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I. INTRODUCTION

The dramatic rise in interest rates in the United States in the past few years has given added significance to the uncertain tax consequences of interest-free loans made between family members, between corporations and shareholders, and between affiliated corporations. Such loans can create a variety of tax problems depending on the relationship of the parties. An interest-free loan from one family member to another may constitute a gift equal in value to the use of the money loaned or even to the amount of the entire principal. A corporation that makes an interest-free loan to one of its shareholders not only risks the imposition of a constructive dividend on the shareholder in an amount equal to the value of the use of the money loaned, but also marks itself as an attractive candidate for imposition of the accumulated earnings tax since it apparently has little need for productive employment of the funds in its own business.[1] Furthermore, interest-free loans between affiliated corporations may cause the Commissioner to invoke his authority under section 482 of the Internal Revenue Code[2] to reallocate gross income, deductions, credits and allowances among the corporations involved in order to prevent evasion of taxes or clearly to reflect income. The

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1. Sections 531 to 537 of the Internal Revenue Code of 1954 impose the accumulated earnings tax on the accumulated taxable income of every corporation formed or availed of for the purpose of avoiding income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being distributed. Section 533 provides tbat the fact tbat earnings and profits are permitted to accumulate beyond the reasonable needs of the business is determinative of tbe purpose to avoid the income tax with respect to its shareholders unless the corporation proves the contrary. Most accumulated earnings tax cases, therefore, turn on whether the company's earnings and profits were accumulated for the reasonable needs of its business. In addition, in computing the accumulated earnings subject to tax a credit is provided for earnings accumulated for the reasonable needs of the business. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF SHAREHOLDERS AND CORPORATIONS ¶ 8.03 (3d ed. 1971).

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

specific adjustments that must be made in the case of an interest-free loan between commonly controlled corporations[3] are detailed in the regulations promulgated under section 482 and have been the subject of extensive litigation in recent years.[4] It is the purpose of this article to explore the tax treatment of interest-free loans in these various situations.

II. Interest-Free Loans Between Family Members

The tax treatment of interest-free loans between family members has generated surprisingly little attention or litigation. In the 1966 decision of *Johnson v. United States*,[5] a Texas federal district court held that the taxpayers, husband and wife, did not make taxable gifts of the value of the use of money loaned to their childern interest-free. Surprisingly, the government did not appeal the decision and it is also remarkable that no subsequent decisions have arisen on the same point. *Johnson* has received little attention by commentators,[6] and after seven years the Internal Revenue Service has announced in Revenue Ruling 73-61[7] that it will not follow the court's decision in the case. The failure of the case to attract any siguificant attention is surprising since *Johnson* represents a significant tax planning opportunity. Under *Johnson*, an interest-free loan may have tax advantages over a short-term trust. At a time when historically high interest rates have raised the stakes both to taxpayers and to the government, *Johnson* and Revenue Ruling 73-61 deserve careful study.

In *Johnson*, the taxpayers had made large interest-free demand loans to their children for more than eleven years. With a minor exception, all of the loans were repaid in 1962 prior to Mr. Johnson's death. Thereafter, the Service assessed and collected gift taxes from Mrs. Johnson and her husband's estate for the years 1959-62. Although it was stipulated in the refund suit that the loans were bona fide, the Service claimed that the taxpayers had made gifts to their children of the value of the use of the money loaned equal to 3 ½ percent per annum on the average unpaid balance each year. In refusing to find that the taxpayers had made such a gift, the district court noted that the issue was one of first impression, stating:

> There is nothing about this transaction that defeats the purpose of the gift

3. Treas. Reg. § 1.482-2(a) (1968).
4. *See* cases discussed in notes 41-67 *infra* and accompanying text.
5. 254 F. Supp. 73 (N.D. Tex. 1966).
6. The decision was criticized in case comments shortly after it appeared. 5 Houston L. Rev. 138 (1967); 65 Mich. L. Rev. 1014 (1967); 19 Stanford L. Rev. 870 (1967).
7. 1973 Int. Rev. Bull. No. 5, at 15.

> tax laws . . . to prevent a person from evading estate taxes through reduction of his estate by inter vivos gifts. The parents were under no duty to lend or otherwise invest their money. They had a right to keep it in cash. These loans were conceded to be genuine. Most of them had been repaid before the father's death. The unpaid amount of the loans appeared on the books, and was includable as an asset of his estate in arriving at the amount of his estate taxes.
>
> The right to interest must arise from an express or implied contractual obligation or from statute. There was no express or statutory duty on the part of the children to pay their parents interest. . . .
>
> The time has not yet come when a parent must suddenly deal at arm's length with his children when they finish their education and start out in life. There is no legal requirement, express or implied, to charge them interest on money advanced to them at that stage, whether it be to open a law office and hang out a shingle, to go into the oil business on a substantial scale, or to begin life on their own in some other way.[8]

In Revenue Ruling 73-61[9] the Service announced that it would not follow the *Johnson* decision. In that ruling a parent borrowed 200,000 dollars from a bank and later in the same month loaned 250,000 dollars to his son's wholly-owned corporation, receiving in return two noninterest-bearing corporate notes. The first note was in the amount of 50,000 dollars, payable at the end of ten years; the second was a demand note in the amount of 200,000 dollars.

The ruling states that a transfer by gift to a corporation normally represents a gift to the shareholders, with a gift arising when property is transferred for less than adequate and full consideration in money or money's worth. The right to use property—in this case money—is described as an interest in property which results in a gift when transferred without adequate consideration. Consequently, a gift tax is imposed on the value of the right to use money, normally stated in terms of interest.

In support of its conclusion, Revenue Ruling 73-61 relies on the Tax Court decision in *Gertrude H. Blackburn.*[10] There the court held that the taxpayer made a gift in the transfer of real property to her childern in exchange for a note bearing interest at a rate of only 2 ¼ percent per annum when the market rate of interest for debt obligations secured by real estate at the time was four percent per annum. The court held it was proper for the Commissioner to discount the note from its face value because of its lower rate of interest and to treat the amount of the discount as a gift made by the taxpayer to her children.

