheless could give rise to important tax repercussions. For example, the itemized deduction for medical expenses is the amount by which medical expenses exceed three percent of adjusted gross income.²⁴ If adjusted gross income is increased by the economic benefit of an interest-free loan, the allowable medical deduction is reduced.²⁵ Moreover, in the case of an employee receiving an interest-free loan, use of the two-payment transaction approach could yield tax liability lower than that produced by the no-income, no-deduction approach. This would occur in situations where the economic benefit from the interest-free loan—which benefit constitutes "earned income" to the employee—is subject to tax at a

²¹ *Id.* at 1090.

²² *Id.*

²³ *Id.*

²⁴ I.R.C. § 213(a)(1).

²⁵ This result does not obtain, however, where the borrower's deduction for the constructive interest payment constitutes a business expense or is attributable to property held for the production of rents or royalties. In such cases, the constructive interest deduction reduces gross income. See note 9 *supra*. Because this reduction in gross income arising from the constructive interest payment exactly equals the increase in adjusted gross income attributable to the economic benefit of the interest-free loan, the reduction and increase cancel one another. As a result, adjusted gross income remains the same as it would have been had neither adjustment been made. So the "floor" of 3% of adjusted gross income is neither raised nor lowered, and the medical expense deduction (the amount above the floor) is identical to that provided by the no-income, no-deduction approach.

marginal rate of no higher than 50%,²⁶ while the equal interest deduction offsets some income otherwise taxable at a 60% or 70% marginal bracket.²⁷ In these and in other situations,²⁸ the no-income, no-deduction approach fails to give effect to provisions of the tax code by excluding from gross income or adjusted gross income the impact of the economic benefit attending an interest-free loan.

A second flaw in the majority's analysis in *Dean* can be found in its failure to identify certain situations in which the two-payment analysis would yield an interest deduction but would not produce an equivalent inclusion in income. For example, consider the case where an interest-free loan is provided to a shareholder at a time when the corporate lender has no current or accumulated earnings or profits. Applying *Dean*, the shareholder-borrower would have neither income nor a deduction. In a two-payment transaction, however, the borrower would have an interest deduction but no dividend income. This is so because Code sections 301 and 316 provide that a distribution which is not out of earnings or profits is not a taxable dividend.²⁹ In this case, then, the two-payment analysis, by providing a deduction which is not offset by an equivalent income inclusion, produces a more favorable tax result for the shareholder-borrower than does the no-income no-deduction method.³⁰

A third problem with the court's reasoning in *Dean* can be found in its implicit, broad assumption that the interest paid in a two-payment transaction will always be deductible under section 163.³¹ So broad an assumption is not warranted.³² For example, a person who does not itemize his de-

²⁶ I.R.C. § 1348 provides an alternative tax computation for earned income under which earned income in taxable income brackets which would otherwise be greater than 50% is subject to a flat 50% rate.

²⁷ For a full discussion of the mechanics of I.R.C. § 1348, see J. CHOMMIE, *THE LAW OF FEDERAL INCOME TAXATION* § 22 (2d ed. 1973).

²⁸ E.g., I.R.C. § 6501(e) (extends the running of the normal three year statute of limitations to six years where an omitted item, properly includible, exceeds 25% "of the amount of gross income stated in the return"); I.R.C. § 6012 (the necessity of filing an income tax return); I.R.C. § 6013(e)(1)(A) (relief of a spouse from joint tax liability); I.R.C. § 151(e)(1)(A) (the right to claim a dependent as an exemption); I.R.C. § 170(b) (limitations on the charitable contributions deduction). Judge Oppen, in a concurring opinion in *Dean*, recognized that although the amount required to be included in income under the two-step transaction analysis normally will be offset by an equivalent deduction, "it would not necessarily follow that there was no gross income." *Dean*, 35 T.C. at 1090-91. Nonetheless, he concurred in the court's opinion on the ground that there was no deficiency since the interest income and interest deduction probably would offset and cancel one another in this case. *Id.* at 1090.

²⁹ The borrower-shareholder, however, would be required to reduce his basis in the stock by the amount of the economic benefit, I.R.C. § 301(c)(2), with any amount greater than basis being treated as gain from the sale or exchange of his stock. I.R.C. § 301(c)(3).

³⁰ Favorable treatment under the two-payment analysis also results where the dividend income of an individual shareholder-borrower, excluding the constructive interest income, is less than \$100. Code section 116 excludes the first \$100 of dividend income for individual shareholders. In this case, that portion of the economic benefit of the interest-free loan which is applied against the statutory \$100 dividend exclusion would not be taxed, I.R.C. § 116, yet the shareholder would still enjoy the full interest deduction. The same result, full deduction without offsetting income, would accrue to corporate shareholders due to the dividends received deduction of I.R.C. § 243, provided I.R.C. § 482, which authorizes the Commissioner to allocate income among controlled taxpayers to reflect true income, does not apply.

³¹ 35 T.C. at 1090.

³² The court's overly broad generalization was criticized by the concurring and dissenting judges. *Id.* at 1091 (Oppen, J., concurring); *id.* at 1091 (Bruce, J., dissenting).

ductions³³ could not, of course, deduct the interest paid unless the borrowed funds were used for his business purposes.³⁴ Similarly, even the person taking itemized deductions would be entitled to this interest deduction only if the indebtedness were not "incurred . . . to purchase or carry obligations . . . the interest on which is wholly exempt from . . . taxes."³⁵ In these respects, then, Judge Raum's no-income, no-deduction approach could result in undertaxing the recipient of an interest-free loan when compared with the treatment afforded the taxpayer in the economically equivalent two-payment transaction where the taxpayer receives a dividend and pays an equal amount of interest.

Another flaw in the court's analysis in *Dean* appears in the majority's reliance on the deductibility of interest, contrasted with the non-deductibility of rent, as the factor distinguishing the interest-free loan cases from those involving the rent-free use of property.³⁶ The majority asserted this distinction as the basis for refusing to apply the line of cases holding that the rent-free transfer of corporate property to a shareholder produces income to the shareholder.³⁷ The court's assumption that a stockholder-recipient of a rent-free transfer of corporate property would never be entitled to a tax deduction had he actually paid rent for the property is inaccurate. Only where such property is for the recipient's personal use is a deduction impermissible. Where the property is used for his business or income producing purposes, a deduction is permitted.³⁸ This point was made by Judge Opper in a concurring opinion in *Dean*. As an example of an allowable deduction for constructive rent payments, Judge Opper suggested the case where a stockholder receives the rent-free use of corporate property which the stockholder then leases to a third party:

Would the fact that [the stockholder] could presumably deduct as a business or nonbusiness expense the hypothetical rental value theoretically paid by him to the corporation, section 212, I.R.C. 1954, and thereby completely offset any gross income, lead us to conclude, as here, contrary to that whole line of cases, that there could be no gross income in the first place?³⁹

Thus, the *Dean* Court was mistaken in concluding that loan interest payments are always deductible while rental payments are always nondeduct-

³³ See I.R.C. § 63. A taxpayer will itemize his deductions only if they exceed \$3,200 in the case of a joint return or surviving spouse, \$2,200 in the case of other single individuals, and \$1,600 in the case of a married individual filing separately.

³⁴ See note 9 *supra*.

³⁵ J. Simpson *Dean*, 35 T.C. at 1091 (Opper, J., concurring), citing I.R.C. § 265(2). Interest deductions are disallowed in other circumstances as well. For example, no deduction generally is allowed for any interest paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance, endowment, or annuity contract, I.R.C. § 264; or for certain interest paid or accrued by a noncorporate taxpayer to carry investment property which produces little or no current income, I.R.C. § 163(d)(1). In addition, interest can be denied in certain sham transactions. See, e.g., *Knetsch v. United States*, 364 U.S. 361, 362-70 (1960). For examples of other instances in which an interest deduction is disallowed, see J. CHOMMIE, *supra* note 27, at § 74.

³⁶ This criticism was made by Judge Opper in his concurring opinion. *Dean*, 35 T.C. at 1091 (Opper, J., concurring).

³⁷ *Id.* at 1090.

³⁸ I.R.C. §§ 162, 212.

³⁹ *Dean*, 35 T.C. at 1091 (Opper, J., concurring).

ible. As has been seen, both loan interest payments and property rental payments are deductible in some instances and nondeductible in others.

A final weakness in the court's reasoning lies in its failure to perceive the problem of timing involved where the date of repayment of an interest-free loan is more than a year in the future.⁴⁰ In such cases, the financial benefit is received currently and would be included in income in the current year, but the equivalent deduction for the constructive interest payment would be deferred more appropriately to a later year. This difference in the timing of income and deductions, which will be explored fully in Part III of this article, is another factor distinguishing the two-payment transaction analysis from the no-income, no-deduction approach.

The number of obvious problems with Judge Raum's analysis makes one wonder why he wrote the opinion as he did. The most likely answer is that, while he wanted to reach a result—no net taxable income to the recipient—that would prove rational in most interest-free loan cases, Judge Raum was unsure that this rational result could be reached once he held that the economic benefit from the interest-free use of corporate funds was income. The unexpressed fear presumably was a belief that even if such economic benefit were included in the shareholder's income, no offsetting interest deduction would be permitted for interest neither paid nor accrued. Without the offsetting interest deduction the shareholder would be overtaxed in a system which generally affords deductions for all interest paid.

Professor Joseph Sneed has suggested that this possibility of overtaxation justifies the result in *Dean*.⁴¹ While recognizing the rational force of taxing alike the interest-free loan and its economically equivalent two-payment transaction,⁴² Sneed concludes that it is impossible to reach the rational result once the shareholder-recipient includes the economic benefit of an interest-free loan in income. He observes that

[b]ecause it is difficult, to say the least, to obtain an interest deduction for interest neither paid nor owed, the best way to make these two economically equivalent transactions yield similar tax results is to exclude from the gross income of [the officer or shareholder] the economic benefits of an interest-free loan. Although the Tax Court's opinion in *J. Simpson Dean* is somewhat cryptic, its analysis, in holding an interest-free loan by a corporation to its shareholder did not result in gain to the borrower, is consistent with that just set forth.⁴³

Recognizing, however, many of the objections to this no-income, no-deduction result of *Dean*, Sneed concludes that the exclusion from income

⁴⁰ This timing problem has escaped the attention not only of the Tax Court in *Dean*, but also of commentators on that case. E.g., Baum, *Effects of Stockholder Use of Corporate Property, Including Stockholder Borrowings Deemed Dividends in Relation to Section 1341*, N.Y.U. 25th INST. ON FED. TAX 509 (1967); Duhl & Fine, *supra* note 2; O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. L. REV. 1085 (1974); Schlifke, *Taxing As Income the Receipt of Interest-Free Loans*, 33 U. CHI. L. REV. 346 (1966); Sneed, *supra* note 4.

⁴¹ Sneed, *supra* note 4, at 651-53.

⁴² *Id.*

⁴³ *Id.* at 653.

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should apply only where if the interest actually had been paid, the deduction for that interest would, in fact, have been available to the stockholder. If for any reason the deduction would not have been available, then Sneed would require that the economic benefit of the interest-free loan be taxed:

[T]he test should be this. *Is the interest-free loan such that had it been at interest a deduction for such interest would have been available?* If the answer is affirmative an exclusion is justified; otherwise it is not. While some may regard use of this test as the equivalent of inclusion accompanied by an offsetting deduction, it avoids direct confrontation with the problem of justifying a deduction for interest neither paid nor owed in fact.⁴⁴

While Professor Sneed's concern with reaching rational tax results is entirely appropriate, he employs a bizarre view of a court's role in interpreting the Internal Revenue Code. Professor Sneed first argues that a court may not legitimately interpret the words "paid or accrued" as used in section 163 to include constructive interest payments,⁴⁵ although, as this article demonstrates, such a non-literal interpretation is entirely defensible.⁴⁶ Then, in order to reach a rational result, while avoiding the "direct confrontation" of that non-literal interpretation, Professor Sneed proposes a strange and nearly unprecedented test for the existence of gross income.⁴⁷ That test would render the existence of income dependent on the availability of an itemized deduction offsetting the economic benefit received.⁴⁸

⁴⁴ *Id.* at 655 (emphasis in original).

⁴⁵ *Id.* at 652-53. Professor Sneed observed that "[t]o argue that an interest-free loan generates a deduction for interest 'paid' requires an affection for paradoxes, which many do not possess." *Id.* at 652 n.31.

⁴⁶ See text at notes 55-61 *infra*.

⁴⁷ Professor Sneed's no-income, no-deduction analysis is not entirely without precedent, but the precedent that does exist is of dubious validity. In the recent case of *Donald D. Focht*, 68 T.C. 223 (1977), the Tax Court held that the assumption of an obligation by a transferee in connection with a nontaxable incorporation will not produce taxable gain to the transferor under I.R.C. § 357(c) to the extent that the obligation would have been deductible by the transferor had he paid it. The Tax Court relied heavily on a footnote in the Supreme Court's opinion in *Crane v. Commissioner*, 331 U.S. 1 (1946). The Supreme Court held in *Crane* that the amount realized on a transfer of property subject to a mortgage includes the amount of the mortgage. *Id.* at 13. The Court did not, however, include in the amount realized the mortgage interest which the transferor had not yet paid or deducted, since the I.R.S. had conceded that the principal alone would enter into the amount realized. The I.R.S. made this concession because the transferor would have been entitled to a deduction for the interest had she paid it. The Supreme Court noted the Service's concession, without comment, in a footnote in *Crane*. *Id.* at 4 n.6. The Tax Court's reliance in *Focht* on the *Crane* footnote is unjustified since that footnote represented merely the Supreme Court's acknowledgement of a concession by the government attorney trying the case and did not constitute a holding. Moreover, the *Crane* footnote's approach would lead to an erroneous result in cases involving the transfer of a capital asset. Under a two-payment analysis, the amount of unpaid interest would be included in the amount realized and so would constitute capital gains, while the offsetting interest deduction would have been ordinary. For these reasons the footnote in *Crane* can hardly be deemed to constitute adequate precedent for adoption of the no-income, no-deduction approach urged by Professor Sneed. For a view of the *Crane* footnote as supporting the approach in *Focht*, see Kahn & Oesterle, *A Definition of "Liabilities" in Internal Revenue Code Sections 357 and 358(d)*, 73 MICH. L. REV. 461 (1975).

⁴⁸ There are a few other situations where the existence of gross income may turn on the availability to the taxpayer of an offsetting itemized deduction. For example, the cancellation by a creditor of a cash basis debtor's obligation to pay him interest might result in no income to the debtor. See Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of*

Moreover, Sneed's roundabout approach in fact would not resolve many of the problems of the no-income, no-deduction approach previously discussed.⁴⁹

Yet, with all its defects, the Sneed approach produces, in most cases, the logical result: no net taxable income for the shareholder or employee recipient of an interest-free loan. The same claim cannot be made for those commentators⁵⁰—with whom the I.R.S. apparently agrees⁵¹—who would have the recipient recognize income from an interest-free loan but would not permit him an offsetting deduction. For example, Professor James T. O'Hare, in a recent article on the subject, concluded that the correct analysis of an interest-free loan from corporation to shareholder is "dividend income that should not be offset by an interest deduction for unpaid interest."⁵² The asymmetry of O'Hare's conclusion apparently stems from the same statutory interpretation problem that influenced Professor Sneed and perhaps the majority in *Dean*; in Professor Sneed's words, "it is difficult, to say the least, to obtain an interest deduction for interest neither paid or owed."⁵³

As has been demonstrated, Professor O'Hare is correct in concluding that the borrower receives dividend income from the economic benefit of the interest-free loan.⁵⁴ He seems to be troubled by the concept of a deduction for constructive interest payments. That this difficulty is more apparent than real will be demonstrated in the next section.

