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STATUTE NOTE

TAXATION—Deficit Reduction Act of 1984—Treatment of Loans With Below-Market Interest Rates (Section 172)

Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 172, 98 Stat. 699 (to be codified at I.R.C. § 7872).

Both lenders and borrowers have historically utilized below-market interest rate and interest-free loans for evading income and/or gift tax liability.¹ Congress, however, has amended the Internal Revenue Code of 1954, providing the Internal Revenue Service (hereinafter Service or IRS) with legislation outlining the tax liabilities to now be applied to such bargain loans.² The new Code provision (section 7872) is the legislature's effort to recharacterize below-market interest rate and interest-free loans as loans made at market interest rates.³ Under the new statute, such loans are treated as though:

- (1) the borrower has paid interest to the lender resulting in an interest deduction for the borrower and additional income to the lender, and
- (2) the lender is deemed to have:

1. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (to be codified at I.R.C. § 7872) (below-market rate loans utilized as means for avoiding assignment of income rules, grantor trust rules, corporate income tax rules, and employment tax rules).

2. See Keydel, *Interest-Free and Below-Market Interest Loans*, 13 PROB. & PROP. 33, 33 (1984) (new section sets forth income, gift, and estate tax consequences of interest-free and below-market rate loans). See generally 71 STAND. FED. TAX REP. (CCH) No. 34, at 2-4 (Aug. 8, 1984) (below-market loans result in income and/or gift taxation of dividends or wages).

3. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (to be codified at I.R.C. § 7872) (committee believes bargain loans can be viewed as market rate loans); see also A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2526, at 1651 (Prentice-Hall 1984) (Senate amendment to House bill professes to follow House's approach defining below-market loans as loans at arms length). The Code now applies to below-market loans restructured by section 7872; the conference committee report states, "payments deemed made under this provision are treated as if actually made for all purposes of the Code." See *id.* at 1652-53.

- (a) made a gift to the borrower that is subject to gift taxation, or
- (b) paid compensation to the borrower if the loan is to one providing services from the person benefitting from such services, or
- (c) given a dividend in the case of a loan to a shareholder from a corporation.⁴

The new Code provision is a specific effort to directly attach tax liability to gift loans,⁵ compensation-related loans,⁶ corporation-shareholder loans,⁷ tax-avoidance loans,⁸ and other below-market loans.⁹ Section 7872 applies to all term loans made after June 6, 1984, and affects demand loans outstanding after such date.¹⁰

The shifting of income from a higher tax bracket to a lower tax bracket has always been regarded as a legitimate tax planning objective.¹¹ To shift income in this manner may lessen the aggregate amount of taxes collected by the IRS and has been pursued as a means for minimizing income tax liabilities.¹² Traditional methods of shifting income, however, have been tightly

4. See Detzel, *Interest-Free Loans:—The Supreme Court Closes a Loophole*, 1 *COMPLEAT LAW*. 45, 48 (1984).

5. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(1)(A), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(c)(1)(A)). The legislature stated that "the term 'gift loan' means any below-market loan where the foregoing of interest is in the nature of a gift." *Id.* § 7872(f)(3).

6. See *id.* § 7872(c)(1)(B). A compensation-related loan is defined as "any below-market loan directly or indirectly between— (i) an employer and an employee, or (ii) an independent contractor and a person for whom such independent contractor provides services." *Id.* § 7872(c)(1)(B).

7. See *id.* § 7872(c)(1)(C). A corporation-shareholder loan is "[a]ny below-market loan directly or indirectly between a corporation and any shareholder of such corporation." *Id.* § 7872(c)(1)(C).

8. See *id.* § 7872(c)(1)(D). A tax-avoidance loan is "[a]ny below-market loan 1 of the principle purposes of the interest arrangements of which is the avoidance of any Federal tax." *Id.* § 7872(c)(1)(D).

9. See *id.* § 7872(c)(1)(E). The new law defines "other below-market loans" as any below-market loan that is not a gift loan, a compensation-related loan, or a corporation-shareholder loan where "the interest arrangements of such loan have a significant effect on any Federal tax liability of the lender or the borrower." See *id.* § 7872(c)(1)(E).

10. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 172(c), 98 Stat. 699, 703. Section 7872 does not apply to demand loans outstanding on June 6, 1984, if repaid within 60 days after this provision's enactment. See *id.* § 172(c). Furthermore, this section applies to "any loan renegotiated, extended or revised after June 6, 1984." See *id.* § 172(c); see also 71 *STAND. FED. TAX REP.* (CCH) No. 34, at 1 (Aug. 8, 1984) (date of enactment was July 18, 1984); *A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984* ¶ 2625, at 1656 (Prentice Hall 1984) (amendment to gift tax laws inapplicable to loan made prior to June 6, 1984, to continuing care facilities by any residents of such facilities).

11. See Detzel, *Interest-Free Loans:—The Supreme Court Closes a Loophole*, 1 *COMPLEAT LAW*. 45, 45 (1984).

12. See *id.* at 45. Income splitting is a recognized method for reducing tax liability, as

controlled by the special requirements and restrictions imposed by the IRS.¹³ For example, where a lender allows a lower bracket taxpayer to receive proceeds from the lender's income-producing assets, the Service still calculates the amount of taxes due on the income realized according to the higher tax rate applicable to the lender.¹⁴ A taxpayer may establish an irrevocable trust so as to completely effectuate the desired income tax break, but to do so imposes another burden on the grantor as he must sacrifice the use of the trust principle for at least ten years.¹⁵ Therefore, prior to discovering the advantages of below-market rate loans, the grantor was traditionally compelled to either pay income taxes based on the higher tax rate or give up full control of his assets when making an assignment of income.¹⁶

Another means by which a higher bracket taxpayer can shift income out of his estate is to transfer by gift his property to a lower bracket taxpayer.¹⁷ Such transfers have long been the object of tax rules.¹⁸ In 1924, lawmakers decided that the topic of gift taxation warranted legislative action.¹⁹ The gift tax laws enacted in 1924, however, were repealed because of low revenue returns and the 1924 Act's poor structure, allowing for easy tax circumvention.²⁰ The Revenue Act of 1932 revived the practice of gift taxation and acted as the foundation from which present gift tax laws have been derived.²¹ The Internal Revenue Code of 1954 thereafter emerged and pres-

income is realized by the borrower who presumably is in a lower tax bracket. *See id.* at 45. With progressive tax rates, less liability is incurred with the practice of shifting income(s). *See id.* at 45.

13. *See id.* at 45.

14. *See id.* at 45; *see also* *Helvering v. Horst*, 311 U.S. 112, 118-19 (1940) (investment income taxed to lender because lender still has control over income-producing property's disposition).

15. *See* *Detzel, Interest-Free Loans:—The Supreme Court Closes a Loophole*, 1 COMPLETE LAW. 45, 45 (1984) (grantor of trust not taxed assuming beneficiary entitled to trust proceeds for at least 10 years or lifetime of beneficiary). This type of trust is called a "Clifford Trust" and is subject to a variety of restrictions. *See id.* at 49 n.4.

16. *See id.* at 45.

17. *See id.* at 46 (below-market loans used as means of transferring money while at the same time avoiding gift tax consequences).

18. *See* *Gifts, [154-4th Estates, Gifts, & Trusts] TAX MGMT.* (BNA), at A-1 (1982) (first federal gift tax imposed by Revenue Act of 1924); *see also* I.R.C. § 2501(a)(1) (1980) (present Code calls for tax to be "imposed . . . on the transfer of property by gift").

19. *See* Revenue Act of 1924, ch. 234, §§ 319-324, 43 Stat. 253, 313 (repealed 1926) (gift taxation first addressed by 1924 legislature).