In the case of the term loan of 50,000 dollars, Revenue Ruling 73-61 further holds that a gift equal in value to the right to use the

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8. 254 F. Supp. at 77.
9. 1973 INT. REV. BULL. No. 5, at 15.
10. 20 T.C. 204 (1953).

money for the term of the loan has been made at the time the loan is granted. In comparison, a gift is made in each quarter in which the 200,000-dollar demand loan is outstanding, with the amount of the gift equal to the value of the use of the money for such portion of the year as the funds are used by the borrower before repayment. Finally, the ruling notes as a practical matter that a taxable gift will not arise in the case of most small interest-free loans because of the availability of the annual 3,000-dollar exclusion per donee and the 30,000-dollar lifetime exemption under the gift tax provisions of the Code.[11]

It is difficult to accept the conclusion of the *Johnson* case that an interest-free loan is not a gift of the value of the use of the money loaned. Under the gift tax laws, a gift occurs when there is a transfer of property for less than adequate and full consideration in money or money's worth.[12] A transfer of money in return for a promissory note that provides only for the payment of principal at a future date without interest results in an unequal exchange. The interest-free note is worth less than the amount of principal loaned, because a dollar received at once is worth more than a dollar to be received at some date in the future.[13] Therefore, the interest-free note should be discounted from its face value with the discount representing the amount of the gift. It is impossible, however, to determine the appropriate discount on an interest-free demand note at the time the loan is made since it is not known how long the debt will remain outstanding. It can clearly be seen that as long as the lender permits the loan to remain outstanding he accepts less than equal value for the money he has transferred to the borrower and thereby makes a gift; the amount of such a "discount" will increase in proportion to the length of time the demand loan remains unpaid.

The necessity of including the principal amount of a demand loan in the estate of the lender and the right of parents to make interest-free loans to their children cited by the court in *Johnson* do not conflict with the finding of a gift. The estate of the lender has been effectively diminished by the lack of return of the money loaned and the parent's right to benefit his childern is consistent with the making of a gift.

Revenue Ruling 73-61 may be correct in its conclusion that an interest-free loan between family members is a gift of the value of

11. Section 2503(b) provides for an annual exclusion of $3,000, while the $30,000 lifetime exemption is contained in § 2521.

12. Commissioner v. Wemyss, 324 U.S. 303 (1945); INT. REV. CODE OF 1954, § 2512(b).

13. *See* E. HELFERT, TECHNIQUES OF FINANCIAL ANALYSIS 108-21 (1972) for a discussion of the time value of money.

the use of the money, but the ruling leaves substantial uncertainty in determining the amount of the gift. In *Johnson* the government valued the gift by using 3½ percent interest per annum on the money loaned as provided in the regulations governing the valuation of life estates, term interests, remainders, and reversions transferred on or before December 31, 1970.[14] Revenue Ruling 73-61 states, "[t]he rate of interest that would represent full and adequate consideration may vary, depending upon the actual circumstances pertaining to the transaction."[15] In the case of the term loan the ruling states that "the value of the right to the use of the money loaned is ascertainable by accepted actuarial methods, as of the date the money and the note were exchanged, and is, therefore, subject to the gift tax at that time. See section 25.2512-5 of the regulations."[16]

The ruling fails to indicate whether the amount of the gift is determined by reference to the market rate of interest prevailing at the time of the loan or by application of the tables in the regulations. Moreover, the reference to section 25.2512-5 of the regulations to ascertain the value of the right to the use of the money loaned creates additional confusion, since that section contains tables based on 3 ½ percent per annum interest for valuation of an interest transferred *on or before December 31, 1970.* It is unclear why the ruling refers to the section containing the old tables instead of section 25.2512-9, which contains the tables using six percent per annum interest for valuing transfers made after December 31, 1970. Futhermore, in the situation described in Revenue Ruling 73-61 it might be more appropriate to treat the interest paid by the parent in the 200,000-dollar bank loan he obtained as the amount of the gift to his son on the interest-free demand loan of 200,000 dollars, assuming that the proceeds of the bank loan were reloaned to the son interest-free.

If, instead of employing the three percent or six percent interest rates, the gift is valued according to market rates of interest on arm's-length loans, there will be substantial uncertainty about the amount of the gift. Judged by arm's-length standards, an unsecured demand or term loan from a parent to his child might require the use of a very substantial rate of interest. Under current market conditions, a standard unsecured loan might require an interest rate of eighteen percent or more. Further an unsecured interest-free term loan could require a valuation discount of over fifty percent of the

14 Treas. Reg. § 25.2512-5 (1956), *as amended*, T.D. 6826, 1965-2 Cum. Bull. 367.

15. 1973 Int. Rev. Bull. No. 5, at 15.

16. *Id.* at 16.

face amount of the note. Moreover, what 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 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 gift by reference to the standard of the shylock,[17] but quite another to use the rate of the loan sharks.

An alternative suggestion is to use the income actually produced by the loan as the amount of the gift.[18] This standard of valuation has the advantage of including in the gift the full amount of any income received by the donee from the loan. On the other hand, such an approach raises the problem of tracing the amount of income derived from the loan proceeds. Ascertaining the income arising from the borrowed funds might be simple when the borrower has purchased bonds with the loan proceeds but impossibly complex in cases where he has invested the proceeds in his business enterprise. Furthermore, if the loan proceeds were traced to unproductive investments, a gift would be precluded.