B. *Is the Shareholder-Borrower Entitled to an Interest Deduction Under Section 163?*

If the interest-free loan is to have the same tax consequences for the shareholder-borrower as the economically equivalent two-payment cash transaction in which the shareholder receives an additional cash dividend which he pays as interest to the corporation, then not only must the recip-

Creeping Confusion, 14 TAX L. REV. 225, 252-53 (1959). The other side of the coin is illustrated by *Haverly v. United States*, 513 F.2d 224, 226-27 (7th Cir.), cert. denied, 423 U.S. 912 (1975), in which a taxpayer was deemed to have realized gross income on the receipt of unsolicited sample textbooks because he transferred those books to charity and took a charitable deduction. *Accord*, Rev. Rul. 70-498, 1970-2 C.B. 6.

⁴⁹ See text at notes 24-40 *supra*. The only problem resolved by Professor Sneed's approach is that of the case where an offsetting deduction would not be available under a two-payment analysis. See text at notes 31-35 *supra*.

⁵⁰ E.g., O'Hare, *supra* note 40, at 1096; Schlifke, *supra* note 40, at 353-58. Schlifke proposes a variety of esoteric alternatives for taxing the employee or shareholder-recipient of an interest-free loan; Schlifke, *supra* note 40, at 354-58; none of the alternatives, however, is the straightforward one of taxing the recipient on the economic value of the interest-free loan, and giving him an offsetting interest deduction in the same amount.

⁵¹ The I.R.S. has announced its nonacquiescence to the *Dean* case. 1973-2 C.B. 4. This clearly indicates its belief that there is income to the shareholder-recipient of an interest-free loan to the extent of the economic benefit derived from the loan. Exactly what the Service's nonacquiescence means with respect to the offsetting interest deduction issue is less clear, although presumably the I.R.S. would not allow the dividend income to be offset by an interest deduction. A number of commentators have assumed this to be the Service's position. E.g., Duhl and Fine, *supra* note 2, at 35; O'Hare, *supra* note 40, at 1096.

⁵² O'Hare, *supra* note 40, at 1096.

⁵³ Sneed, *supra* note 4, at 653. See O'Hare, *supra* note 40, at 1095.

⁵⁴ Recognition of dividend income depends, of course, on the presence of sufficient earnings and profits. See note 13 *supra*.

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ient realize income equal to the economic benefit derived from the loan, but he also must be entitled to an offsetting itemized deduction in the same amount, assuming only that an interest deduction would have been available to him had interest actually been paid. Once the interest value of an interest-free loan is recognized and taken into income, to permit its recipient to take a deduction for interest not actually "paid or accrued" would be far from revolutionary. Such an approach is analogous to the well-established practice of recognizing a cost basis in property which a taxpayer literally receives at no cost but includes in income.

Recognition of a basis in such property requires a broad, non-literal interpretation of the word "cost" in section 1012, which identifies basis simply as "cost." Applied literally, section 1012 would preclude any basis where, for example, an employee receives property as compensation. Yet it has long been accepted in these circumstances that the employee's basis in the property is the amount at which the property was includable in income.⁵⁵ Referring to the cost basis practice, Professor Ernest Brown has written that just such a non-literal understanding of the term "cost" is necessary "to give the statute the quality of rationality."⁵⁶ In his well-known piece on *The Growing "Common Law" of Taxation*, Professor Brown hypothesizes the case of a taxpayer who receives an automobile valued at \$5,000 as a bonus from his employer or as a prize in a lottery.⁵⁷ The taxpayer reports the automobile's value as income, and soon thereafter decides to sell it for cash.

Its value, let us say \$5,000, is clearly income to him when received. He reports it as such and pays the appropriate tax. But he decides that such a car is beyond his needs and style and sells it for cash. What is the tax result? What is his basis? Search the statute as we will, all we can find is "cost". And what is cost? Literally in the case of the lottery prize, it is the price of the ticket.

⁵⁵ See, e.g., *Smith v. Russell*, 76 F.2d 91, 92 (8th Cir. 1935), cert. denied, 296 U.S. 614 (1936); *E.D. Knight*, 28 B.T.A. 188, 190 (1933); *J. Heninger*, 9 B.T.A. 1318, 1320 (1928); *B. BITTKER & L. STONE*, *supra* note 14, at 464; 1 S. SURREY, W. WARREN, P. McDANIEL & H. AULT, *FEDERAL INCOME TAXATION* 838 (1972); Brown, *The Growing 'Common Law' of Taxation*, 1961 SO. CAL. TAX INST. 1, 7-8; Greenbaum, *The Basis of Property Shall Be The Cost of Such Property: How is Cost Defined?* 3 TAX L. REV. 351, 360-61 (1948); Wurzel, *The Tax Basis for Assorted Bargain Purchase or: The Inordinate Cost of "Ersatz" Legislation*, 20 TAX L. REV. 165, 175 (1964-65).

An individual shareholder who receives property as a dividend includes in income the fair market value of the property and takes that value for the property's basis. Since 1954, I.R.C. § 301(d)(1) has specifically provided for a fair market value result. However, even prior to 1954 it was quite clear that a shareholder receiving a property distribution took a cost basis in the property equal to its fair market value, even though, literally, he had no "cost" in the property.

It must be recognized that the cost of a taxable distribution in kind is not the same necessarily as its cost in an economic or accounting sense. The tax detriment to the stockholder resulting from the receipt of a property dividend should be taken into account in the determination of its cost. Consequently, the "cost" of a taxable property dividend generally is accepted to be its fair market value at the time of receipt.

Greenbaum, *supra*, at 376.

⁵⁶ Brown, *supra* note 55, at 8.

⁵⁷ Brown, *supra* note 55, at 7-8.

But we should all be startled if our taxpayer were required to pay a tax on the value of the car when he received it and another tax on all, or almost all, of the proceeds of the sale. *So we should, I am sure, stretch the word "cost" almost out of recognizable shape to make it mean the amount at which the car was taken into income, and we should feel justified in doing so in order to give the statute the quality of rationality.*⁵⁸

When Professor Brown speaks of giving the statute "the quality of rationality," he obviously means that it would be irrational to tax a person who received a \$5,000 automobile differently from the similarly situated taxpayer who received \$5,000 cash and purchased the automobile. Now, if Professor Brown were asked whether a taxpayer who received an interest-free loan, the economic benefit of which he was required to take into income, should be able to take a deduction for interest neither paid nor owed, presumably his answer would be:

[W]e should, I am sure, stretch the word[s] "interest paid or accrued" almost out of recognizable shape to make [them] mean the amount at which the [interest-free loan] was taken into income and we should feel justified in doing so in order to give the statute the quality of rationality.

The recommended non-literal reading of section 163 is supported by the opinion of the concurring judge in the *Dean* case.⁵⁹ There, Judge Opper assumed that a shareholder-officer who received the rent-free use of corporate property, which he then rented to another, would have gross income equal to the fair rental value of the property, but could then "presumably deduct as a business or non-business expense [under sections 162 or 212] the hypothetical rental value [taken into income and] theoretically paid by him to the corporation."⁶⁰ Judge Opper was not concerned that an amount "theoretically paid" might not fit within the term "expenses paid or incurred." Rather, Judge Opper's readiness to permit a deduction for an amount that is "paid" only in a constructive sense demonstrates that a literal reading of the tax statutes is not unavoidable. As Judge Opper apparently recognized, permitting the deduction of an amount that is paid in a merely hypothetical sense is the only analysis that will give the statute "the quality of rationality." The words "paid or accrued," in section 163 must

⁵⁸ *Id.* (emphasis added). Professor Brown goes on to note that "[p]rior to 1954, we would have been faced with the same problem [of reading the word "cost" in a non-literal fashion] had our taxpayer sold property received as a dividend in kind, but section 301(d)(1) has now filled that gap" *Id.*

⁵⁹ See 35 T.C. at 1091 (Opper, J., concurring). See text at note 39 *supra*. Judge Opper, in his example concerning the recipient's right to offset his income by a business or a non-business expense, was actually construing the words "paid or incurred," rather than "paid or accrued," but the slight difference in wording is probably not significant to his interpretation. Under I.R.C. § 163, a taxpayer is entitled to a deduction for "all interest paid or accrued within the taxable year on indebtedness." On the other hand, both I.R.C. § 162 (ordinary and necessary business expenses) and § 212 (ordinary and necessary expenses for the production of income) allow a taxpayer a deduction for expenses "paid or incurred."

⁶⁰ 35 T.C. at 1091 (Opper, J., concurring). If, in Judge Opper's example, the shareholder were in control of the distributing corporation, it is possible that I.R.C. § 482 would be applicable to the transfer. See, e.g., *Revel D. Cooper*, 64 T.C. 576, 580 (1975).

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not, therefore, be applied literally. Rather, "paid or accrued," like the term "cost," should be considered a technical tax concept which possesses the flexibility necessary to achieve a rational result.⁶¹

There appears to be no authority specifically rejecting the suggested non-literal reading of "paid or accrued." It is true that in the *Dean* case, the majority said that it had previously given "full force to interest-free loans for tax purposes" by "holding that they result in no interest deduction for the borrower."⁶² However, not one of the cases cited in *Dean* for this no-deduction proposition⁶³ actually explored the broad issue of whether a taxpayer who received an interest-free loan, and reported the fair interest rate as income, could take an offsetting deduction for interest paid.⁶⁴ Rather, those cases focused on a narrower issue—whether interest-free loans could be converted retroactively by the taxpayer-recipient into interest-bearing loans for purposes of obtaining an interest deduction. The case of *Howell Turpentine Co.*⁶⁵ is typical. There, a taxpayer had borrowed money on open account, over a nine year period, from a corporation of which he was the principal stockholder.⁶⁶ At no time was the taxpayer subject to any obligation to pay interest, and he paid none.⁶⁷ He neither reported income at-

⁶¹ Both the I.R.S. and the courts have often interpreted the words "paid or accrued" or "paid or incurred" in the non-literal fashion necessary to achieve rational tax results. For example, in Rev. Rul. 73-13, 1973-1 C.B. 42, a corporation engaged and paid a professional counseling firm to counsel a number of its highly paid executives concerning the handling of their personal financial affairs. The Service ruled that the particular executive involved in the ruling had realized income equal to the fee paid on his behalf, but was entitled to an equal offsetting deduction under I.R.C. § 212 for the ordinary and necessary expenses "paid" for financial counseling. This was the Service's ruling, even though the financial counseling expense was neither literally "paid" by the executive, nor literally an expense of the executive at all. It was the payor corporation, and not the executive which had contracted for the services of the counseling firm, and which was liable for its fee. Likewise, where a corporation pays any other deductible expense of a shareholder, that shareholder receives gross income in the amount of the corporation's payment, but is entitled to an offsetting deduction for an expense he literally does not pay himself. *E.g.*, Earl E. Cloud, 33 T.C.M. (CCH) 597 (1974); Donald G. Peters, 29 T.C.M. (CCH) 1440 (1970) (deduction allowed for property taxes paid by intermediary). See also Rev. Rul. 69-497, 1969-2 C.B. 23.

⁶² 35 T.C. at 1090.

⁶³ The cases cited for this proposition were *D. Loveman & Son Export Corporation*, 34 T.C. 776 (1960); *Howell Turpentine Co.*, 6 T.C. 364 (1946), *rev'd on other grounds*, 162 F.2d 316 (5th Cir. 1947); *Rainbow Gasoline Corporation*, 31 B.T.A. 1050 (1935); *A. Backus, Jr. & Sons*, 6 B.T.A. 590 (1927). It must be admitted that these cases contain some general language which, read literally, counsels against permitting a deduction. In *Loveman*, for instance, the court adverted to the "general rule—that interest may not be accrued where there is no obligation to pay interest," 34 T.C. at 805, and then discussed *Howell Turpentine* as support for this broad statement. Yet *Howell Turpentine*, as shall be shown, does not justify so broad a rule. Even assuming that the court previously has given force to this "general rule," it would nonetheless appear advisable for the court to abandon the rule in those situations where its application would produce illogical results.

⁶⁴ One case, not cited in *Dean*, did suggest a reason why the recipient of an interest-free loan would not be entitled to an interest deduction. In *Wilbur Security Co.*, 31 T.C. 938 (1959), the Tax Court characterized an interest-free loan as "a withdrawal of capital, later re-invested." *Id.* at 952. A withdrawal of capital differs from an interest-free loan, however, because the former involves no obligation of repayment. Consideration of transfers which are not bona fide loans is beyond the scope of this article. See note 3 *supra*.

⁶⁵ 6 T.C. 364 (1946).

⁶⁶ *Id.* at 374-75.

⁶⁷ *Id.* at 394.

tributable to the interest-free loans, nor attempted to obtain a deduction for interest paid.⁶⁸ At the end of the nine-year period, however, the taxpayer repaid the principal, plus an amount allegedly representing interest at six percent on the average daily balances owed the corporation during the nine year period.⁶⁹ The court disallowed the taxpayer's claimed deduction for interest paid or accrued because there was no obligation to pay interest at any time prior to the payment.⁷⁰ It is significant that the court did not address the broader question of whether the interest-free loans themselves resulted in income and/or a deduction to the borrower. As a result, *Howell Turpentine* does not forbid the recognition of both income and deduction in interest-free loan cases. In the absence of any authority clearly rejecting the suggested non-literal interpretation of the words "paid or accrued," it seems reasonable to aim for the logical result by granting the borrower an interest deduction.

In summary, the shareholder receiving an interest-free loan should be treated identically with the economically equivalent taxpayer who receives a cash dividend and pays interest in discharge of a bona fide obligation. Both taxpayers should recognize income in the amount of the actual or constructive dividend and both should be permitted a deduction in the equivalent amount of the actual or constructive interest payment.

C. *Does the Corporation-Lender Realize Interest Income?*

If a corporation makes a loan to a stockholder, receives \$1,000 interest thereon, and pays \$1,000 to the stockholder as an increased dividend—the two-payment transaction—the corporation will be taxable on the \$1,000 interest it receives, and, of course, will not be entitled to a deduction for the \$1,000 dividend paid. Yet a corporation that makes an interest-free loan to its stockholders and is in the identical economic position escapes tax altogether.⁷¹

A number of commentators have recognized the illogic of this latter result⁷² and one has suggested specifically that the corporate lender of an interest-free loan be taxed on the constructive interest received.⁷³ Yet it appears that the Treasury has never claimed that the corporate lender received constructive interest and therefore the courts have never considered the question.⁷⁴

⁶⁸ *Id.* at 374-75.

⁶⁹ *Id.*

⁷⁰ *Id.* at 394.

⁷¹ *Brandtjen & Kluge, Inc.*, 34 T.C. 416, 447 (1960); *Society Brand Clothes, Inc.*, 18 T.C. 304, 320-21 (1952); *Combs Lumber Co.*, 41 B.T.A. 339, 342-43 (1940).

⁷² *E.g.*, *Baum*, *supra* note 40, at 520-21; *Sneed*, *supra* note 4, at 660-61.