20. *See* Revenue Act of 1926, ch. 27, § 1200(a), 44 Stat. 9, 126 (amended 1939) (gift tax imposed by Revenue Act of 1924 repealed as of January 1, 1926); *Gifts, [154-4th Estates, Gifts, & Trusts] TAX MGMT.* (BNA), at A-1 (1982) (construing S. REP. NO. 52, 69th Cong., 1st Sess. 9 (1926)) (Senate Finance Committee sought repeal of 1924 act due to low revenue returns and act's poor structure allowing for easy circumvention of tax liability).

21. *Compare* Revenue Act of 1932, ch. 209, § 501, 47 Stat. 169, 245 (gift tax statutes reinstated) (amended 1939) *with* Internal Revenue Code of 1939, 53 Stat. 1, 144, §§ 1000-1031

ently acts as the foundation for current gift tax legislation.²² The Tax Reform Act of 1976²³ and the Economic Recovery Tax Act of 1981 (ERTA)²⁴ substantially modified gift tax rules as outlined in the 1954 Code. These relatively recent legislative efforts, combined with the 1954 Code, comprise the corpus of the gift tax laws that are pertinent to an understanding of the impact of section 172 of the Deficit Reduction Act of 1984.²⁵

Below-market rate and interest-free loans have been widely utilized for transferring wealth without incurring tax consequences.²⁶ For example, below-market loans have allowed grantors (lenders) to enjoy the benefits of assigning income without enduring the burdens generally associated with income splitting.²⁷ Taxpayers have understandably been induced to make use of below-market loans since the grantor is permitted to maintain control over any money transferred; the grantor benefits further as the income derived from the loan is taxed at the lower tax rate applicable to the borrower.²⁸ Below-market loans gained additional recognition and became more attractive as they were adjudged to not result in any gift tax consequences.²⁹ The careful structuring of below-market loans quickly became a popular practice and soon represented a substantial loss of dollars to the IRS.³⁰ The Service's response to this income shifting technique became ap-

(Revenue Act of 1932 gift tax provisions substantially adopted) (amended 1954). *See generally* I.R.C. §§ 2501-2524 (1980) (1954 Code's gift tax rules substantially derived from 1939 Code).

22. *See* I.R.C. §§ 2501-2524 (1980).

23. Pub. L. No. 94-455, 90 Stat. 1520; *see also* *Gifts*, [154-4th Estates, Gifts, & Trusts] TAX MGMT. (BNA), at A-2 (1982) (construing H.R. REP. No. 1380, 94th Cong., 2d Sess. 12-17 (1976)) (explanation of Tax Reform Act of 1976). *See generally* *Gifts*, [154-4th Estates, Gifts, & Trusts] TAX MGMT. (BNA), at A-2 (1982) (key contribution of Tax Reform Act was that it modified unified tax credit as applied against estate and gift taxes).

24. Pub. L. No. 97-34, 95 Stat. 172. The unified credit for all taxpayers increased to \$192,800, and I.R.C. § 2505 was amended to allow taxpayers an annual gift tax exclusion of \$10,000 per donee, as opposed to \$3000 per donee. *See* *Gifts*, [154-4th Estates, Gifts, & Trusts] TAX MGMT. (BNA) at A-2 (1982).

25. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172, § 7872, 98 Stat. 699, 699 (to be codified at I.R.C. § 7872) (reorganization of approach to taxation of below-market loans); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 441, 95 Stat. 172, 319 (allowed \$10,000 gift tax exclusion); Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1520, 1846-50 (most significant contribution to gift taxation was increase to unified tax credit).

26. *See* Detzel, *Interest-Free Loans:—The Supreme Court Closes a Loophole*, 1 COMPLETE LAW. 45, 45 (1984); *see also* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (to be codified at I.R.C. § 7872).

27. *See* Detzel, *Interest-Free Loans:—The Supreme Court Closes a Loophole*, 1 COMPLETE LAW. 45, 45 (1984).

28. *See id.* at 45.

29. *See id.* at 46.