Employing a flat six percent per annum interest rate for valuing the amount of a gift resulting from an interest-free loan is consistent with the present method of valuation of other interests requiring a rate of return assumption[19] and also provides a more certain basis for measuring the gift. A degree of gift tax avoidance, however, can be achieved under this valuation method if interest rates remain above six percent on money market investments. For example, an interest-free loan of 100,000 dollars may be invested by a borrower in corporate bonds yielding in excess of nine percent currently.[20] If the lender is considered to have made a gift of only six percent of 100,000 dollars, or 6,000 dollars, while the borrower has been able to produce 9,000 dollars of income on the investment of the loan

17. "I hate him for he . . . lends out money gratis and brings down the rate of usance here with us in Venice. If I can catch him once upon the hip I will feed fat the ancient grudge I bear him. . . . [H]e rails, even there where merchants most do congregate, on me, my bargains, and my well-won thrift, which he calls interest." Wm. Shakespeare, *The Merchant of Venice*, Act I, sc. iii (G.B. Harrison, ed., 1968).

18. This approach may be required when the donor is taxable on the income produced by the loan under assignment of income principles. *See* notes 26-29 *infra* and accompanying text.

19. *See* Treas. Reg. § 25.2512-9 (1956).

20. In September 1974 single A rated bonds were offered at yields of over 10%. *See, e.g.*, Wall Street Journal, Sept. 25, 1974, at 19.

proceeds, an economic benefit given to the borrower has not been subjected to the gift tax. This result is possible because the regulations valuing interest—which depend upon a rate of return assumption—are outdated under current market conditions since they are based on a low rate of six percent. The Treasury may be expected to revise the regulations in this regard if interest rates remain at current levels.

A loan between family members often raises the question whether the borrower actually intends to repay the amount "loaned." If a bona fide indebtedness is not created or maintained, a gift of the principal amount of the loan results.[21] Depending upon when the intent that the "loan" need not be repaid arises, the gift results either when the "loan" is initially made or later when the indebtedness is forgiven.

A provision for interest is almost always accepted as a principal feature of genuine indebtedness.[22] Thus, when an interest-free demand loan remains outstanding year after year with no repayments of principal it is not difficult to reach the conclusion that genuine indebtedness does not exist and that the gift tax should be imposed on the entire principal amount of the "loan." A family lender may initially make a loan with the intent that it be repaid but subsequently find that losses of the borrower require a different approach. Parents who loan their children substantial sums that are lost in bad investments originally may have intended to create genuine indebtedness but may later be forced to choose between sending their children into bankruptcy court or making a substantial gift by forgiving the indebtedness. If the borrower has lost the ability to repay the loan, a decision to allow the loan to remain uncollected for a substantial period of time nevertheless indicates that the once genuine indebtedness has been forgiven.

The tax consequences of interest-free loans and short-term trusts are interesting to compare. A grantor who creates a revocable trust or one in which the property will revert to him in less than ten years is treated as the owner of the trust property for income tax purposes and is taxed on the income of the trust.[23] In addition, the

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21. It has often been said that a loan to a family member is presumed to be a gift. *See* Estate of Pearl Gibbons Reynolds, 55 T.C. 172 (1970). Frequently, the question arises in the context of a bad debt deduction sought by the lender. The courts often conclude that a gift rather than a loan was intended. *See, e.g.*, Estate of Carr, 12 T.C. 1158 (1949); C.B. Hayes, 17 B.T.A. 86 (1929).

22. The fact that a note does not bear interest has been held to be evidence of a gift. *See, e.g.*, Elizabeth N. Rude, 48 T.C. 165 (1967).

23. INT. REV. CODE OF 1954, § 676 (revocable trusts). Section 673 provides that the

grantor is subject to the gift tax on the term interest of the short-term trust and on income of the revocable trust that is received by the beneficiary prior to revocation.[24] If instead, the grantor creates an irrevocable trust with a minimum duration of ten years, he will not be taxable on the income of the trust,[25] but the value of the term interest created in the beneficiary will still be subject to the gift tax.[26] In contrast, a taxpayer who makes an interest-free loan may retain the power to reacquire his funds on demand or at the end of a short term without subjecting himself to the income and gift taxes on the return produced by the funds loaned to his borrower, who retains all of the income on the investment of the loan proceeds. Income from such investment is taxable to the borrower, and under *Johnson* the lender has not made a gift. Even if *Johnson* is incorrect, interest-free loans may have the advantage over a short-term trust of permitting the taxpayer to avoid income taxation on the income produced by the funds.

There are situations, however, in which an interest-free loan will not be an appropriate substitute for a revocable or short-term trust. For example, an interest-free loan to a minor would probably not be appropriate because the borrower should be of legal age to enter into contracts in order to establish a bona fide indebtedness. In addition, the taxpayer might not be willing to entrust the family member with responsibility for investing a substantial amount of money. In such case, the transfer of funds to a trustee with investment expertise may be the better alternative. An interest-free demand loan to fund a trust would probably be treated as a revocable trust.

While the income produced by borrowed funds is normally taxed to the borrower, it is arguable that the income arising from an interest-free loan should be taxed to the lender through the application of the assignment of income doctrine. This would result in tax treatment equivalent to that of a revocable or short-term trust.

grantor will be treated as the owner of any interest in a trust that will or may reasonably be expected to take effect in possession or enjoyment within 10 years of the transfer of that portion of the trust. Under subsection 673(c), however, the grantor is not treated as the owner of an interest that will not take effect in possession or enjoyment until after the death of the person to whom the income from the trust is payable.

24. Treas. Reg. §§ 25.2511-1(e), -2(f) (1956).

25. INT. REV. CODE OF 1954, §§ 671, 673. This assumes, of course, that the provisions of the trust instrument do not run afoul of any other of the grantor trust provisions, such as § 674, which deals with the power to control beneficial enjoyment of corpus or income. Also, as noted in footnote 23, if the trust income is payable to the beneficiary for life, the grantor will not be taxed on the income even though the beneficiary has a life expectancy of less than 10 years.