⁷³ *Sneed*, *supra* note 4, at 660-61 (emphasis in original), suggests the following test: *Is the interest-free loan such that had it been at interest the lender would have been entitled to deduct the interest so earned had he paid it over to the borrower?* If the answer is affirmative, an exclusion [of the constructive interest income] is justified, otherwise it is not.

Since dividends are not deductible, this test results in taxing the corporate lender of an interest-free loan. An opposite result is favored by O'Hare, *supra* note 40, at 1096, who not only does not suggest taxing the corporate lender, but uses the nontaxation of the corporate lender as justification for not giving the shareholder-borrower an interest deduction. O'Hare's views on the shareholder's deduction are described in the text at notes 51-52 *supra*.

⁷⁴ See *Baum*, *supra* note 40, at 515.

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In this section of the article, it will be argued that there is ample authority in the line of cases dealing with the anticipatory assignment of income for taxing such constructive interest to the corporate lender. It also will be suggested that the failure of the Treasury and the courts to tax such income may be the result of their misunderstanding of the scope and purpose of the concept of "imputed income."

1. An Interest-Free Loan as a Corporate Assignment of Income

The major stumbling block to taxing a corporate lender of an interest-free loan on the constructive receipt of interest is found in the Supreme Court's 1935 decision in *General Utilities & Operating Co. v. Helvering*⁷⁵ and its statutory progeny, section 311 (a) (2).⁷⁶ The case and the Code section stand for the proposition that a corporation realizes no gain or loss from the distribution of appreciated or depreciated property as a dividend to its shareholders.⁷⁷ In other words, a corporation that distributes property to its shareholders will not be taxed in the same manner as the corporation that, in a two-payment transaction, distributes a cash dividend equal to the value of the property, and receives the same cash amount back from its shareholder as the purchase price of the property, despite the fact that the transactions are economically equivalent. The government's argument in *General Utilities* that "it [was] incomprehensible how a corporation [could] distribute to its stockholders something which it [had] not itself received"⁷⁸ was ignored by the Supreme Court. Thus, under the principles of *General Utilities* and section 311(a) (2) a corporation can distribute something of value, such as the element of appreciation, without ever paying tax on its receipt.⁷⁹ As a result, *General Utilities* and section 311(a) (2) block a direct logical approach to taxing the corporate lender of an interest-free loan—i.e., an approach that would state that a corporation itself receives any value which it transfers to a shareholder and which it has not included pre-

⁷⁵ 296 U.S. 200 (1935).

⁷⁶ I.R.C. § 311(a)(2) provides that, with certain exceptions, no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of property.

⁷⁷ In fact, the Supreme Court in *General Utilities* never decided the nonrecognition point for which it became known. It decided only that because the dividend in that case was declared in the appreciated property rather than in cash, the dividend declaration did not create an indebtedness to the shareholders such that the distribution of the appreciated property in satisfaction of the dividend would cause the corporation to realize income. 296 U.S. at 202, 206. See B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 7.21, at 7-40 n.78. Nevertheless, the *General Utilities* case "has received judicial and administrative acceptance as standing for the proposition that a corporation does not realize income from the distribution (as a dividend) of property which has appreciated in value over its cost." *Commissioner v. Godley's Estate*, 213 F.2d 529, 531 (3d Cir.), *cert. denied*, 348 U.S. 832 (1954).

⁷⁸ B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 7.21, at 7-40 n.78 (quoting government's brief to the Supreme Court in the *General Utilities* case).

⁷⁹ The result reached by *General Utilities* and I.R.C. § 311(a)(2) has been subjected to much well deserved criticism. See, e.g., Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, in HOUSE COMMITTEE ON WAYS AND MEANS, 3 TAX REVISION COMPENDIUM 1643, 1645-49, 86th Cong., 1st Sess. (1959). A recent draft by the American Law Institute, amending Subchapter C, would eliminate § 311. ALI, *FED. INCOME TAX PROJECT SUBCHAPTER C 122-3* (Tent. Draft No. 1 1977).

vously in income.⁸⁰ However, it has long been accepted that neither *General Utilities* nor section 311 (a) (2) stands in the way of taxing a corporation on an in kind distribution "which distribution is in effect an anticipatory assignment of income."⁸¹ For example, a corporate owner of a bond that detaches interest coupons from that bond and transfers them to a shareholder as a dividend, would remain taxable on the interest derived from those transferred coupons under the "common law" doctrine of assignment of income.⁸² Applying Justice Holmes' classic fruit tree metaphor of *Lucas v. Earl*,⁸³ the corporation in the above example may not retain the tree (bonds) and transfer the fruit (the right to interest) and escape taxation on that fruit (interest).

The interest-free loan from a corporation to shareholder appears to be nothing more than another example of a corporate attempt to assign income to its shareholders. The corporation retains the tree (the right to be repaid the principal sum of the loan at maturity) but transfers the fruit (the use of the money during the period of the loan) to its shareholders. The value of the fruit, that is, the constructive interest, should be taxed as income to the assignor (the corporation).⁸⁴

⁸⁰ If § 311 were eliminated from the Code as suggested by the recent American Law Institute Draft, see ALI, *supra* note 79, the direct analysis used in Part II *infra*, for taxing the employer transferring an interest-free loan to an employee would seem equally applicable to the situation of the corporation making a like transfer to a shareholder.

⁸¹ Treas. Reg. § 1.311-1(a). The regulation's interpretation of the Code section is supported by the legislative history. S. REP. NO. 1622, 83d Cong., 2d Sess. 247 (1954) (Senate report on Code § 311). See also *Commissioner v. First State Bank of Stratford*, 168 F.2d 1004, 1009 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948); Lyon & Eustice, *Assignment of Income: Fruit and Tree As Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 295, 396 (1962).

⁸² The "common law" doctrine of assignment of income is best exemplified by the Supreme Court's classic decision in *Helvering v. Horst*, 311 U.S. 112 (1940). In *Horst*, a taxpayer had detached interest coupons from some negotiable bonds shortly before their due date and had given them to his son. The son, in the same year, collected the interest at maturity. The Supreme Court upheld the Commissioner's ruling that the interest coupons were taxable to the donor in the year paid, even though the donor had kept his books on a cash receipts basis and had never received the interest in cash. *Id.* at 115-16, 120. The interest coupons in *Horst* were the fruit produced by the "tree" of the father's investment. In transferring the interest to his son, the father enjoyed the "nonmaterial satisfaction" of giving something of value to a loved one. *Id.* at 117. This non-material satisfaction could be valued at the amount of the interest.

⁸³ 281 U.S. 111, 117 (1930). In *Lucas v. Earl*, the Court held that despite a contract between a husband and wife which provided that they would receive and hold all income as joint tenants, income earned by the husband was taxable to him. *Id.* at 114-15.

⁸⁴ See Treas. Reg. § 1.311-1(a) (1960). The conclusion that the corporate transferor of an interest-free loan recognizes income on the transfer in a manner similar to that of the anticipatory assignment of income cases is supported by the language used by courts in the assignment of income cases. For example, in *Commissioner v. First State Bank of Stratford*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948), a bank distributed as a dividend to its shareholders, promissory notes that it previously had written off as worthless but which were thought by the bank to have some value at the time of distribution. The court held that the corporation realized income when the shareholders collected those notes. Paraphrasing language from *Horst*, the Fifth Circuit said:

Even though the bank never received the money, it derived money's worth from the disposition of the notes which it used in place of money in procuring a satisfaction that was procurable only by the expenditure of money or money's worth. *The enjoyment of the economic benefit was realized as completely as it would have been if the bank had collected the notes in dollars and cents and paid the money as a dividend to its shareholders. . . .*

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Despite this clear analogy to the assignment of income cases, the granting of an interest-free loan by a corporation to a shareholder has never been held to result in realized income to the corporation under the assignment of income doctrine. This is perhaps because the courts and the Treasury have considered the income that would have to be assigned back to the corporation—i.e. the constructive interest—as “imputed income,” and therefore non-taxable to anyone under our tax system.⁸⁵ The following analysis demonstrates the invalidity of this conclusion.

2. Taxable In-Kind Income or Nontaxable Imputed Income

The classic definition of “imputed income” is as follows:

Imputed income may be defined provisionally as a flow of satisfactions from durable goods owned and used by the taxpayer, or from goods and services arising out of the personal exertions of the taxpayer on his own behalf.⁸⁶

The imputed income described by this definition—for example, the imputed rental income of a homeowner, the imputed wages and profits arising from services one renders to one’s family or oneself—is not taxed under the Code.

If the benefit that a corporation derives from the transfer to its shareholders of interest-free loans is imputed income, the corporation should not be taxed thereon. However, the constructive interest income to the corporate grantor of an interest-free loan in no relevant way resembles that described in the definition of imputed income. The definition indicates that an essential aspect of imputed income is that the satisfaction flows directly to the owner of the goods or provider of the services.

The corporate-lender of an interest-free loan does not derive a “flow of satisfaction” from using its goods—its cash—itself and accordingly does not receive imputed income. Rather, by disposing of its right to collect interest to a separate taxable entity—its shareholders—the corporate lender receives non-cash income, or “income in kind.”⁸⁷ This income in kind consists of the economic benefit the corporation derives from satisfying its general obligation to pay dividends to its shareholders. Thus, as a theoretical matter, the transfer of the economic value of the temporary use of money does not fit the definition of nontaxable imputed income.

... The acquisition of profits for its shareholders was the purpose of its creation. The collection of interest on loans was a principal source of its income. The payment of dividends to its shareholders was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way. Like the “life-rendering pelican,” it feeds its shareholders upon dividends.

Id. at 1009 (emphasis added).

⁸⁵ Sneed, *supra* note 4, at 660 states:

It has been pointed out that the flow of satisfactions from owned property is a form of imputed income which is not subject to tax. This may well justify the present state of case-law authority which holds that the lender in an interest-free loan has no income.

⁸⁶ Marsh, *The Taxation of Imputed Income*, 58 POL. SCI. Q. 514, 514 (1943).

⁸⁷ Professor Sneed has defined income in kind as “gain . . . received in a form other than money or its very near equivalent.” Sneed, *supra* note 4, at 644 (emphasis in original).

Moreover, the policy reasons often advanced for excluding from tax certain forms of imputed income seem entirely inapplicable to the corporate lender's situation. For example, the exclusion of most imputed wage income is said to be unobjectionable on equity grounds since first, such income generally arises from the use of otherwise nontaxable leisure time and second, it normally goes largely to individuals in lower income brackets.⁸⁸ Obviously, neither of these considerations is in any way relevant to the exclusion of the constructive interest income here under discussion. The constructive interest income does not arise from the use of otherwise nontaxable leisure time; nor is it likely that low income individuals would normally receive the benefit of interest-free loans from corporations to shareholders. Other items of imputed income should be excluded, it is said, because of the smallness of the amount involved in relation to the difficulty of computation by the taxpayer and the government. However, as the *Dean* case illustrates, the constructive interest involved may be anything but small. In *Dean*, the corporation had outstanding more than two million dollars in interest-free loans.⁸⁹ Another policy reason often asserted on behalf of the exclusion from income of imputed rental income on owner-occupied homes is that such exclusion encourages home ownership.⁹⁰ However, there is no indication that Congress similarly intended to encourage dividends in the form of interest-free loans rather than in cash. Thus, none of the traditional policy justifications for the exclusion from tax of imputed income apply to the interest-free loan from corporation to shareholder.

The only general policy consideration that would exclude from taxation both the traditional forms of imputed income and the constructive interest income on an interest-free loan is related to the difficulties involved in computing the income. Yet it must be remembered that although valuation difficulties exist whenever a taxpayer receives income in kind rather than in cash, those difficulties have not prevented the I.R.S. or the courts from determining and taxing a shareholder or employee on the fair market value of the economic benefit he receives as income, whether the economic benefit takes the form of property, services, or the rent-free use of property.⁹¹ Similarly, there is no convincing reason why the recipient of an interest-free loan should not be taxed on the economic benefit received. Once the taxation of the shareholder-borrower is accepted, there is no additional valuation problem involved in taxing the corporation-lender, since the same figure will be used to tax both.⁹²

⁸⁸ Marsh, *supra* note 86, at 525.

⁸⁹ 35 T.C. at 1083.

⁹⁰ Marsh, *supra* note 86, at 536.

⁹¹ See STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, *supra* note 15, at 158-60.

⁹² This valuation problem is analogous to the one involved where a corporation uses appreciated property to pay an employee's salary. The employee's income is the fair market value of the property received, and the corporation's amount realized is that same value. *E.g.*, *International Freighting Corp. v. Commissioner*, 135 F.2d 310, 313 (2d Cir. 1943). *Cf.* *United States v. General Shoe Corp.*, 282 F.2d 9, 12-14 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961) (transfer of appreciated property to an employees' trust); *Tasty Baking Co. v. United States*, 393 F.2d 992, 995 (Ct. Cl. 1968) (same). "[T]he values of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal." *United States v. Davis*, 370 U.S. 65, 72 (1962), *quoting Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Ct. Cl. 1954).

3. The Absence of Any Reasoned Authority For Not Taxing the Corporation-Lender

Since neither tax logic nor administrative necessity dictates exempting the corporate lender of an interest-free loan from tax, it is not surprising that there exists no reasoned authority that requires this result. Yet the Tax Court in *Dean* misleadingly suggested that such authority existed by stating that "[w]e have heretofore given full force to interest-free loans for tax purposes, holding that they result in no . . . interest income to the lender"⁹³ An examination of the cases cited as authority for this point by the Tax Court indicates, however, that although such cases impliedly held that the corporate transferor of an interest-free loan does not receive income, their implicit holdings lack any reasoned foundation. In each of the three cases cited in *Dean*, the court simply assumed, without discussion, that the corporate lender should not be taxed. However, the issue before the court in each case was whether or not the specific loan actually was intended to be interest-free. In each case the lender successfully sought escape from the taxation of interest income by oral evidence that no interest was intended, despite the existence of a stated interest figure on a form note.⁹⁴ As the following quotation from the Board of Tax Appeals' decision in *Combs Lumber Co.*,⁹⁵ indicates, once the factual question of intention was decided, so was the case:

While the notes here given formally provided for interest, it is clearly established by the evidence that the parties intended that no interest should be charged or paid. In pursuance of such intention no interest was in fact paid and no interest was ever accrued by petitioner on its books. As no liability for interest was ever created, the respondent erred in including the interest in controversy in petitioner's gross income.⁹⁶

Combs Lumber thus assumes without discussion that a loan intended to be interest-free results in no income to a corporate lender.

The two other cases cited by *Dean*,⁹⁷ *Society Brands Clothes, Inc.*,⁹⁸ and *Brandtjen & Kluge, Inc.*,⁹⁹ each involved a factual situation identical to that in *Combs Lumber Co.* In both cases, the Tax Court found that no interest was intended, and concluded, therefore, that the corporate lender had no income.¹⁰⁰ *Society Brands Clothes* cited *Combs Lumber Company* as its authority,¹⁰¹ and *Brandtjen & Kluge* cited as its authority, both *Combs Lumber* and

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

⁹⁴ *Brandtjen & Kluge, Inc.*, 34 T.C. at 447; *Society Brands Clothes, Inc.*, 18 T.C. at 320-21; *Combs Lumber Co.*, 41 B.T.A. at 340-41.

⁹⁵ 41 B.T.A. 339 (1940).

⁹⁶ *Id.* at 342-43.

⁹⁷ 35 T.C. at 1090.

⁹⁸ 18 T.C. 304 (1952).

⁹⁹ 34 T.C. 416 (1960).

¹⁰⁰ *Society Brand*, 18 T.C. at 320-21; *Brandtjen*, 34 T.C. at 447.

¹⁰¹ *Society Brand*, 18 T.C. at 321.

Society Brands Clothes.¹⁰² Accordingly the cases cited for the proposition that a corporation realizes no income when it issues an interest-free loan do not constitute persuasive precedent.¹⁰³

It is clear that the case law dealing with the tax treatment of a corporate lender of an interest-free loan rests upon the unexplored, and unexplained, assumption that the corporate lender is not taxable on the constructive interest received. This assumption may have been the result of the inaccurate application of the term "imputed" to this in-kind income, together with a conditioned reflex declaration that "imputed" income is non-taxable. However, in the absence of any reasoned authority for not recognizing interest income to the corporate lender, courts should permit the analogy to *Helvering v. Horst* and the other assignment of income cases to control, so that the corporation will be taxed on the interest income.

II. THE INTEREST-FREE LOAN FROM AN EMPLOYER TO AN EMPLOYEE

Interest-free loans from employer to employee give rise to many of the considerations discussed in relation to similar loans from corporation to shareholder. The applicable case law, however, differs in certain respects in the two contexts, and so separate analysis is required. This section will examine loans from employer to employee, addressing first, the employee's tax consequences and then, those of the employer.

A. *The Tax Consequences to the Employee*

Like the shareholder receiving an interest-free loan as a dividend, the employee receiving additional compensation in the form of an interest-free loan should be taxed as if he had received additional cash compensation which he then used to pay interest on the loan. That is, he should have additional compensation income equal to the economic benefit derived from the interest-free loan. If he would have been entitled to an interest deduction had he actually paid interest, he should then be permitted an offsetting deduction.

The analysis of the employee-borrower's tax status is virtually identical to that discussed for the shareholder-borrower in sections A and B of Part I and accordingly will not be repeated here.¹⁰⁴

¹⁰² *Brandtjen*, 34 T.C. at 447. The Tax Court in *Brandtjen & Kluge, Inc.* also cited the similar case of *Wilbur Security Co.*, 31 T.C. 938 (1959), *aff'd*, 279 F.2d 657 (9th Cir. 1960). Two other cases often cited for the proposition that a corporation realizes no income when it issues an interest-free loan (or gives rent-free use of its property) are equally unilluminating. *Smith-Bridgman & Co. v. Commissioner*, 16 T.C. 287 (1951), and *Tennessee-Arkansas Gravel Co. v. Commissioner*, 112 F.2d 508 (6th Cir. 1940) (both decided under the predecessor of I.R.C. § 482) simply assumed, like the three cases discussed in the text, that there could be no interest (or rental) income realized where none was, in fact, charged. In *Tennessee-Arkansas* the Sixth Circuit concluded that the corporate grantor of the rent-free use of property could not have rental income allocated to it when it "neither charged, collected or could have collected rent under its agreement." 112 F.2d at 510. In *Smith-Bridgman* the Tax Court accepted the taxpayer's contention that the Commissioner had "merely created fictitious interest income where none in fact existed." 16 T.C. at 293.

¹⁰³ Nonetheless, the Service is still citing these cases and applying the rule that interest-free loans produce no income to the lender. See I.R.S. Letter Ruling 7731007 (April 29, 1977).

¹⁰⁴ See text at notes 13-70 *supra*.

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B. Does the Employer-Lender Realize Interest Income?

If the interest-free loan from an employer to an employee is to be taxed the same way as the economically equivalent two-payment transaction, the employer-lender must be deemed to realize interest income, from which it normally could deduct a business expense in the same amount for compensation paid. Yet it appears, under existing law, that the employer granting an interest-free loan to an employee will have neither income nor a deduction. The subject of the employer's income will be discussed first.

The case of *Reynard Corporation*¹⁰⁵ raised this very income issue in relation to a corporation which had transferred the rent-free use of its property to its president and sole stockholder, Fox. The Board of Tax Appeals concluded that Fox had additional compensation income,¹⁰⁶ but held, without stating reasons, that the rental value of the premises was improperly included in the gross income of the employer, Reynard.¹⁰⁷ The illogic of that result was pointed out by the dissenting judge who stated that,

The majority opinion, although it approves the charging of the petitioner, Fox, with additional compensation for the rental value of the corporation's residence which he used during the taxable years, reverses the action of the respondent in including this identical rental value in the corporation's income for the same years. I think the decision upon this latter action inconsistent with the former and erroneous. This amount, recognized as compensation to Fox from the corporation, must be treated as having been constructively paid to the corporation as rental, and therefore taxable income, to it, *before* it can be held to have been paid by the corporation to Fox.¹⁰⁸

In 1964, the Internal Revenue Service announced its acquiescence in the Board's determination that the Reynard Corporation had no income on the rent-free transfer of its property to its employee.¹⁰⁹

¹⁰⁵ There were two Reynard Corporation cases: Reynard Corp., 30 B.T.A. 451 (1934) (involving the taxpayer's fiscal years ended March 31, 1930 and 1931) and Reynard Corp., 37 B.T.A. 552 (1938) (involving the taxpayer's fiscal year ended March 31, 1932). In the first Reynard case, the Board of Tax Appeals held that a corporation that allowed its employee to use corporate property rent-free did not realize income equal to the fair rental value of the property. Nevertheless the court hinted that the corporation might have been entitled to a business deduction equal to the fair rental value of the property transferred had it been able to prove that that fair rental value plus the cash salary paid constituted reasonable compensation for that employee. 30 B.T.A. at 454. In the second Reynard case, however, the Board of Tax Appeals clarified its first decision. It said that, whether or not the total compensation was reasonable, Reynard Corporation could not deduct the fair rental value of the property transferred since it was not charged, for tax purposes, with fair rental value income. 37 B.T.A. at 559-60.

¹⁰⁶ Reynard Corp., 30 B.T.A. at 453. Only the first Reynard case dealt with the tax consequences to the shareholder-president.

¹⁰⁷ *Id.* at 454. The inclusion of that rental value in Reynard Corporation's income would have resulted in a net increase in the corporation's taxable income. No offsetting business deduction would have been permitted for salary paid, since the corporation did not prove that the total salary paid, including the rent-free use of the property, was reasonable. *Id.*

¹⁰⁸ *Id.* at 454-55 (emphasis in original).

¹⁰⁹ 1964-2 C.B. 7.

This no-income result for an employer transferring its property to its employee without charge is even more difficult to justify than the same result where the transfer is by a corporation to a shareholder. In the latter situation, the issue of income realization to the corporation was clouded by the Supreme Court's decision in *General Utilities & Operating Co. v. Helvering*,¹¹⁰ which permitted a corporation without recognizing gain to distribute appreciated property to its shareholders, and that case's statutory offshoot, section 311(a)(2).¹¹¹ In the corporation-shareholder transfer situation, therefore, authority to tax the corporate lender of an interest-free loan was found by resort to the assignment of income line of cases.¹¹² But in the compensation area, the approach can be more direct, by virtue of an analogy to the line of cases which describe an employer's tax consequences on its transfer of appreciated property to its employees or employees' trust.¹¹³ These cases indicate that when an employer pays its employees in-kind compensation the employer is treated as having received consideration in exchange.

For example, in *Tasty Baking Co. v. United States*,¹¹⁴ a case involving the contribution of appreciated property by an employer to an employees' retirement trust, the Court of Claims held that the employer realized a capital gain measured by the difference between the fair market value of the property transferred and the employer's basis for that property.¹¹⁵ The court explained the result in language which seems equally applicable to the interest-free loan transfer:

The underlying rationale would appear to be that though no money or other tangible property was received by the taxpayer-employer, the property contributed was additional compensation for the employees' . . . services, . . . plus the expectation of continued services in the future. The value of those services has been held to be presumably equal to the fair market value of the property contributed.¹¹⁶

Thus, based both on tax logic, and the precedent provided by the property transfer cases, it must be concluded that when an employer makes an interest-free loan to an employee, it receives from that employee a quid pro quo in the form of the employee's services equal to the fair market value of the property transferred, *i.e.*, the interest foregone. The employer-lender should be taxed accordingly.

¹¹⁰ 296 U.S. 200 (1935). See text at notes 75-80 *supra*.

¹¹¹ See text at notes 75-80 *supra*.

¹¹² See text at notes 81-84 *supra*.

¹¹³ *E.g.*, *Tasty Baking Co. v. United States*, 393 F.2d 992 (Ct. Cl. 1968); *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961); *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943).

¹¹⁴ 393 F.2d 992 (Ct. Cl. 1968).

¹¹⁵ *Id.* at 994-95.

¹¹⁶ *Id.* at 994.

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C. Is The Employer-Lender Entitled to a Business Expense Deduction for Compensation Paid?

Once it is determined that an employer realizes income on the issuance of an interest-free loan to an employee, then it follows logically that what the employer received as income, it also paid to the employee as compensation. The necessity for this symmetrical result is made clear in analogous cases involving the compensatory transfer of appreciated property¹¹⁷ and of the rent-free use of property¹¹⁸ to an employee. Where it has been determined that the in-kind transfer resulted in realized income to the employer, it has consistently been held that the income so received was also paid out to the employee as additional compensation.¹¹⁹ It is only where the courts have determined that an in-kind transfer resulted in no realized gain to the employer-transferor that they have refused to provide such employer with a fair value business deduction.¹²⁰ Since it has already been determined that the interest-free loan produces income to the employer-lender, it follows that a deduction for compensation paid will also be available.¹²¹

¹¹⁷ See cases cited in note 113 *supra*.

¹¹⁸ See, e.g., *Reynard Corp.*, 30 B.T.A. 451 (1934), and 37 B.T.A. 552 (1938); K.C. Bellows, 26 T.C.M. (CCH) 978 (1967).

¹¹⁹ E.g., *Tasty Baking*, 393 F.2d at 994-95; *General Shoe Corp.*, 282 F.2d at 12-13; *International Freighting*, 135 F.2d at 313.

¹²⁰ For example, the 1941 case of *International Freighting Corporation v. Commissioner*, 135 F.2d 310 (2d Cir. 1943) involved the tax consequences of an employer's transfer of bonuses to its employees, in the form of appreciated stock. The case raised the dual questions, first whether the employer realized taxable gain in the amount of the difference between the cost and fair market value of such stock, and second, whether the amount deductible by it was the basis or the fair market value of the stock at the time of the distribution. The I.R.S. seemed to demand nothing more than symmetry of tax consequences. Either the employer realized gain and received a fair market value deduction, or did not realize gain and received only a basis deduction. *Id.* at 312. The Second Circuit held that the correct result for the employer was realization of gain and a fair market value deduction, a result that is beyond dispute today. See cases cited in note 113 *supra*.

Symmetry was also achieved in *Reynard Corporation*, 30 B.T.A. 451 (1934) and 37 B.T.A. 552 (1938), but there it was the illogical no-income, no-deduction symmetry. In that case, it will be recalled, the Board of Tax Appeals held that the rental value of premises, provided rent-free by the employer to its employee, did not result in gross income to the corporation. Nevertheless, the Court, in the first *Reynard* case, 30 B.T.A. 451 (1934), seemed to assume that a deduction for compensation paid, equal to the fair rental value of the premises transferred, could have been allowed the employer, even though it was not required to recognize the constructive rental income. *Id.* at 454. In fact, the court permitted no such deduction in the case because there was no proof that the total compensation paid, taking into account the fair rental value of the property transferred, was reasonable. *Id.* The tax law permits a business expense deduction for compensation paid only when the compensation was reasonable. I.R.C. § 162(a)(1). In the second *Reynard* case, 37 B.T.A. 552 (1938), however, which involved a later year of the same taxpayer, the Board of Tax Appeals clarified its position on the employer's right to a deduction. The court held that so long as the corporation was not deemed to have realized the fair rental value as income, there was no basis upon which it could claim a deduction for the compensation paid, whether or not the total compensation was reasonable. *Id.* at 560. See also K.C. Bellows, 26 T.C.M. (CCH) 978 (1967).

¹²¹ This result assumes that the compensation paid is reasonable in amount. Unreasonable compensation is not deductible. I.R.C. § 162(a).

D. *The Inadequacy of the No-Income, No-Deduction Approach*

It has been concluded in the previous section that because the employer-lender realizes constructive interest income on an interest-free loan to its employee, it follows that the employer must have paid the same amount as compensation for services. Yet, if this is so, the initial question—whether or not the employer-lender has constructive interest income—appears academic, since, if it does have that income, the income will be offset by an equal deduction. Thus, one might conclude that the no-income, no-deduction approach and the two-payment transaction analysis produce identical results. However, as in the case of the taxation of shareholders and employee recipients of interest-free loans,¹²² that conclusion is deceptive for a number of reasons. First, the income and deduction, though equal in amount, may be reportable by the employer in different years. This possibility is examined fully in Part III of this article. Second, even though offset by an equivalent deduction, the existence of the gross income interest item may itself have important tax consequences. For example, an increase in interest income may cause problems of qualification for a Subchapter S corporation¹²³ or could generate personal holding company problems for corporate employers.¹²⁴ Third, the offsetting deduction in fact will not always be available to the employer-lender. This result would obtain, for example, where the total compensation paid, taking into account the economic value of the interest-free loan transferred, is deemed unreasonable, since unreasonable compensation is not deductible.¹²⁵

That an offsetting deduction will not arise in all cases was recognized by Professor Sneed. Yet he rejected the two-payment approach because he feared that even if the employer-lender were deemed to realize income when it made an interest-free loan, it would never be entitled to an offset-

¹²² See text at notes 24-35 *supra*.

¹²³ I.R.C. § 1372(e)(5)(A) states that a Subchapter S election terminates in any year in which a corporation "has gross receipts more than 20 percent of which is passive investment income." I.R.C. § 1372(e)(5)(C) defines passive investment income to include "gross receipts derived from . . . interest." See B. BITTKER & J. EUSTICE, *supra* note 3, at ¶ 6.03.

¹²⁴ I.R.C. § 542(a)(1) defines a "personal holding company" as any corporation if "at least 60 percent of its adjusted gross income . . . is personal holding company income." I.R.C. § 543(a)(1) states that personal holding company income includes "interest." See B. BITTKER & J. EUSTICE, *supra* note 3, at ¶ 8.22.

Another example of consequences attending the existence of a gross income item is found in I.R.C. § 6501(e). Under that section an omission of an item of gross income which is in excess of 25% of the amount of gross income stated in the return will lead to an extension of the statute of limitations from three to six years.

¹²⁵ I.R.C. § 162(a).

Excessive compensation can be disallowed (1) because if paid to officer-stockholders or employee-stockholders it is really a guise for the distribution of profits to stockholders and not an operating expense of the business enterprise; (2) because it represents a gift by the owners of the enterprise and lacks the requisite connection with business operations; and (3) perhaps because, though neither a distribution of profits nor a gift, it is unreasonable in amount.