26. Treas. Reg. § 25.2511-1(e) (1956).

Even when interest-free loans are payable on demand or are for a short term, they are not embraced by the grantor trust provisions of the Code.[27] The history of those provisions taxing the grantor on the income of the trust as the substantial owner of the trust property, however, may support application of the assignment of income doctrine to interest-free loans. In *Corliss v. Bowers*,[28] the Supreme Court upheld the power of Congress to treat the grantor of a revocable trust as the owner of the trust property and as such to tax him on the income of the trust. On the basis of general income tax principles, the Supreme Court held in *Helvering v. Clifford*[29] that a taxpayer who had created a trust with himself as trustee for a five-year term for the benefit of his wife was taxable on the income of the trust as the substantial owner of the trust property. These two cases concerning grantor trusts indicate that courts might treat a taxpayer who has loaned money interest-free to a family member as the substantial owner of the loaned funds, authorizing the Service to tax him on the income produced by the loan. Additional justification for such treatment would exist if the lender obtained a security interest in property purchased with the loan and had or exercised control over the use made of the loaned funds. Moreover, taxing the lender on the income produced by the loan might provide a basis for imposing gift tax liability on the amount of income received by the borrower.

Conversely, failure to tax the lender on income produced by the interest-free loan might result in that income escaping income taxation altogether. If income produced by the loan is treated as a gift, the borrower may contend that it is therefore excludable from his own income.[30] Unless the income is then taxed to the lender on assignment of income principles it may not be subjected to the taxation at all. In order to avoid this peculiar result it may be

27. Part I [of Subchapter J] has no application to any organization which is not to be classified for tax purposes as a trust under the classification rules of §§ 301.7701-2, 301.7701-3, 301.7701-4. . . ." Treas. Reg. § 1.641(a)-0(a) (1954). "Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit." Treas. Reg. § 301.7701-4(a) (1954) (Ordinary Trusts).

28. 281 U.S. 376 (1930).

29. 309 U.S. 331 (1940).

30. INT. REV. CODE OF 1954, § 102. Of course, while the definition of the term "gift" is not the same for purposes of income tax exclusion as for gift tax purposes, nevertheless, the donative intent on the part of the lender-donor required for the income tax exclusion is present in the interest-free family loan.

necessary to apply the assignment of income doctrine to assure income taxation of income produced by the loan.

III. INTEREST-FREE CORPORATE LOANS TO SHAREHOLDERS

In *J. Simpson Dean*,[31] the taxpayers, husband and wife, received substantial loans of money from their controlled corporation in exchange for interest-free notes. The Commissioner contended that the taxpayers realized income to the extent of the economic benefit derived from the use of the money borrowed interest-free. Rejecting the Service's arguments, the Tax Court held that the borrowers did not realize income from the interest-free corporate loans. The majority opinion reasoned as follows:

> In support of its present position, the Government relies primarily upon a series of cases holding that rent-free use of corporate property by a stockholder or officer may result in the realization of income. . . . These cases bear a superficial resemblance to the present case, but reflection convinces us that they are not in point. 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. Not only would they not be charged with the additional income in controversy herein, but they would have a deduction equal to that very amount. We think this circumstance differentiates the various cases relied upon by the Commissioner, and perhaps explains why he has apparently never taken this position in any prior case.[32]

In a concurring opinion, four judges took the position that it was unnecessary to decide whether an interest-free loan resulted in income to the borrower. In their view, if the interest-free loan did result in income to the borrower, "the corresponding interest deduction would perhaps exactly offset and nullify it,"[33] and consequently no deficiency would result.

One member of the court dissented, arguing that an interest-free loan to a shareholder does result in income; consequently, the dissent stated that in order to escape taxation the shareholder must plead and prove that he would have been entitled to an interest deduction that would not be barred by section 265(2)'s prohibition on using the loan proceeds to purchase or carry tax-free bonds. Since the taxpayers did not plead or prove these matters, the dissent would have sustained the deficiency.

31. 35 T.C. 1083 (1961).
32. *Id.* at 1089-90.
33. *Id.* at 1090.

Although the government did not appeal *Dean*, it waited twelve years to announce its nonacquiescence.[34] The Service's rejection of the result in *Dean* indicates that the issue deserves further examination.

When a corporation confers an economic benefit on a shareholder the usual result is dividend income, provided the company has sufficient earnings and profits.[35] The rent-free use of corporate property by shareholders is a common example of an indirect dividend payment.[36] No real economic difference exists between a shareholder's rent-free use of tangible corporate property and the same shareholder's interest-free use of corporate funds. In both cases an economic benefit is conferred upon the shareholder by the corporation and dividend income results. The *Dean* case, however, suggests a distinction in the net result of the two cases based upon the interest deduction a shareholder would have if he paid interest to the corporation. Although the shareholder may have dividend income as a result of the interest-free loan, under the rationale of the opinion in *Dean* he has a corresponding interest deduction that prevents an increase in his net income.

Despite this line of reasoning articulated in *Dean*, it is not clear that a shareholder is entitled to an interest deduction for interest he has not paid. Section 163 allows an interest deduction for "all interest *paid* or *accrued* within the taxable year on indebtedness." (Emphasis added). A shareholder with an interest-free corporate loan does not pay or accrue interest on it. Moreover, a conflict with the *Dean* rationale is found in a number of cases holding that a borrower has no interest deduction on an interest-free loan.[37] If the taxpayer had paid interest on the indebtedness, the corporation would have reported interest income on the loan. In the case of an interest-free loan the corporation does not report interest income that it did not receive,[38] and the shareholder should not be permitted to deduct interest expense that was not paid. An interest-free loan is not the same as an interest-bearing loan to a shareholder with an accompanying cash dividend to use for the payment of

34. 1973 INT. REV. BULL. No. 51, at 7.

35. The existence of sufficient earnings and profits to cover an actual or constructive distribution of a dividend is assumed in the following discussion.