1 S. SURREY, W. WARREN, P. McDANIEL & H. AULT, *supra* note 55, at 320. In the first *Reynard* case, the Board of Tax Appeals disallowed a deduction for the compensation paid because of the third reason stated above. 30 B.T.A. at 454.

ting business deduction, under section 162, for an amount not literally "paid or incurred."¹²⁶ Therefore, Professor Sneed proposed a modification of the no-income, no-deduction approach which would produce a rational result even where a deduction would not normally be available. The test is similar to the one he suggested in connection with the taxation of the shareholder or employee-borrower:

*Is the interest-free loan such that had it been at interest the lender would have been entitled to deduct the interest so earned had he paid it over to the borrower? If the answer is affirmative, an exclusion [of the income] is justified, otherwise it is not.*¹²⁷

Professor Sneed again appears to be rejecting a logical statutory construction (i.e., income to the employer-lender, and an offsetting deduction in the same amount, if otherwise available) for a much less justifiable construction: income to the lender only if the lender would not have been entitled to a deduction had it actually paid a cash amount to the borrower. While his test does account for the situation where, under the two-payment analysis, income would be recognized but a deduction denied, it fails to remedy the other defects identified in the no-income, no-deduction approach. Professor Sneed's test ignores the timing consideration discussed in Part III, and also reaches the wrong result where the Code makes the determination of "gross" income independently significant.¹²⁸

Moreover, the problem which Professor Sneed's approach seeks to avoid—the unavailability of a deduction for an amount not literally paid or incurred—is, as previously demonstrated, quite illusory.¹²⁹ Amounts "paid or incurred" can easily be interpreted to include constructive payments,¹³⁰ permitting deduction of the foregone interest amounts. Thus Professor Sneed's modified no-income, no-deduction approach retains several of the flaws of the original version, and does not respond to any compulsion of Code interpretation. Since both Professor Sneed's suggestion and the pure no-income, no-deduction approach produce illogical results in certain instances, the two-payment analysis is highly preferable.

The two-payment analysis produces the results previously described. The employee should be deemed to receive compensation in the amount of the foregone interest and should be entitled to a deduction under section 163 for the interest constructively paid. The employer should be deemed to recognize income in the amount of the constructive interest payment and a business expense deduction for the compensation paid to the employee—the value of the interest-free loan—provided that that compensation is reasonable in amount.

¹²⁶ Sneed, *supra* note 4, at 661.

¹²⁷ *Id.* (emphasis in original). Sneed's test would result, of course, in always taxing a corporation that transferred an interest-free loan as a dividend. This is the same result called for in Part I, *supra*.

¹²⁸ See text at notes 123-24 *supra*.

¹²⁹ See text at notes 53-70 *supra*.

¹³⁰ See text at notes 53-70 *supra*.

III. VALUATION AND TIMING QUESTIONS

A. Valuation Problems

In Parts I and II it was concluded that both the transferor and the transferee of an interest-free loan should realize income—and often be entitled to an offsetting deduction—in an amount equal to the interest charge that would have been made had the loan been at arm's length. The method for computation of that arm's length interest charge must now be determined.¹³¹

The rate of interest that would represent full and adequate consideration in any given interest-free loan transaction could vary widely depending upon the actual circumstances of the case. To determine the most accurate interest rate in each case, the Service would have to investigate first the value of the security given, if any, and second the borrower's credit rating. It would then have to determine the interest rate an arm's length lender in the community would charge to a like borrower. Such a detailed investigation of the complex circumstances of each loan would strain the Service's capabilities. Nor is this the only difficulty that the Internal Revenue Service would face in this valuation process. As one author notes:

[W]hat role state usury laws should play in valuing the discount using arm's-length standards is uncertain. If the normal interest rate for an unsecured loan is eighteen percent per annum, may the gift be measured by that rate even though the maximum legal rate of interest to the individual under state law is twelve

¹³¹ In the decided gift and income tax cases and rulings, the I.R.S. generally has imputed interest using either the prime rate or the rates set forth in the regulations governing the valuation of life estates, term interests, remainders, and reversions. For example, in *Dean*, the Service used the prime rate to measure the income to the stockholders. 35 T.C. at 1087. The Commissioner originally charged the taxpayers with income equal to interest computed at the legal rate in Delaware (6%), but on brief reduced the income to the lower prime rate (which varied between 3% and 4%) since it was stipulated that the taxpayers could have borrowed the funds at the lower rate. *Id.* The approximate prime rate of interest was also used by the government to value the gift of an interest-free loan in the recent Tax Court case of *Lester Crown*, 67 T.C. 1060, 1061 (1977). In that case the Tax Court held that the donative transfer of a non-interest bearing loan does not result in a taxable gift, *id.* at 1064-65, and hence did not need to reach the valuation question. In *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966), also a gift tax case, the government unsuccessfully argued that an interest-free loan was a gift which could be valued at 3½% interest per annum. *Id.* at 73. The 3½% rate may have been borrowed from the regulations then governing the valuation of life-estates, term interests, remainders and reversions. See Treas. Reg. § 25.2512-5 (1956), as amended, T.D. 6826, 1965-2 C.B. 367. As in *Crown*, however, the district court in *Johnson* held that there was no taxable gift, and thus never reached the valuation issue. In Rev. Rul. 73-61, 1973-1 C.B. 408, also a gift tax ruling, the Service stated that it would not follow *Johnson* but instead would find a gift of the value of the use of the money loaned in cases of interest-free loans from taxpayers to their children. The Service found that the value in such a case is "[t]he rate of interest that would represent full and adequate consideration" for the use of the money. This value "may vary," the Service observed "depending upon the actual circumstances pertaining to the transaction." 1973-1 C.B. at 409. But the Service went on to cite the regulations governing the valuation of term and contingent interests in property. Treas. Reg. 25.2512-5. It is, therefore, unclear whether the Service intended the amount of the gift in the ruling to be determined by reference to the market rate of interest, or by application of the regulations table then in effect.

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percent? What interest rate should be imputed to the loan if an arm's-length lender would not make an unsecured loan to the borrower under any circumstances? It may be one thing to measure the value of the [transfer] by reference to the standard of the shylock, but quite another to use the rate of the loan sharks.¹³²

Clearly, therefore, an individualized approach to the valuation of constructive interest is beset with too many difficulties to be feasible.

The most appealing alternative to the individualized approach is found in the Regulations under sections 482¹³³ and 483.¹³⁴ These sections permit the Secretary, under certain circumstances, to reallocate income and deductions among businesses controlled by the same parties and to treat as interest a portion of deferred payments on sales where no interest is stated in the sales contract. The regulations under both those sections provide, as a general rule, that an interest rate of seven percent will be imputed in a non-arm's length loan or in an installment sale transaction, unless certain safe haven interest rates are provided for in the contract.¹³⁵ If the courts reject the no-income, no-deduction approach and instead treat interest-free loans in conformity with their economically equivalent two-payment transactions, it would seem appropriate for the Internal Revenue Service, by regulation, to make these specified rates also govern the computation of income and deduction in the case of all interest-free loans whether or not governed by section 482 or 483. Because the specified rates do not take into account all the factors that, in any given case, would influence the interest rate, the result achieved by the recommended approach will not always mirror that produced by the equivalent two-payment transaction. Applying the interest rates specified in the regulations under sections 482 and 483 will, however, closely approximate the two-payment result while avoiding the procedural complexities of an individualized approach.

¹³² O'Hare, *supra* note 40, at 1090. In discussing the proper valuation of interest-free loans for gift tax purposes, O'Hare suggests as an alternative to market valuation, the possibility of using the "income actually produced by the loan" as a means of determining the amount of the gift. *Id.* This valuation technique seems appropriate, however, only if the transferor has kept such control over the use of the funds that the transfer can be considered a sham and the income actually produced by the borrowed funds can be attributed to the lender. Otherwise, there would seem to be no precedent or logic for such an approach.

¹³³ Treas. Reg. § 1.482-2(a) generally provides the following rules for advances by one member of a controlled group to another: (1) On loans or advances entered into on or after July 24, 1975, no allocations of income and deduction will be made by the Commissioner if the annual interest charge is at least 6% but not more than 8%. Moreover, if an arm's length rate, based on the facts, is more than 8% or less than 6%, the arm's length rate may be applied. These rules apply only if the creditor is not regularly engaged in the business of making loans. If it is so engaged, an arm's length interest rate will be used in all cases by the Commissioner to allocate income and deductions; (2) If the rate actually charged is not an arm's length or safe haven rate, the Commissioner may establish an allocation reflecting an annual rate of 7% simple interest.

¹³⁴ Treas. Reg. § 1.483-1(c)(2)(ii)(B) provides that for payments on account of a sale or exchange of property entered into on or after July 24, 1975, the imputed interest rate shall be 7% per annum compounded semiannually. No interest will be imputed, however, if the contract provides for not less than 6% per annum simple interest. Treas. Reg. § 1.483-1(d)(1)(ii)(B).

¹³⁵ See notes 133-34 *supra*.

B. *Timing Problems*

Since the constructive interest amount is never actually received or paid, interest-free loans give rise to problems regarding the timing of income and deductions. In considering these problems, the distinction between loans that are payable on demand and loans with a fixed repayment date must be noted. The demand loan is relatively simple and will be briefly discussed. The loan with a fixed repayment date will be given a more extensive analysis. In the latter discussion the transfer from employer to employee will be considered separately from the transfer from corporation to shareholder.

1. Demand Loans

If the interest-free loan from a corporation to a shareholder or from an employer to an employee is a demand loan, no substantial problems will arise in determining the correct time at which the various parties should report their income and deductions. Consider the following example:

On January 1, 1978, employer makes an interest-free demand loan of \$1,000 to employee. The principal is repaid by employee to employer on December 31, 1978.

Assuming that a reasonable interest rate would have been seven percent, a calendar year employer, whether a cash or accrual basis taxpayer, should realize \$70 of interest income in 1978, and normally would be entitled in that year to an offsetting business expense deduction,¹³⁶ in an equal amount. Likewise, the employee, whether a cash or accrual basis taxpayer, should realize \$70 of income in 1978, and normally would be entitled to an offsetting interest deduction in the same year.¹³⁷

Minor timing complications arise, however, for a cash basis employer and employee, if that demand loan is not repaid by the employee in the same year in which the loan was granted. In that case certain assumptions would have to be made as to when the constructive interest was paid. This is so since a cash basis taxpayer reports income and deductions only when received and paid,¹³⁸ and in the interest-free loan situation no interest payments are ever actually made. This problem, however, can be resolved easily by presuming that constructive cash interest payments are made at least once a year. In effect, the demand loan transaction will be treated as a series of independent one year seven percent loans. In the example above, assuming the employee repaid the demand loan on December 31, 1980, instead of on December 31, 1978, the result would be a \$70 income and deduction item for both the employer and employee in 1978, 1979 and 1980.

If the same demand loan is repaid by a shareholder-borrower to a corporation-lender, rather than by an employee to an employer, the corporate lender would still have \$70 of interest income in each of the three years the loan was outstanding. However, the corporation would lack the

¹³⁶ If the total compensation paid is unreasonable, the employer would not be entitled to the deduction. See note 125 *supra*.

¹³⁷ I.R.C. § 163. For exceptions, see text at notes 33-35 *supra*.

¹³⁸ Treas. Reg. §§ 1.451-1 (1960); 1.461-1(a)(1) (1960).

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benefit of any offsetting deduction since dividend payments, unlike compensation payments, are not deductible.

The timing problem in the demand loan situation thus is easily resolved. If the demand loan is repaid in the year in which made, the constructive interest income and deduction should be attributed to that year. If the loan is not repaid within that year, annual constructive interest payments can be presumed and the income and deduction can be timed accordingly.

2. Loans with Fixed Repayment Dates

When the timing questions involved when a corporation or an employer transfers an interest-free loan with a fixed repayment date are considered, the problems multiply. The employer-employee transfer will be examined first.

a. *Transfers by Employer to Employee*

It is helpful to begin the discussion with the following hypothetical involving a fixed term interest-free loan from an employer to an employee.

Employer lends employee \$10,000 in exchange for the employee's \$10,000 promissory note payable in ten years and bearing no interest. Assuming a fair annual interest rate on the loan would be seven percent, the present discounted value of the promissory note transferred to the employer by the employee is approximately \$5,000.¹³⁹

The transaction that actually occurred is economically identical to a transaction in which an employer transfers \$5,000 cash compensation outright to an employee, while at the same time making a \$5,000 discount loan to that employee in exchange for the employee's promise to repay \$10,000 in ten years. In a discount loan the lender discounts to present value the face amount of the debtor's note and transfers the discounted value in exchange for the note. The subsequent payment of the note may be viewed as payment of principal (the discounted value transferred) plus interest (the difference between the face amount of the note and the discounted value).¹⁴⁰ Since this analysis reflects the economic realities of the fixed term interest-free loan transaction, it also should determine its actual tax consequences. In analyzing those consequences, the timing of the employee's income and interest deduction will be considered first. Then the compensation deduction and income of the employer will be discussed.

¹³⁹ To compute this figure, apply Table IV, Treas. Reg. § 1.483-1(g)(2) (1966), which computes the present value of \$1 at 7%, compounded semiannually.

¹⁴⁰ Thus, in our example, the principal of the loan is seen to be \$5,000. Repayment in year ten therefore consists of \$5,000 of principal and \$5,000 of interest. An alternative analysis views the principal of the loan as \$10,000, from which \$5,000 of interest is deducted before the loan money is transferred to the borrower. Repayment in year 10 would then consist of \$10,000 of principal. See note 160 *infra*.

i. The Employee's Tax Consequences

(A) Timing of Inclusion of Employee's Income

The employee should realize immediate compensation income equal to the \$5,000 economic benefit received. The employee has received \$10,000 cash from his employer and has given in exchange a note with a present value of only \$5,000. The employee can use the \$5,000 excess cash value received to satisfy his own immediate personal needs while insuring that the funds will be available to repay the \$10,000 ten years hence by re-lending the remaining \$5,000 to a third party on equivalent terms, *i.e.*, by making a discount loan of \$5,000 requiring the repayment of \$10,000 in ten years. The fact that the employee eventually will pay the full \$10,000 face amount of the note in accordance with its terms in no way diminishes the amount of the compensation he receives in year one.¹⁴¹

The \$5,000 excess value is the measure of the economic value of the interest-free use of money and corresponds to the constructive interest in the demand loan example. Taxing the employee on the \$5,000 excess value received in year one is consistent with the position taken by the Internal Revenue Service in a situation involving the gift tax treatment of interest-free loans. In Revenue Ruling 73-61,¹⁴² the Service held that a donative transfer of \$50,000 in exchange for a note of the donee in the same amount payable in ten years, with no interest, resulted in an immediate gift, within the purview of section 2501 of the Code, in an amount equal to the difference between the \$50,000 cash transferred and the present discounted value of the non-interest bearing note received. This same rule for valuation should be applied in the case of interest-free loans between employers and employees with the result that the employee should recognize income at the time the loan is made in the amount of the difference between the cash received and the present value of the debt obligation.

Applying this rule to the example, the employee who received the \$10,000 interest-free term loan would be required to report \$5,000 of compensation income in year one. This result is consistent not only with Revenue Ruling 73-61 but also with the result reached recently by the Seventh Circuit Court of Appeals in *Mason v. United States*.¹⁴³ In that case, a taxpayer sold property to a charity for a stated price equal to the fair market value of the property.¹⁴⁴ The charity paid the stated price by delivering a small amount of cash and an unsecured long-term promissory note in the amount of the balance.¹⁴⁵ The present value of the note was substantially lower than the note's face value, due in large part to the fact that the four percent interest rate on the loan was less than the fair market rate of interest.¹⁴⁶ The court held that the taxpayer had made a deductible gift to

¹⁴¹ This point was specifically made on somewhat different facts by the Seventh Circuit. *Mason v. United States*, 513 F.2d 25, 29 (7th Cir. 1975). See text at notes 143-47 *infra*, where the facts of *Mason* are discussed.

¹⁴² 1973-1 C.B. 408.

¹⁴³ 513 F.2d 25 (7th Cir. 1975).

¹⁴⁴ *Id.* at 26.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 26-27.

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the charity, in the year of the transfer, in an amount equal to the difference between the fair market value of the property transferred and the fair market value of the cash and note received.¹⁴⁷

A similar analysis was rejected, however, by the Tax Court in the recent case of *Lester Crown*.¹⁴⁸ The majority in that case concluded that a donative transfer of an interest-free loan does not result in a taxable gift.¹⁴⁹ The dissent in *Lester Crown* embraced the Service's reasoning that the transfer of an interest-free loan is a gift if full and adequate consideration is not received in exchange therefore.¹⁵⁰ Judge Simpson, writing for the dissenters,¹⁵¹ observed that the Service's approach had been applied in several cases.¹⁵² One of these, *Gertrude H. Blackburn*,¹⁵³ involved a part gift part sale transaction. The petitioner transferred property to her children in return for a note which had a face amount significantly below the fair market value of the property, and which bore interest at a rate significantly below the usual rate.¹⁵⁴ The petitioner argued that the amount of the gift was measured by the difference between the value of the property and the face amount of the note.¹⁵⁵ The Tax Court disagreed, observing that the note was not worth its face value. According to the court, the proper measure for the taxable gift portion of the transfer was the difference between the fair market value of the property and the discounted value of the note. To reach the present value of the note, the court discounted the face amount by the difference between the going rate of interest and that provided for in the note.¹⁵⁶ Dissenting in *Lester Crown*, Judge Simpson observed that the same rule applies where the interest amount provided for in the note is zero.¹⁵⁷ He concluded that the majority had improperly disregarded the holdings in *Blackburn* and other recent cases.¹⁵⁸

Applying the gift tax approach taken by the Service in Revenue Ruling 73-61, by the Seventh Circuit in *Mason v. United States* and by the dissent in *Lester Crown*, to the case of the interest-free loan from employer to employee, it is found, as previously demonstrated, that the employee should recognize immediate compensation income in the amount of the difference between the cash received and the present value of the debt obligation.

¹⁴⁷ *Id.* at 29. See Duhl & Fine, *supra* note 2, at 34, 36.

¹⁴⁸ 67 T.C. 1060 (1977).

¹⁴⁹ *Id.* at 1064.

¹⁵⁰ *Id.* at 1068, (Simpson J., dissenting). See Rev. Rul. 73-61, 1973-1 C.B. 408.

¹⁵¹ Judge Simpson was joined in dissent by Judges Raum, Tannenwald, and Wilbur.

¹⁵² The cases cited by Judge Simpson were *Gertrude H. Blackburn*, 20 T.C. 204 (1953); *Estate of Koert Bartman*, 10 T.C. 1073 (1948); *Estate of Sarah A. Bergan*, 1 T.C. 543 (1943).

¹⁵³ 20 T.C. 204 (1953).

¹⁵⁴ *Id.* at 205.

¹⁵⁵ *Id.* at 204.

¹⁵⁶ *Id.* at 207.

¹⁵⁷ 67 T.C. at 1068.

¹⁵⁸ Judge Simpson wrote that

[t]he same approach has been applied in those cases involving members of a family exchanging property for an annuity. See *Estate of Koert Bartman*, 10 T.C. 1073 (1948); *Estate of Sarah A. Bergan*, 1 T.C. 543 (1943). In such cases, it was held that the present value of the annuity was to be computed and that if the value of the property exceeded the present value of the annuity, there was a taxable gift. The conclusion of the Court in this case has ignored the holdings in *Blackburn*, *Bartman* and *Bergan*.

Id. at 1068-69 (Simpson, J., dissenting).

(B) Timing of Employee's Deduction

Once the logical conclusion that the employee in the above hypothetical realizes \$5,000 compensation income in one year is accepted, then the next question to be answered is when, if at all, the employee will be able to take a deduction for interest paid. It is clear that the employee should not be entitled to deduct the \$5,000 difference between the \$10,000 principal amount of the discount loan and the \$5,000 actually received as "interest paid" in the year of borrowing.¹⁵⁹ Assuming that the employee is a cash basis taxpayer, he will be entitled, under a discount loan approach, to deduct the interest only in the year he pays it, and that will be in year ten in the hypothetical.¹⁶⁰ If he is an accrual taxpayer, he will have to deduct ratably the \$5,000 interest discount over the ten year period of the loan.¹⁶¹ Thus, although the employee who receives an interest-free term loan, whose economic benefit he takes into income, will normally be entitled to an interest deduction equal to that economic benefit, the compensation income and the interest deduction will be in different years. This is another, and a most significant, factor ignored by those who favor the no-income, no-deduction treatment of interest-free loans.

¹⁵⁹ See, e.g., John C. Cleaver, 6 T.C. 452, 454-55, *aff'd*, 158 F.2d 342 (7th Cir. 1946), *cert. denied*, 330 U.S. 849 (1947); Rev. Rul. 73-482, 1973-2 C.B. 44.

¹⁶⁰ An alternative way of analyzing the facts in the hypothetical would change the timing of the employee's deduction. It might be said that the hypothetical facts have the same economic effect as a transaction by which an employer transfers both a \$10,000 loan and an additional \$5,000 cash to an employee. The \$5,000 cash is compensation for services. Immediately upon receipt, the employee repays this \$5,000 to the employer as prepaid interest on the \$10,000 loan. In that case the cash basis employee could be considered to have prepaid the interest in year one. See, e.g., G. Douglas Burck, 63 T.C. 556, 560 (1975) *aff'd* 533 F.2d 768 (1976); Newton A. Burgess, 8 T.C. 47, 50 (1947). These cases indicate that where the lender actually transfers an amount that includes the interest payment to the borrower who commingles this amount with his other funds and shortly thereafter makes the interest payment to the lender, the borrower is deemed to have paid the interest at the outset. Nevertheless, the employee would still not be able to deduct the entire \$5,000 in year one. Rather, he would, under newly enacted I.R.C. § 461(g), have to deduct the \$5,000 prepaid interest ratably over the ten year period of the loan. In the simple discount loan case, where a creditor withholds a sum from the face amount of the loan as interest, and transfers only the remainder, there is no payment of interest until actual repayment of the loan. John Randolph Hopkins, 15 T.C. 160, 180-82 (1950). See also Edward L. Smallwood, 36 T.C.M. (CCH) 1615 (1977) (cash basis taxpayer cannot deduct interest paid in year of execution of promissory note for interest liability; normal discount loan rules apply); Burton Foster, 32 T.C.M. (CCH) 243 (1973) (loan fee discounted from transfer of loan principal is not deductible by cash basis borrower until loan is repaid); Rev. Rul. 75-12, 1975-1 C.B. 62 (discount amount deductible by cash basis borrower only when loan is repaid; by accrual basis borrower as the interest accrues).

Thus the courts, in finding a prepaid interest loan only in those cases where the borrower has received an amount equal to principal plus interest and commingled this amount with his other funds, has made the identification of a prepaid interest loan contingent upon the form of the transaction. Because the form of the transaction discussed in the text does not correspond to that required for a finding of prepaid interest, the prepaid interest analysis was not applied.

¹⁶¹ See Treas. Reg. § 1.461-1(a)(2) (1957).

ii. The Employer's Tax Consequences

(A) Timing of the Employer's Deduction

In the above hypothetical the employer should be entitled to a \$5,000 business expense deduction in year one for the compensation paid, assuming that the compensation is reasonable in amount. This, of course, is the only result consistent with taxing the employee on \$5,000 of compensation income in year one. Moreover that deduction result comports with economic reality, since the employer has parted irrevocably in year one with \$5,000 cash. It has transferred \$10,000 cash in exchange for a promissory note which it now can discount for no more than \$5,000. The fact that the full \$10,000 face value of the note eventually will be paid to the employer does not alter in any way the fact that it has made a \$5,000 compensation transfer to the employee in year one.¹⁶² Because the employer has paid \$5,000 compensation in year one, it is entitled to a business expense deduction at that time.

(B) Timing of the Employer's Income Inclusion

As has been shown, in the above hypothetical, the employer is entitled to a year one, \$5,000 business deduction. However, if the discount loan is seen as involving the transfer of \$5,000 of principal in year one in return for a repayment in year ten of the \$5,000 of principal plus \$5,000 of interest, the employer should not realize the \$5,000 loan discount as interest income in year one.¹⁶³ Rather, the employer should accrue the \$5,000 of interest income over the ten year term of the note if it is an accrual basis taxpayer,¹⁶⁴ or should report all the interest income in year ten when it receives payment of the note if it is a cash basis taxpayer.¹⁶⁵ Therefore, to suggest, as have several judges and commentators,¹⁶⁶ that it normally is irrelevant to the employer making an interest-free loan whether it has income and an offsetting deduction, or no income and no deduction, is incorrect. For when the interest-free loan has a fixed repayment date, the employer's deduction will be in year one, while, under the proposed analysis, the income will not be reportable until a later year or years.¹⁶⁷

¹⁶² *Mason v. United States*, 513 F.2d 25, 29 (7th Cir. 1975).

¹⁶³ See, e.g., *Chatham & Phenix Nat'l Bank*, 1 B.T.A. 460 (1925). However this result would be different if the hypothetical were analyzed as a prepaid interest transaction, see note 160 *supra*, rather than as a discount loan transaction. If the corporation is considered to have received \$5,000 prepaid interest in year one, it would be required to report the entire \$5,000 in that year whether it were a cash or accrual-basis taxpayer. See *Jack A. Mele*, 61 T.C. 358, 364-66 (1973).

¹⁶⁴ See *Chatham & Phenix Nat'l Bank*, 1 B.T.A. 460 (1925); *Treas. Reg. § 1.451-1(a)* (1957). The result would be different if the hypothetical facts were analyzed as a prepaid interest situation. See note 160 *supra*.

¹⁶⁵ *Treas. Reg. § 1.451-1(a)* (1957).

¹⁶⁶ E.g., *K.C. Bellows*, 26 T.C.M. (CCH) 978, 980 (1967); *Sneed*, *supra* note 4, at 655, 661.

¹⁶⁷ This deferral of income recognition favors the taxpayer. The benefit of the business expense deduction is received in year one. The tax savings from year one can be invested pending the recognition and taxation of the interest income.

b. *Transfer by Corporation to Shareholder*

If the fixed term interest-free loan hypothesized in the previous section were from a corporation to a shareholder, rather than from an employer to an employee, the analysis of tax consequences would not change. The shareholder would recognize \$5,000 of dividend income in year one, assuming that the corporation has adequate earnings and profits. If the shareholder is a cash basis taxpayer, the \$5,000 constructive interest payment will be deductible in year ten. If he is an accrual basis taxpayer, the \$5,000 will be deducted ratably over the ten year period of the loan.¹⁶⁸ The corporate lender will report the interest income in year ten if it is a cash basis taxpayer. If it is an accrual basis taxpayer, it will accrue the \$5,000 of interest income over the ten year period of the note. There is, however, one difference between the tax consequences of the employer-employee loan and those of the corporation-shareholder loan. In the latter case, the corporation-lender would not be entitled to a deduction for the \$5,000 cash dividend it effectively paid in year one, since dividends, unlike compensation payments, are not deductible.

As has been shown, the valuation and timing problems are not insurmountable. Appropriate valuation and timing of constructive interest payments can be achieved by applying the preceding analysis. Because in most cases the income and deduction are properly recognized in different years, the no-income, no-deduction approach, which presumes that the income and deduction will occur in the same year and so nullify one another, is inadequate.

IV. THE USE OF INTEREST-FREE LOANS TO ACCOMPLISH A BARGAIN SALE OF PROPERTY: THE OVERLAP WITH SECTION 483

Corporations and employers can use interest-free loans in tandem with sales of property to provide benefits to their shareholders or employees. For example, a corporation or employer might sell property to its shareholder or employee in exchange for the latter's non-interest bearing fixed term promissory note in a face amount equal to the present fair market value of the property transferred. This type of transaction can be viewed in two distinct ways: first, it can be seen as a sale of property by the corporation or employer for full value combined with the simultaneous transfer to its shareholder or employee of a fixed term interest-free loan in the amount necessary to pay the purchase price of the property; second, it can be viewed in the way the parties actually structured it, as a single sales transaction at a bargain price.

If the transaction were deemed to result in a separate, fixed term interest-free loan to the employee or shareholder, unrelated to the sale of property, current law would, as previously demonstrated, provide neither income nor deduction consequences to any of the parties on the loan part of the transaction. If viewed, however, as a single sales transaction—which

¹⁶⁸ See Treas. Reg. § 1.461-1(a)(2) (1957).

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is the way the Treasury Regulations apparently would view the transaction¹⁶⁹—under current law a reasonable interest amount would be imputed, producing interest income to the lender and an interest deduction to the borrower.¹⁷⁰ This result is provided by section 483 of the Code, which authorizes the Commissioner to treat a reasonable portion of deferred payments on the sale of property as constructive interest rather than as part of the purchase price, in the absence of a contract provision for adequate interest payments. In combination with other provisions of current law,¹⁷¹ section 483 produces the rational results of the recommended two-payment analysis in certain cases of bargain sales of property in exchange for interest-free promissory notes.

The normal operation of section 483 in an arm's length sales transaction now will be examined. The section's application to the bargain sale transaction described above will then be considered.

A. Section 483—Its Usual Application

Section 483 provides for the imputing of interest in cases of deferred payment sales or exchanges of property where no interest, or inadequate interest, has been specified. The situation that was contemplated by the drafters of section 483 was one in which there was an arm's length installment sale of property between an unrelated buyer and seller, which failed to call specifically for any interest on the deferred payments, or which called for an interest rate on those payments that was too low.¹⁷² Section 483 provides a method for determining what portion of the apparent sale price actually constitutes interest. The total unstated interest is identified as the excess of the sum of the payments to be made over the sum of the present value of such payments and of the stated interest payments, if any.¹⁷³ The regulations provide tables for computing the present value of the promised payments. The interest rate used in computing present value is currently seven percent.¹⁷⁴ A portion of the total unstated interest is allocated to each payment.¹⁷⁵

As an example of the operation of section 483 in the usual arm's length transfer situation, consider the case of stock sold by a seller to an unrelated buyer for \$20,000, payable \$10,000 in year five and \$10,000 in year ten. In this example, it is obvious that the real economics of the deal are different from those set forth in the agreement. It is clear that the actual present fair market value of the property sold is less than \$20,000, since the total \$20,000 figure the buyer is to pay over time represents not

¹⁶⁹ See Treas. Reg. § 1.483-1(b)(6), Ex. 6 (1966). The example indicates that the transaction would be viewed as a single sales transaction even if the parties structured it as an interest-free loan and a separate sale of property. *Id.*

¹⁷⁰ I.R.C. § 483.

¹⁷¹ *E.g.*, I.R.C. § 83, which requires that an employee recognize income on the receipt of property in exchange for services; I.R.C. § 162(a)(1) which permits the employer a deduction for reasonable compensation; and I.R.C. §§ 301, 316 which provide for a shareholder's recognition of dividend income.

¹⁷² H.R. REP. NO. 749, 88th Cong., 1st Sess. 72 (1963); S. REP. NO. 830, 88th Cong., 2d Sess. 101-02 (1964).