36. *See, e.g.*, 58th St. Plaza Theatre, Inc. v. Commissioner, 195 F.2d 724 (2d Cir.), *cert. denied*, 344 U.S. 820 (1952); International Artists, Ltd., 55 T.C. 94 (1970).

37. *See* D. Loveman & Son Export Corp., 34 T.C. 776 (1960); Howell Turpentine Co., 6 T.C. 364 (1946); Rainbow Gasoline Corp., 31 B.T.A. 1050 (1935); A. Backus, Jr. & Sons, 6 B.T.A. 590 (1927).

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

interest to the corporation: in the former case the corporation has paid a constructive dividend, but receives no income itself, while in the latter case the corporation has paid an actual dividend and earns interest income on the loan.

The government is probably correct in refusing to follow the decision in *Dean*. An interest-free loan by a corporation to a shareholder produces dividend income that should not be offset by an interest deduction for unpaid interest not reported as income by the corporation. If the corporation does charge a shareholder interest on a loan, then no dividend results, the shareholder receives a deduction for interest paid to the corporation, and the corporation reports the interest income received—a result that accords with economic reality.

Still other dangers are created by interest-free loans to shareholders. If no bona fide debt obligation exists, there may be a dividend distribution by the corporation in the full amount of the loan.[39] The problem is aggravated by the absence of a provision for interest on the loan, a principal feature found in genuine indebtedness.[40] Finally, an interest-free loan to shareholders may strengthen the case for imposition of the accumulated earnings tax. A corporation with adequate funds to loan to its shareholders demonstrates that it does not need to employ the funds in its business and probably has the financial ability to distribute the money loaned as dividends. If the loans to shareholders are interest-free, the corporation's ability to do without the productive use of its funds is spotlighted and the case for concluding that it has retained earnings beyond the reasonable needs of its business is fortified.[41]

IV. Interest-Free Loans Between Commonly Controlled Corporations

Section 482 of the Internal Revenue Code authorizes the Commissioner to distribute, apportion, or allocate gross income, deductions, credits or allowances among two or more commonly owned or

39. *See* Bittker & Eustice, *supra* note 1, ¶ 7.05, at 7-26; Werner, *Stockholder Withdrawals—Loans or Dividends?* 10 Tax L. Rev. 569 (1955).

40. In many cases holding that a purported "loan" by a corporation to its shareholder was a dividend distribution, the lack of interest on the "loan" has been cited as a factor in determining that the indebtedness was not genuine. *See* Myer v. Commissioner, 383 F.2d 883 (8th Cir. 1967); Roschuni v. Commissioner, 271 F.2d 267 (5th Cir. 1959), *aff'g* 29 T.C. 1193 (1958); Niederkrome v. Commissioner, 266 F.2d 238 (9th Cir. 1958); Christopher v. Burnet, 55 F.2d 527 (D.C. Cir. 1931).

41. The issue whether earnings have been accumulated beyond the reasonable needs of the business is often determinative in an accumulated earnings tax case. *See* note 1 *supra*.

controlled entities if he determines such action is necessary to prevent evasion of taxes or to reflect income clearly. The regulations under section 482 are based on the premise that transactions between controlled entities should adhere to an arm's-length standard,[42] and require adjustments, where necessary, to equate the tax consequences of such transactions with those that would obtain as the result of independent bargaining.

This arm's-length standard is reflected in the regulations[43] pertaining to loans between controlled corporations. If the rate of interest charged is more or less than that which would have been charged between independent parties, an adjustment is required in the interest income of the lender and in the interest deduction of the borrower. Unless the lender is engaged in the lending business, generally the rate of interest charged on a loan between commonly controlled corporations will not be adjusted if it is not less than four nor more than six percent. In cases in which the loan represents the proceeds of a loan obtained by the lender at the situs of the borrower, however, the rate will be adjusted to the rate paid by the lender on the primary loan. If the market rate is less than four percent, the lender may charge less than four percent but not less than the market rate, while if the market rate is greater than six percent he may charge more than six percent but not more than the market rate. When the transaction requires an adjustment, however, the rate of interest will be adjusted to five percent per annum.

The validity of the regulations summarized above has been challenged in recent litigation, with primary emphasis on the "creation of income" issue. Modern litigation on this issue begins in 1940 with the case of *Tennessee-Arkansas Gravel Co. v. Commissioner*,[44] in which a brother corporation leased equipment rent-free to its sister company. The Commissioner increased the income of the brother corporation by the amount of rent that would have been charged in an arm's-length lease, but did not reduce the income of the sister corporation by the rent that would have been paid. The Sixth Circuit held that the Commissioner had not allocated income, but instead had "set up income where none existed."[45] In *Smith-Bridgeman & Co.*,[46] the Tax Court relied on *Tennessee-Arkansas*

42. "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treas. Reg. § 1.482-1(b)(1) (1962).

43. *See* Treas. Reg. § 1.482-2(a) (1968).

44. 112 F.2d 508 (6th Cir. 1940).

45. *Id.* at 510.

46. 16 T.C. 287 (1951), *acq.* 1951-1 CUM. BULL. 3.

Gravel Co. in upsetting the Commissioner's imputation of interest income to a subsidiary on interest-free loans to its parent. The court stated that the predecessor section of section 482 did not authorize "the creation of income out of a transaction where no income was realized by any of the commonly controlled businesses."[47] No allocation of income was made "since the record shows that [the Commissioner] made no adjustment to the income or deductions of [the parent]."[48]

Although the Service acquiesced in *Smith-Bridgeman*, it later clarified its position in Revenue Ruling 67-79,[49] explaining that its acquiescence was intended only to connote agreement that when interest income is imputed to the lending corporation, the income of the borrowing corporation must be correspondingly reduced in order to allocate gross income properly under section 482.