¹⁷³ I.R.C. § 483(b).

¹⁷⁴ Treas. Reg. § 1.483-1(c)(2)(ii)(B) (1966).

¹⁷⁵ I.R.C. § 483(a).

only the purchase price for the stock, but also unstated interest on the deferred payments. Under section 483 the present value of the two payments of \$10,000 can be computed by discounting the promised payments at seven percent compounded semiannually, in accordance with the current regulations.¹⁷⁶ The resulting figure is approximately \$12,000.¹⁷⁷ The difference between the amount owed, \$20,000, and the present value of that obligation, \$12,000, provides a figure of \$8,000 for unstated interest. This imputed interest will be allocated pro rata to each stated principal payment due more than six months after the date of sale.¹⁷⁸ Therefore, part of the purchase price will be deductible interest to the buyer and ordinary interest income to the seller. In the example given above, of each \$10,000 payment, \$4,000 would be considered a payment of interest.¹⁷⁹

The drafters of section 483 apparently never considered the proper tax treatment of a sales transaction in which the buyer and seller were not bargaining at arm's length.¹⁸⁰ That is, they did not consider a transaction in which the seller intended to grant the buyer an economic benefit by not charging interest on the deferred payments. An example of such a non-arm's length transaction would be the sale of property by a corporation or employer in exchange for the latter's non-interest bearing fixed term promissory note in a face amount equal to the present fair market value of the property transferred. While Code section 483 may not have been specifically designed to cover this non-arm's length situation, it seems that the section would apply to the deferred payments that the employee or shareholder makes to the employer or corporation.¹⁸¹ The situation of an employer transferring property to an employee will be considered first.

1. Sale of Property By Employer To Employee In Exchange For Note Bearing No Interest

The following hypothetical is illustrative of the transaction now under discussion:

¹⁷⁶ Treas. Reg. § 1.483-1(d)(1)(ii)(B) (1966) (test rate or minimum interest that must be stated to escape imputation of interest under I.R.C. § 483 is six percent in the case of sales or exchanges after July 24, 1975); Treas. Reg. § 1.483-1(c)(2)(ii)(B) (1966) (imputing rate is seven percent in the case of sales or exchanges after July 24, 1975).

¹⁷⁷ See Table IV of Treas. Reg. § 1.483-1(g)(2) (1966).

¹⁷⁸ I.R.C. § 483(a); Treas. Reg. § 1.483-1(a)(1) (1966).

¹⁷⁹ I.R.C. § 483(a); Treas. Reg. § 1.483-1(a)(1) (1966).

¹⁸⁰ See H.R. REP. NO. 749, 88th Cong., 1st Sess. 72 (1963); S. REP. NO. 830, 88th Cong., 2d Sess. 101-02 (1964).

¹⁸¹ The language of I.R.C. § 483 is broad. Section 483(a) provides that

[f]or purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

The payments to which the section applies are payments toward the sales price which are due more than six months after the date of such sale or exchange under a contract under which at least some of the payments are due more than one year after the date of such sale or exchange, and under which there is total unstated interest. I.R.C. § 483(c)(1). Nothing in § 483 excludes the case of a bargain sale of property in exchange for a deferred payment, non-interest bearing note.

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An employer owns stock with a basis of \$5,000 and a fair market value of \$20,000. The employer sells this stock to its employee in exchange for a promissory note under which the employee agrees to pay the employer, without interest, \$10,000 at the end of year five and an additional \$10,000 at the end of year ten.

If a fair interest rate of seven percent, as provided in the section 483 regulations, is assumed, then the present discounted value of the notes given by the employee to the employer in the hypothetical is approximately \$12,000.¹⁸² Therefore, the true economics of the situation are these: the employer has effectuated a bargain sale of stock worth \$20,000 to the employee for \$12,000. The employee has paid the \$12,000 bargain purchase price with non-interest bearing promissory notes payable after five and ten years in the face amount of \$20,000 but with a present discounted value of \$12,000. Thus, this bargain sale, like any bargain sale, can be broken down into its two elements, a transfer of \$8,000 of property in exchange for services, and a sale of \$12,000 of property in exchange for a non-interest bearing note with a present value of \$12,000. If this correctly describes the economics of the transaction, it should also determine the tax consequences for both the employer and the employee.

a. *Employee's Tax Consequences*

Two questions are presented by the employee's tax situation—the timing of the interest deduction and the realization of compensation income. As to the former, section 483 gives the answer.¹⁸³ Under that section the unstated interest on the employee's \$20,000 note would be approximately \$8,000,¹⁸⁴ and the employee would be entitled to a \$4,000 interest deduction in year five, and an additional \$4,000 interest deduction in year ten.¹⁸⁵ This would be true whether the employee was a cash or ac-

¹⁸² See text and note 177 *supra*.

¹⁸³ See note 181 *supra*. The regulations under I.R.C. § 483 contain an example indicating that the I.R.S. would, in this hypothetical, apply § 483 to the two \$10,000 payments made by the employee to the employer. Treas. Reg. § 1.483-1(b)(6), Ex. 6 (1966). The regulation example actually deals with the attempt of an employer to circumvent § 483 by granting an interest-free loan to his employee at the same time as he is selling property to him. The example is as follows:

On December 31, 1963 M Corporation sells 500 shares of stock to A, one of its employees, for a lump-sum payment of \$10,000. At the same time, A borrows \$10,000 from M Corporation and gives M a non-interest bearing promissory note which provides that A is to pay M \$2,000 at the end of each of the next 5 years. Section 483 applies to any payments made by A under the promissory note in the same manner as if such payments were being made under a deferred-payment contract for the sale or exchange of the stock.

It is not clear in the regulation example whether the lump sum payment of \$10,000 represents the fair market value of the stock, indicating a bargain sale situation, or whether it represents the sum of the fair market value and a reasonable, but unstated, interest amount. If the latter was intended, the example is within the usual operation of § 483. See text at notes 172-79 *supra*. Nonetheless, the section's failure to exclude bargain sales should suffice to bring them within its operation. If the \$10,000 payment in the example represents merely the fair market value, however, then the example explicitly confirms this reading of § 483 as applying to bargain sales of property accomplished through interest-free loans.

¹⁸⁴ I.R.C. § 483(a); Treas. Reg. § 1.483-1(a)(1) (1966).

¹⁸⁵ I.R.C. § 483(a); Treas. Reg. §§ 1.483-1(a)(1) (1966); 1.483-2(a)(ii) (1966).

crual basis taxpayer, since section 483 specifically requires that all taxpayers ratably allocate the imputed interest over all definite principal payments.¹⁸⁶

The question of the employee's realization of compensation seems clearly to require the answer that the employee realizes \$8,000 ordinary compensation in year one. That \$8,000 represents the difference between the \$20,000 fair market value of the stock he received and the \$12,000 present value of the notes transferred.¹⁸⁷ This result, in fact, is required by section 83, which provides that where property is transferred in connection with services, the difference between the property's fair market value and the price paid for the property is additional compensation to the person who performed the services. This result is also consistent with that reached for gift tax purposes by the Tax Court in *Gertrude Blackburn*,¹⁸⁸ and for charitable deduction purposes by the Seventh Circuit in *Mason v. United States*,¹⁸⁹ both previously discussed.¹⁹⁰ The employee's basis in the stock would be \$20,000, \$8,000 representing the \$8,000 compensation he took into income,¹⁹¹ and an additional \$12,000 representing the value of the note with which he paid for the property.

In summary, then, the tax consequences for the employee in the above hypothetical should be:

- (a) \$8,000 ordinary compensation income in year one;
- (b) a \$4,000 interest deduction in years five and ten; and
- (c) a \$20,000 basis in the stock received.

As has been demonstrated, these rational results are provided by current law through the combined operations of section 483, which grants the employee a deduction for constructive interest, and section 83, which requires that he recognize compensation income.

b. Employer's Tax Consequences

The tax consequences for the employer in the above hypothetical become evident once the employee's tax results have been determined. Under section 483, the employer will recognize total constructive interest income of \$8,000, reportable in the same years in which the employee is allowed the interest deduction, i.e., \$4,000 in year five and \$4,000 in year ten.¹⁹²

¹⁸⁶ Treas. Reg. §§ 1.483-1(a)(1) (1966); 1.483-2(a)(ii) (1966).

¹⁸⁷ If property is transferred by an employer to an employee for an amount less than its fair market value, the difference between the amount paid for the property and the amount of its fair market value is taxable compensation to the employee. Treas. Reg. § 1.61-2(d)(2)(1) (1957). The same rule applies to a bargain purchase by a shareholder from a corporation. Treas. Reg. § 1.301-1(j) (1955).

¹⁸⁸ 20 T.C. 204 (1953). See text at notes 153-56 *supra* for a description of the *Blackburn* case. As noted above, see text at notes 148-58 *supra*, in the recent case of *Lester Crown*, 67 T.C. 1060 (1977), the majority of the tax court, in holding that a donative interest-free loan did not result in a taxable gift, entirely ignored its previous contrary decision in *Blackburn*. *Id.* at 1068-69 (dissenting opinion).

¹⁸⁹ 513 F.2d 25 (7th Cir. 1975). For a discussion of this case see text at notes 143-47 *supra*.

¹⁹⁰ See text at notes 143-47 and 153-56 *supra*.

¹⁹¹ See cases cited in note 55 *supra*.

¹⁹² I.R.C. § 483(a); Treas. Reg. §§ 1.483-1(a)(1) (1966); 1.483-2(a)(1)(ii) (1966).

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This will be true whether the employer is a cash or accrual basis taxpayer.¹⁹³ Then, under section 162(a)(1), the employer will deduct \$8,000 in year one as a business expense for compensation paid. This deduction corresponds to the employee's recognizing compensation income of \$8,000 in that same year. In addition, the employer will realize a total capital gain of \$15,000 on the sale of the stock. This result obtains because the employer's basis in the stock was \$5,000 and the amount realized is the promissory note with a present value of \$12,000 plus the \$8,000 of services received.¹⁹⁴ The difference between the amount realized, \$20,000, and the basis, \$5,000, constitutes the employer's capital gain.¹⁹⁵ Again, section 483, in combination with other principles of tax law, has produced the logical result.

2. Sale Of Property By Corporation To Shareholder In Exchange For Note Bearing No Interest

a. Shareholder's Tax Consequences

Using the same analysis as for the employee, the shareholder who receives stock with a value of \$20,000 in exchange for his non-interest bearing obligation to pay the corporation \$10,000 at the end of year five and \$10,000 at the end of year ten will have, under section 483, a \$4,000 interest deduction in years five and ten.¹⁹⁶ In addition, the shareholder should recognize \$8,000 of dividend income in year one. The \$8,000 of dividend income corresponds to the compensation income of the employee in the preceding example. Moreover, the shareholder will obtain a \$20,000 basis in the stock received. \$12,000 of this basis represents the cost of the stock to the shareholder, *i.e.*, the present value of the note transferred in exchange for the stock.¹⁹⁷ The remaining \$8,000 of the basis is attributable to the dividend amount which the shareholder has taken into income.¹⁹⁸

b. Corporation's Tax Consequences

In the situation of the transfer of \$20,000 worth of stock by a corporation to a shareholder in exchange for the latter's non-interest bearing notes for payment of \$10,000 in year five and \$10,000 in year ten, the corporate transferor will realize \$4,000 interest income in years five and ten under section 483.¹⁹⁹ In addition, the corporation will be considered to have paid a non-deductible \$8,000 dividend in year one. This, again, represents the difference between the value of the property transferred

¹⁹³ Treas. Reg. § 1.483-2(a)(1)(ii) (1966).

¹⁹⁴ The amount realized under I.R.C. § 1001 clearly includes the \$8,000 of services rendered. See cases cited in note 119 *supra*.

¹⁹⁵ It may be possible for an employer to defer part of the capital gain under the installment sale method, if the requirements of section 453(b) are met. To qualify for installment sale treatment, payments in the year of the sale must be less than 30% of the total contract price. Since the \$8,000 worth of services received in year one of the example constitutes 40% of the \$20,000 price, this particular sale would not qualify for such treatment.

¹⁹⁶ I.R.C. § 483(a); Treas. Reg. §§ 1.483-1(a)(1) (1966); 1.483-2(a)(1)(ii) (1966).

¹⁹⁷ See I.R.C. § 1012.

¹⁹⁸ The \$8,000 becomes part of the shareholder's basis under I.R.C. § 301(d).

¹⁹⁹ I.R.C. § 483(a); Treas. Reg. §§ 1.483-1(a)(1) (1966); 1.483-2(a)(1)(ii) (1966).

and the present value of the notes given in exchange therefor. Also, the corporation will recognize a \$7,000 capital gain on the transfer of the stock in the sale portion of this part-sale, part-dividend transaction. This \$7,000 represents the difference between the \$12,000 value of the promissory note received from the shareholder and the stock's \$5,000 basis. The additional \$8,000 of gain will go unrecognized. This is so because section 311(a)(2) provides that a corporation will recognize no gain or loss on the distribution of property with respect to its stock.²⁰⁰ Thus, although the appreciation in the stock is realized on the sale thereof, it is not realized on the dividend distribution.

Accordingly, when property is sold to a shareholder or employee in exchange for his non-interest bearing note in a face amount equal to the fair market value of the property transferred, the transaction is properly seen as containing two distinct elements. First, it is a bargain sale of property with income and deduction consequences for the transferor and transferee, just as in any bargain sale. Second, it is a deferred payment sale of property to which section 483 applies, resulting in interest income to the transferor corporation or employer, and interest deductions to the transferee employee or shareholder. Thus, in these combined bargain sale and interest-free loan situations, rational tax consequences can be reached under current law. Adoption of the recommended two-payment analysis of interest-free loans thus would represent simply the extension of logical tax treatment to the entire field of interest-free loans between employers and employees and between corporations and shareholders.

V. THE SECTION 482 REGULATIONS: THEIR EFFECT ON INTEREST-FREE LOANS FROM CORPORATIONS TO INDIVIDUAL STOCKHOLDERS

Under section 482 of the Code, in order to prevent tax evasion or properly to reflect income, the Commissioner may allocate items of "income, deductions, credits, or allowances" between "two or more organizations, trades, or businesses (whether or not incorporated . . .) owned or controlled directly or indirectly by the same interests."²⁰¹ In 1968 new regulations were adopted under that section, dealing, *inter alia*, with the imputation of interest on non-interest bearing or low interest loans between controlled business enterprises. A typical fact pattern with which these regulations deal is the following:

Subsidiary corporation makes a \$100,000 interest-free loan to its 100% owner parent. The parent uses the loan proceeds as working capital, and it is therefore impossible to show whether or not the proceeds of the loan, in fact, generated income outside the controlled group.

²⁰⁰ I.R.C. § 311(a)(2) provides generally that "no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of— . . . (2) property."

²⁰¹ For discussions of the enactment and purposes of § 482, see J. CHOMMIE, *supra* note 27, § 218, at 633; B. BITTKER & J. EUSTICE, *supra* note 3, at ¶ 15.06; Lewis, *Allocations (Sec. 482)—General Coverage*, 230-2d TAX MANAGEMENT PORTFOLIO (1976); Schmid, *Allocations (Sec. 482)—Specific Transactions*, 230-2d TAX MANAGEMENT PORTFOLIO (1976).