The Tax Court's position was amplified in its decisions in *Huber Homes, Inc.*[50] and *PPG Industries, Inc.*[51] In *Huber Homes*, a parent company sold homes to a subsidiary at a price that was less than fair market value. Rather than reselling the homes, the subsidiary rented them to third parties. The Commissioner increased the parent's income by the difference between the sale price of the homes and their fair market value while making a corresponding adjustment to the basis of the homes in the hands of the subsidiary. None of the rental income from the homes, however, was allocated to the parent. Although in this instance the Commissioner had adjusted the income of both corporations, the Tax Court found the adjustments improper, stating that "even in light of this adjustment income is being attributed to petitioner that was not in fact realized by the controlled group."[52] Since the court held that section 482 was not applicable, it did not reach the taxpayer's argument that the excess of the fair market value of the houses transferred to the subsidiary should be treated as a tax-free contribution to capital under section 118.

In *PPG Industries, Inc.*,[53] the Tax Court held that interest income could not be allocated to a parent on interest-free loans to a subsidiary when no income was derived by the subsidiary on the loans. In the view of the Tax Court, only when income is derived

47. *Id.* at 293.
48. *Id.* at 294.
49. 1967-1 CUM. BULL. 117.
50. 55 T.C. 598 (1971).
51. 55 T.C. 928 (1970).
52. 55 T.C. 598, 608 (1971).
53. 55 T.C. 928 (1970).

outside of the controlled group as a result of a nonarm's-length transaction between members of the group may it be reallocated under section 482. If income from outside the group is not traceable to the interest-free, rent-free or below-market transaction within the group, no income exists to be reallocated under the provisions of section 482.

In the Second Circuit decision of *B. Forman Co. v. Commissioner*,[54] the Service won an important victory upholding the regulations on interest-free loans under section 482. In *Forman*, two corporations each owned fifty percent of the stock of a third corporation that had been formed to construct and operate a downtown enclosed shopping mall adjoining the rear entrances of retail stores operated by the parent companies. In the years under review, each of the corporations had loaned 1,000,000 dollars to the controlled corporation interest-free. Pursuant to the section 482 regulations, the Commissioner increased the income of each controlling corporation by five percent of the outstanding loans. The Tax Court held that section 482 was inapplicable because neither corporation acting alone had control of the borrower (each possessed only fifty percent of the stock), and therefore the court did not reach the question whether the corporations could be charged with interest income under the regulations. Reversing the Tax Court decision, the Second Circuit held that the control requirement of section 482 should be broadly construed and that the control each corporation exercised over the affairs of the borrower was sufficient for purposes of section 482. Addressing itself to the question whether the imputation of interest income to the corporations on their interest-free loans was proper, the court stated:

> Reallocation is necessary here in order to properly reflect the income of taxpayers and Midtown. Taxpayers have advanced an argument, supported by case law, that the Commissioner may not create income where none actually existed. . . .
>
> To the extent that the above cases cited by taxpayers may be read as holding that no interest can be allocated under § 482 under the facts of this case, they are not in accord with either economic reality, or with the declared purpose of section 482. Those cases may be correct from a pure accounting standpoint. Nevertheless, interest income may be added to taxpayers' incomes, as long as a correlative adjustment is made to Midtown, for then the true taxable income of all involved will be properly reflected.[55]

The taxpayers alternatively contended that the 1,000,000 dollar advances were not loans, but rather contributions to capital. The

54. 453 F.2d 1144 (2dCir.), *cert. denied*, 407 U.S. 934, *rehearing denied*, 409 U.S. 899 (1972).

55. *Id.* at 1155-56.

court dismissed this argument, finding that the facts clearly indicated that the advances in question were bona fide loans. Curiously, the court did not discuss why the failure to charge interest on the loans could not be treated as a contribution to captial. The Second Circuit apparently rejected the Tax Court's position in earlier cases that income resulting from the loan must be produced outside of the controlled group before interest income may be charged to the lender under section 482.[56] It should be noted, however, that it is possible that gross income may indeed have resulted to the borrowing corporation from the loans in *Forman*,[57] but the Second Circuit did not rest its opinion on the presence of such income.

The Tax Court recently reasserted its views on the creation of income issue in *Kerry Investment Co.*[58] and *Kahler Corp.*,[59] both of which were reversed on appeal. In *Kerry*, a parent company periodically advanced over 500,000 dollars to a subsidiary. Pursuant to the section 482 regulations, the Commissioner increased the parent's income by five percent of the loans in each of the years, allowing correlative adjustments for interest deductions on the returns of the subsidiary. To the extent that the parent was unable to demonstrate that the loans had not been invested productively by the subsidiary, the Tax Court sustained the Commissioner's adjustments. When the parent proved that no gross income had been derived from a particular loan, however, the court held that no interest income could be imputed to the parent on that loan. Reversing the Tax Court's decision in part, the Ninth Circuit held the Commissioner's allocation should be sustained regardless of the loan's production of gross income for the subsidiary:[60]

> When a taxpayer lends $500,000 to a wholly owned subsidiary without interest, it is obvious that the lender is likely divesting itself of interest income

56. Smith-Bridgman & Co., 16 T.C. 287 (1951); Huber Homes, Inc., 55 T.C. 598 (1971); PPG Industries, Inc., 55 T.C. 928 (1970).

57. Apparently Midtown did realize gross income, but it was not traced to the loan proceeds. *See* Nauheim, *B. Forman & Co., Inc.—A Crucial Test of the Future of Section 482*, 26 TAX LAWYER 107, 115 n.28 (1972), citing Respondent's request for findings of fact number 34, Brief for Respondent Before the Tax Court of the United States, Docket Nos. 468-69, 469-69. *See also*, Kerry Inv. Co., 58 T.C. 479, 490 (1972). "In *B. Forman Co., Inc. v. Commissioner*, . . . the court upheld the respondent's determination increasing the taxpayer's income as a result of interest-free loans which it made to a related person. The borrower had sustained a loss during the years in issue, but the Court of Appeals seemed to indicate that § 482 could be applied irrespective of whether the borrower had income during the year. Despite such indication by the court, the borrower did in fact apparently receive gross income during the year."

58. 58 T.C. 479 (1972).

59. 58 T.C. 496 (1972).

60. 7 P-H 1974 FED. TAXES (34 Am. Fed. Tax R.2d) ¶ 74-5065 (9th Cir. June 6, 1974).

that it could have earned by making interest-bearing loans in a competitive market. When such an interest-free loan is made, we see no reason why an allocation of some income on the loan should not be made to the taxpayer even if the interest-free loan did not result in the production of gross income. In short, we hold that the tracing in order to determine whether the borrowed funds generated gross income to the borrower is neither necessary nor required.[61]

In *Kahler Corp.*,[62] decided by the Tax Court on the same day as *Kerry*, the Commissioner did not assert that loans made by a parent to subsidiary corporations had generated gross income to the subsidiaries. Therefore, the Tax Court held that the taxpayer need not prove that the loans were unproductive of gross income and that the imputation of interest income was improper. The Tax Court's decision was reversed by the Eighth Circuit,[63] which held that whether the borrowed funds produced income to the borrowing corporations was of "no importance."[64]

The authority of the section 482 regulations withstood another recent test in the Eighth Circuit on an issue not directly involving creation of income. In *Liberty Loan Corp. v. United States*,[65] the taxpayer corporation was engaged in the consumer finance business in several states, operating through 399 subsidiaries. Borrowing over 110,000,000 dollars at an effective interest rate of 5.55 percent, the taxpayer reloaned these funds to its solvent subsidiaries at an interest rate of 5.75 precent while charging its insolvent subsidiaries little or no interest. The differential in the interest charged to the solvent and insolvent subsidiaries resulted in sufficient interest income to the taxpayer to cover its own interest expense at the rate of 5.55 percent on the funds it had borrowed. Although the Commissioner increased the interest income of the taxpayer by five percent of the funds loaned to the insolvent subsidiaries, he did not reduce the 5.75 percent interest received by taxpayer from the solvent subsidiaries. There was no question that the subsidiaries had all derived gross income on the loans from the taxpayer since they had reloaned the money to consumers at much higher rates of interest.

Finding that there was no distortion of the taxpayer's income, the district court disapproved the Commissioner's adjustment because the taxpayer had recovered its borrowing costs from the group of subsidiaries taken as a whole.[66] The court reasoned that the Com-

61. *Id.* at 74-5240.
62. 58 T.C. 496 (1972).
63. 486 F.2d 1 (8th Cir. 1973).
64. *Id.* at 5.
65. 7 P-H 1974 FED. TAXES (34 Am. Fed. Tax R.2d) ¶ 74-5020 (8th Cir. May 31, 1974).
66. 359 F. Supp. 158 (E.D. Mo. 1973).

missioner would be justified only in making a horizontal adjustment among the subsidiary corporations since it was their incomes alone that had been distorted with respect to each other. On appeal, however, the Eighth Circuit reversed the district court decision on the ground that it made no difference whether the Commissioner first adjusted the income of the subsidiaries or that of the parent and that his determination would not be upset unless it was arbitrary and capricious.[67] Since the interest charged on the loans to the solvent subsidiaries of 5.75 percent was within the regulations' "safe haven" rates of four to six percent, no adjustment was necessary to reduce the rate charged to the solvent subsidiaries to five percent. Instead, the court found that increasing the interest paid by the insolvent subsidiaries to five percent was the only adjustment required. The net effect of the application of the regulations was the attribution of income to the parent at a rate of interest in excess of its own borrowing cost of 5.55 percent. Thus the parent was required to show a net profit on the funds it had loaned to its subsidiaries as a group on terms which were in fact only sufficient to recoup its own borrowing cost.

The Commissioner's success in the circuit courts on the creation of income issue and the apparent validity of the regulations under section 482 on interest-free loans raises the possibility that the Tax Court will concede the validity of the regulations and abandon the tracing of income requirement. All of the circuit courts have not faced the issue, however, and the Tax Court may consequently decide to adhere to its position in cases appealable to other circuits.[68]

The Commissioner's approach to interest-free loans between commonly controlled corporations is mechanical at best, and it is doubtful that imputation of interest income to the lender without a consideration of other factors invariably produces a clear reflection on income. Too often the only thing clearly reflected is a higher income tax liability for the parties. An obsession with an arm's-length standard to the exclusion of all other considerations overlooks the routine manner in which nonarm's-length dealings between a parent and a subsidiary are permitted in the context of capital contributions and dividend distributions.[69] In applying sec-

67. 7 P-H 1974 FED. TAXES (34 Am. Fed. Tax R. 2d) ¶ 74-5020, at 74-5063.

68. The Sixth Circuit took a position similar to that expressed by the Tax Court on the creation of income issue in Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940).

69. Section 118 provides that gross income does not include any contribution to the capital of the corporation. While § 118 does not deal with the tax consequences to the

tion 482 to interest-free loans, a number of factors, including tracing of income from the loans involved, should be considered. An interest-free loan of funds borrowed by the lender at interest may require that the borrower be treated as the true borrower on the interest-*bearing* loan, with a corresponding reallocation of the interest deduction to the borrower regardless of whether the interest-free loan itself produced income. In other situations, whether the interest-free loan has produced income outside of the group or whether the borrower has any gross income at all may be relevant considerations.[70]

The relationship between the corporations should also be considered. If the borrower is a subsidiary of the lender, an interest-free loan to the subsidiary might properly be treated as a contribution to capital by the parent equal in value to the use of the money, regardless of the production of income by the loan. If the subsidiary invests the loan proceeds in a business it operates, no reallocation of income should be necessary since income earned by capital furnished by a parent is not ordinarily reallocated to the parent company. When the interest-free loan has no business purpose, however, or is invested by the subsidiary as a conduit for the parent, or when circumstances otherwise indicate a plan to evade income taxes, reallocation under section 482 may be appropriate.