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The regulations under section 482 make it clear that, on the facts of the hypothetical, the Commissioner is empowered to allocate seven percent annual interest income to the subsidiary-lender.²⁰² To take this action, the Commissioner is not required to show that the loan resulted in the realization of income to the controlled group from dealings outside the group.²⁰³ The parent-borrower, however, must be provided a correlative seven percent interest deduction in the same taxable year.²⁰⁴ "[P]resumably, the [collateral] effect of such adjustments would be to create constructive dividend income to the parent."²⁰⁵ If so, it appears that, where section 482 by its terms applies to an interest-free loan, the logical two-payment transaction tax consequences are reached.

The following discussion will examine first, the significance which the reasoning underlying the section 482 regulations and cases holds for the appropriate treatment of interest-free loans which fall outside the scope of the section; and second, the possible situations in which section 482 will apply to interest-free loans from a corporation to an individual shareholder.

A. *The Relationship of the Creation of Income Issue Under Section 482 to Interest-Free Loans Outside the Scope of Section 482*

All the courts that have considered the issue have upheld the validity of the section 482 regulations against the attack that they authorize the

²⁰² See Treas. Reg. §§ 1.482-1(d)(4) (1962); 1.482-2(a)(2)(iv)(B)(2) (1968). Schmid, *supra* note 201, at A-4 - A-9. Treas. Reg. § 1.482-1(d)(4) (1968) states that:

If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members . . . notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period. For example, . . . if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

²⁰³ See Treas. Regs. 1.482-1(d)(4) (1968) and 1.482-2(a) (1968).

²⁰⁴ See Treas. Reg. § 1.482-1(d)(2) (1962); B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 15.06 at 15-30; Lewis, *supra* note 201, at A-12 - A-14. The Commissioner may take this action without the necessity of showing that the loan resulted in the realization of income to the controlled group stemming from dealings outside the group. Treas. Reg. § 1.482-1(d)(4) (1962).

Numerous recent cases under section 482 have upheld the validity of the section 482 regulations against the attack that they authorize the Commissioner to create income where none otherwise existed, rather than simply permitting the Commissioner to allocate existing income. *E.g.*, Fitzgerald Motor Co. v. Commissioner, 508 F.2d 1096, 1101 (5th Cir. 1975); Kerry Investment Co. v. Commissioner, 500 F.2d 108, 109-10 (9th Cir. 1974); Liberty Loan Corp. v. United States, 498 F.2d 225, 228-32 (8th Cir.) *cert. denied*, 419 U.S. 1089 (1974); Commissioner v. B. Forman & Co., 453 F.2d 1144, 1155-56 (2d Cir.) *cert. denied*, 407 U.S. 934 (1972); Collins Elec. Co., 67 T.C. 911, 921 (1977). For extensive commentary on section 482 and this line of cases, see Black, *What is Income? A View From Section 482 of the Internal Revenue Code*, 42 TENN. L. REV. 673 (1975); Hamlin, *Section 482 in the 1970's: Commissioner's Authority to Allocate—When, How and to Whom*, 1973 SO. CAL. TAX INST. 701, 706-22; Comment, *Creation of Income Versus Allocation of Income: The Section 482 Controversy*, 51 TEX. L. REV. 920 (1973); Nauheim, *B. Forman & Co.—A Crucial Test of the Future of Section 482*, 26 TAX LAW. 107 (1972).

²⁰⁵ B. BITTKER & J. EUSTICE, *supra* note 3, at ¶ 15.06, at 15-34.

Commissioner to create income where none otherwise exists.²⁰⁶ That is, the courts agree that the Commissioner, pursuant to his authority under section 482, may "impute" interest income to a business enterprise that makes an interest-free loan to another, provided that the two businesses are commonly controlled. The Commissioner may impute such income even if the loan does not result in the realization of income to the controlled group by dealings outside the group.²⁰⁷ In so holding, however, all of these courts have derived the Commissioner's authority from section 482,²⁰⁸ apparently assuming without analysis—as did the cases previously discussed in Part I²⁰⁹—that the Commissioner lacks general authority under section 61 to impute interest income to a corporation that transfers money interest-free to its shareholders.²¹⁰ As a result, it might appear that in situations not covered by section 482, the cases forbidding the imputation of interest still govern. If so, under present law, section 61 alone does not give the Commissioner authority to draft regulations to produce results that reflect the economic reality of interest-free loans between corporations and shareholders.

This restrictive view of the Commissioner's authority, however, is subject to considerable doubt. As Professor Chommie points out in his treatise:

The predecessor of section 482 was enacted in 1924 . . . when the assignment of income doctrine and other tax avoidance doctrines were yet to be developed by the courts. Thus, from a present day perspective it may well appear that section 482 adds but little to the general enforcement power of the Revenue Service to insist upon realities governing business transactions for tax purposes, especially transactions between related persons and entities.²¹¹

Indeed, in enforcing section 482, the courts have recognized that the imputation of interest income to interest-free loans accords with economic reality.²¹² Thus, apart from the authority granted by section 482, the Commissioner should have the power to impute interest payments so as to re-

²⁰⁶ *E.g.*, *Kahler Corp. v. Commissioner*, 486 F.2d 1, 4-5 (8th Cir. 1973); *Commissioner v. B. Forman & Co.*, 453 F.2d 1144, 1155-56 (2d Cir. 1972), *cert. denied*, 407 U.S. 934 (1974); *Latham Park Manor, Inc. v. Commissioner*, 69 T.C. No. 15 (Nov. 9, 1977).

²⁰⁷ See cases cited in note 206 *supra*.

²⁰⁸ *See, e.g.*, *Kahler Corp. v. Commissioner*, 486 F.2d 1, 4-5 (8th Cir. 1973); *Commissioner v. B. Forman & Co.*, 453 F.2d 1144, 1155-56 (2d Cir. 1972), *cert. denied*, 407 U.S. 934 (1972); *Latham Park Manor, Inc. v. Commissioner*, 69 T.C. No. 15 (Nov. 9, 1977).

²⁰⁹ *Brandtjen & Kluge*, 34 T.C. 416 (1960); *Society Brand Clothes, Inc.*, 18 T.C. 304 (1952); and *Combs Lumber Co.*, 41 B.T.A. 339 (1940).

²¹⁰ In *Latham Park Manor*, 69 T.C. No. 15, for instance, the Tax Court distinguished prior cases forbidding the imputation of interest income where no interest was actually paid or received on the ground that those cases either were decided prior to the issuance of the pertinent § 482 regulations, *Treas. Regs.* 1.482-1(d)(4) (1968) and 1.482-2(a) (1968), or did not focus on those regulations. The Second Circuit in *B. Forman* noted that to the extent the prior cases could be read as forbidding the allocation of interest income under I.R.C. § 482, they conflicted with the purpose of that section. 453 F.2d at 1155-56.

²¹¹ J. CHOMMIE, *supra* note 27, § 218, at 633. *See* B. BITTKER J. EUSTICE, *supra* note 3, ¶¶ 15.07-15.08, at 15-36 - 15-49.

²¹² *E.g.*, *Kahler Corp. v. Commissioner*, 486 F.2d 1, 4-5 (8th Cir. 1973); *Commissioner v. B. Forman & Co.*, 453 F.2d 1144, 1155-56 (2d Cir. 1972), *cert. denied*, 407 U.S. 934 (1974); *Latham Park Manor, Inc. v. Commissioner*, 69 T.C. No. 15 (Nov. 9, 1977).

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flect economic realities, under the assignment of income and other tax avoidance doctrines, with a statutory basis in the general authority of section 61.

B. *The Possible Application of Section 482 to Certain Interest-Free Loans from a Corporation to an Individual Stockholder*

It is clear that section 482 is not, by its terms, generally applicable to dealings between a corporation and an individual shareholder, even if that individual shareholder controls the corporation. The entities subject to section 482 are "organizations, trades, or businesses," not individuals.²¹³ Nevertheless, section 482 may be applicable where there are non-arm's length dealings between a corporation and an individual shareholder if, in those dealings, the individual shareholder is acting in his capacity as proprietor of a separate business. In that case the controlling individual shareholder could be considered an organization or business within the meaning of section 482, and the rules of that section would be applied.²¹⁴

Consider for example, the situation of Doctor A, who practices medicine in non-corporate form and is also the 100% shareholder of Corporation R, which is engaged in the purchase and sale of real estate. If Corporation R transfers an interest-free loan to Doctor A, which the doctor uses for personal purposes, section 482 is inapplicable and general tax principles will be applied. It was demonstrated in Part I that, under the Tax Court's view, this will result in no income and no deduction for Doctor A²¹⁵ and no interest income for the corporate lender.²¹⁶ Tax logic, on the other hand, would demand that the corporation realize interest income equal to a fair interest rate on the loan, and that the doctor recognize dividend income in the same amount, with an offsetting deduction for the interest "paid."²¹⁷ This logical result apparently would be reached under section 482 if the facts of the hypothetical were changed such that the doctor took the loan proceeds and applied them to purchase new equipment for his medical practice.²¹⁸ In that case the "two business" requirements of section 482 would be met. While there is no law on the subject of tracing loan proceeds for the purpose of invoking the "two business" requirement of section 482, effectuation of the purposes of section 482 would seem to demand such tracing. Otherwise the attempt clearly to reflect income will be frustrated whenever the recipient of the income has both a business and an individual identity.

If, in the above example, the Service traced the use of the interest-free loan to the doctor's medical practice, the Commissioner would have

²¹³ See Treas. Reg. § 1.482-1(a) (1962). But if a court finds that an individual is actually operating an independent business, I.R.C. § 482 may be applied. See, e.g., *Borge v. Commissioner*, 405 F.2d 673, 675-76 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969); *Revel D. Cooper*, 64 T.C. 576, 580 (1975); *Richard Rubin*, 56 T.C. 1155, 1157-60 (1971), *aff'd per curiam*, 460 F.2d 1216 (2d Cir. 1972); *Lewis*, *supra* note 201, at A-3 - A-6.

²¹⁴ See cases cited in note 213 *supra*.

²¹⁵ See notes 11-12 *supra*.

²¹⁶ *J. Simpson Dean*, 35 T.C. 1083, 1090 (1961). See text at notes 93-103 *supra*.

²¹⁷ See Part I *supra*. Dividend income results, of course, only when the corporation has adequate earnings and profits. I.R.C. §§ 301(c)(1); 316(a).

²¹⁸ See text at note 213 *supra*.

authority to reallocate income under section 482. The Commissioner's primary adjustment would be to provide the corporate transferor with interest income equal to a fair interest rate on the loan²¹⁹—currently defined as seven percent in the case of a transferor not in the business of making such loans.²²⁰ The section 482 regulations²²¹ then would provide for a correlative adjustment for the recipient of the loan,²²² which in this case would mean giving the doctor a deduction for interest paid. Moreover, while there are no cases or rulings on the subject, it seems clear that the doctor also should be charged with dividend income in the amount of the economic value of the interest-free loan.²²³

The factual setting of the recent gift tax case of *Lester Crown v. Commissioner*²²⁴ would seem perfectly suited for the invocation of the tracing theory suggested. In that case, a partnership made interest-free loans to trusts for the benefit of the relatives of the donor-partners. The trusts used the loans to acquire interests in another partnership. The Tax Court held that the economic benefit of the interest-free use of money did not constitute a taxable gift.²²⁵ Although the Tax Court held in *Crown* that there was no taxable gift, it might be possible for the Internal Revenue Service to argue that interest income should be imputed to the partners of the donor-partnership with an interest deduction given to the donee-trusts. It would appear that by tracing the loans through the trusts to the acquired partnership the two-business requirement of section 482 would be met, since the section 482 regulations include a trust in their definition of the term "organization."²²⁶ If the two businesses or organizations are deter-

²¹⁹ See Treas. Reg. §§ 1.482-1(d)(4) (1962); 1.482-2(a) (1968).

²²⁰ Treas. Reg. § 1.482-2(a)(2)(iv)(B)(2) (1968).

²²¹ Treas. Reg. § 1.482-1(d)(2) (1962).

²²² The correlative adjustment procedure of Treas. Reg. § 1.482-1(d)(2) (1962) is a principal feature of the regulations.

By requiring an appropriate correlative adjustment to be made on behalf of other members of the group who are affected by the primary adjustment under § 482, the regulations emphasize the fact that § 482 is an allocation section, rather than a disallowance provision. For example, if income is reallocated from Subsidiary X to Subsidiary Y under § 482, the income of X must be decreased to take account of the fact that the income has been attributed to Y.

B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 15.06 at 15-30.

²²³ Cf. B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 15.06 at 15-33 - 15-34. The authors there refer to the collateral effects of § 482 adjustments and note that "[f]oremost among these indirect effects is the possibility of constructive dividend treatment where income or deductions are reallocated between . . . parent-subsidiary corporations." *Id.* They note further that

[r]eallocation of the parent's income to its controlled subsidiary is not covered by any specific cases or rulings, but presumably the effect of such adjustments would be to create constructive dividend income to the parent. Thus, while the parent would be entitled to a correlative adjustment, reducing its income to the extent that it was reallocated to its subsidiary under § 482, there would be an increase in its income due to the constructive dividend treatment . . . resulting in a net reduction of the parent's income.

Id. at 15-34. The net reduction in the parent's income results because the full constructive dividend is unlikely to be taken into the parent's income as a result of the dividends received deduction of § 243.

²²⁴ 67 T.C. 1060 (1977).

²²⁵ *Id.* at 1064-65.

²²⁶ Treas. Reg. § 1.482-1(a)(1) (1962).

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mined to be controlled by the same interests, section 482 would then apply, permitting reallocation of income.

As has been demonstrated, section 482 itself provides logical tax treatment for at least some non-arm's length, interest-free loans between corporations and shareholders. No reason appears for limiting the tax reflection of economic reality to those cases that can be brought within the purview of section 482, since, as explained above, section 61 and the assignment of income cases provide ample support for a logical approach to all interest-free loans between corporations and shareholders and between employers and employees.

CONCLUSION

Interest-free loans between corporations and shareholders, and between employers and employees, are economically equivalent to a two-payment transaction involving a loan on which interest is charged, accompanied by an increase in dividend, or in compensation, in the amount of the interest payment. The tax consequences under present law, however, are quite different. In the two-payment transaction, the recipient shareholder-employee would have dividend or compensation income and a deduction for the constructive interest payment. The lender would recognize constructive interest income. A deduction for reasonable compensation would be available to the employer-lender. The interest-free loan, by contrast, gives rise to no imputed interest income to the transferor under current law. An employer-lender receives no compensation deduction for the economic benefit transferred to the employee. Nor is the recipient of an interest-free loan either required to recognize as income the economic value of the loan or permitted an imputed interest deduction. Were the tax treatment of the interest-free loan made to correspond to that of the two-payment transaction, often the income and deduction would offset one another, producing the same tax liability as under a no-income, no-deduction approach. However, in many cases the tax liability indeed would be different, and frequently important tax repercussions would be felt even though the income is offset by an equivalent deduction.

Where the effects could be different, recognition of economic reality demands that the interest-free loan be analyzed, for tax purposes, as if it were a two-payment transaction. Even where the results do not differ between the two-payment transaction analysis and the no-income, no-deduction approach, the two-payment analysis is preferable because it accords with tax logic and avoids the obfuscation of tax principles inherent in the no-income, no-deduction approach. It is to be hoped that the courts will reconsider their acceptance of the no-income, no-deduction approach and instead adopt the two-payment analysis. Only then will the actual economics of interest-free loans between corporations and shareholders and between employers and employees be reflected in their tax treatment.

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