In the reverse situation, an interest-free loan from a subsidiary to a parent company normally should be considered a dividend in the amount of the value of the use of the money loaned. Under this approach, the parent has the benefit of the dividend received deduction of section 243 to the extent of eighty-five percent of the dividend as it would on any other dividend distribution. Instead of increasing the income of the subsidiary making the loan by imputing interest under section 482, the income of the parent would be increased by fifteen percent of the value of the use of the money.

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contributing shareholder, the regulations provide that such contributions represent an additional price paid for the shares of stock held by the individual shareholders. Treas. Reg. § 1.118-1 (1956). Such treatment implies that the shareholder does not recognize income on making a contribution to the capital of the corporation, but instead increases his cost for the shares. The increase in cost for the shares in the case of contributions of property is probably the shareholder's basis for the property. *See* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 3.14, at 3-51. In the case of the contribution of the value of the use of money loaned to a corporation, the corporation should have no increase in its basis for the stock of the subsidiary, since it has no tax cost or basis for the benefit contributed to the subsidiary.

70. If the borrower has no gross income whatsoever, it is difficult to understand how the Commissioner could make an allocation of income under § 482. While the circuit courts may not require a tracing of gross income from the loan proceeds, it may be necessary that the borrower have some gross income before an allocation may be made under § 482.

Interest-free loans between brother-sister corporations would not, of course, have the benefit of treatment as contributions to capital or as dividend distributions. In some cases such loans might give rise to constructive dividends to the shareholders controlling the brother-sister companies.[71]

Nevertheless, the authority of the Commissioner to make adjustments under the existing regulations recently has been strongly upheld by the circuit courts. In view of those decisions, tax counsel must consider alternatives to the interest-free loan, particularly in the case of parent-subsidiary corporations. Often, a parent company advances money to a financially troubled subsidiary to permit it to continue or improve its operations. Advancing funds in the form of an interest-free loan may seem a sensible approach since an interest burden is not added to the financial problems of the subsidiary, interest income is not realized by the parent, and an interest deduction is not wasted on the unprofitable subsidiary, and yet the parent can receive repayment of its funds without income consequences. Unfortunately, the likely result is that the Service will successfully tax interest income to the parent under section 482. A better approach would be to have the parent advance the subsidiary the necessary funds as a contribution to capital or in exchange for additional stock of the subsidiary.[72] If the parent wished a return of its funds from the subsidiary in the future, repayment could be accomplished through a distribution on the stock of the subsidiary, triggering dividend treatment only if the subsidiary had sufficient earnings and profits.[73] Often a repayment distribution may be planned before the subsidiary had generated earnings and profits. Even if a portion of the repayment distribution is treated as a dividend, only fifteen percent of the dividend would be included in the parent's income, an amount that might be considerably less than five percent of the total amount advanced each year for a number of years as in the case of an interest-free loan to the subsidiary.[74] If

71. According to the Service a reallocation under § 482 between brother-sister corporations requires that the reallocated item be treated as constructively distrihuted to the common shareholders and then contributed by them to the capital of the other controlled corporation. Rev. Rul. 69-630, 1969-2 CUM. BULL. 112; Rev. Proc. 65-31 § 4.04(3), 1965-2 CUM. BULL. 1024, 1037. Under §§ 1501 & 1504, brother-sister corporations not having a common parent corporation are not eligible to file consolidated returns. This ineligibility coupled with the constructive dividend problem severely restricts the mobility of capital between such hrother-sister corporations.

72. A purchase of stock for cash would not entail recognition of gain to the parent company, even though it did not meet the control requirements of § 351.

73. INT. REV. CODE OF 1954, § 316(a).

74. Treas. Reg. § 1.482-2(a) (1968) generally requires imputation of income at a rate of

the parent-subsidiary constitutes an "affiliated group" of corporations, it may elect to file consolidated returns prior to repayment of the capital advanced to the subsidiary. In that case, the parent will have the benefit of the one hundred percent dividend exclusion provided by section 243(a)(3) for dividends received from a member of an affiliated group filing a consolidated return. Another method of returning needed capital to the parent would be through an interest-free loan from the subsidiary to the parent. If the regulations were applied they could work to the advantage of the taxpayers, since the interest imputed to the subsidiary would be absorbed in loss carryovers while the interest deduction of the parent could be used against its income.[75]

V. Conclusion

As demonstrated by the cases and regulations just considered, the tax consequences of interest-free loans are not clearly defined in many respects. Those consequences that should flow from such loans are primarily determined by the relationship of the parties. Interest-free loans between family members not only have obvious gift tax implications but also involve assignment of income considerations. In the corporate context, an interest-free loan by a corporation to its shareholder should be treated as a dividend distribution of the value of the use of the money loaned, while interest-free loans between commonly controlled corporations present difficult reallocation questions under section 482. The regulations rely solely on the absence of an arm's-length interest rate for imputation of interest income to the lender, and the Tax Court's tracing of income requirement has yet to find any support in those circuit courts in which the issue has been litigated.[76] Nevertheless, the regulations are unsatisfactory because of their failure to consider other factors relevant to a determination whether income taxes are being evaded or income is not being clearly reflected. Foremost among these considerations is the interrelationship of the controlled corporations and the possibility that conventional principles of capital contribution and dividend payment should often control the tax conse-

5% per annum where the interest charged on the loan does not measure up to the arm's length standard set forth in the regulation.

75. The adjustments authorized by § 482, however, may not be instituted by the taxpayer. "Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions." Treas. Reg. § 1.482-1(b)(3) (1962).

76. No support exists other than that reflected in the Sixth Circuit's 1940 decision in Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508 (6th Cir. 1940).

quences of interest-free loans between parent and subidiary companies. The Service should take into account these factors, rather than applying arbitrary rules designed simply to produce the most income tax liability.