30. *See id.* at 45; *see also* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 333 (to be codified at I.R.C. § 7872) (Act expected to

parent with the extensive effort to define the treatment to be given below-market interest rate loans.³¹

Prior to the Deficit Reduction Act of 1984, the case law that emerged in this area illustrated the uncertainty that was prevalent within the judiciary as to the proper tax treatment of below-market interest rate and interest-free loans.³² The 1953 case of *Blackburn v. Commissioner*³³ resulted in a holding that below-market rate term loans gave rise to gift tax liability.³⁴ *Johnson v. United States*,³⁵ however, emerged as a critical case favoring the taxpayer as interest-free demand loans between family members were adjudged as not creating tax liability.³⁶ The *Johnson* court took action directing the IRS to refund to the Johnson family all taxes paid upon the intra-family loans.³⁷ The IRS voiced no disapproval of this ruling until seven years after the judgment was rendered,³⁸ whereupon the IRS asserted that interest-free and

"increase fiscal year budget receipts by \$108 million in 1984, \$126 million in 1985, \$143 million in 1986, \$150 million in 1987, \$158 million in 1988, and \$166 million in 1989").

31. See Detzel, *Interest-Free Loans:—The Supreme Court Closes a Loophole*, 1 COMPLETE LAW. 45, 45 (1984). Taxation of below-market demand loans was a starting point for the Service's attack on the preferential treatment of below-market interest rate loans. See *id.* at 46. The IRS asserted that gift tax laws should apply to these loans for the value of the use of money lent, that the lender ought to be treated as though interest income had been received, and that the value of the money received by the employee-borrower, or a shareholder, is also taxable as wages or dividends to the borrower. See *id.* at 46.

32. See *Crown v. Commissioner*, 585 F.2d 234, 234-35 (7th Cir. 1978) (taxation of intra-family interest-free demand loans not allowed); *Johnson v. United States*, 254 F. Supp. 73, 77 (N.D. Tex. 1966) (transfer of interest-free demand loans to children may not be deemed taxable transfer); *Dean v. Commissioner*, 35 T.C. 1083, 1090 (1961) (no taxable income imputed to borrower on interest-free loans from closely held corporation); *Hardee v. United States*, 708 F.2d 661, 662 (1983) (overruled Claims Court Trial Division, which earlier allowed IRS to impute interest income on interest-free loans); *Silverman v. Commissioner*, 28 T.C. 1061, 1068 (1957) (tax liability attached where rent-free use of property not deductible so as to offset taxes due), *aff'd*, 253 F.2d 849 (8th Cir. 1958). For a different view, compare, *Dickman v. Commissioner*, ___ U.S. ___, ___, 104 S. Ct. 1086, 1094-95, 79 L. Ed. 2d 343, 355 (1984) (discusses right of IRS to tax (as gift) transfer of interest-free demand loans).

33. 20 T.C. 204 (1953).

34. See *id.* at 207; see also Harrison, *The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 68 (May-June 1984) (*Blackburn* attaches tax liability to below-market rate term loan represented by note given with sale of realty); *Estate of Berkman*, 48 T.C.M. (P-H) 185, 189 (1979) (*Blackburn* cited as authority and reaffirmed; transfers not at arm's length represent taxable gift).

35. 254 F. Supp. 73 (N.D. Tex. 1966).

36. See *id.* at 77. This federal court was the first to review the question of whether below-market demand loans involved a transfer of a property interest that was taxable under gift tax rules. See Harrison, *The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 68 (May-June 1984).

37. See *Johnson v. United States*, 254 F. Supp. 73, 77 (N.D. Tex. 1966).

38. See Rev. Rul. 73-61, 1973-1 C.B. 408. This ruling states that "the Internal Revenue Service will not follow the decision in [*Johnson v. United States*] that interest-free loans made

other below-market interest rate loans (demand or term) were to be subject to gift tax liability.³⁹ The 1978 case of *Crown v. Commissioner*⁴⁰ afforded the IRS a forum through which to confirm its treatment of below-market demand loans.⁴¹ The tax court and the Seventh Circuit, however, were not persuaded by the government's arguments and ruled in favor of the taxpayer.⁴² Thereafter, *Crown* stood for the proposition that the value of the use of money lent to close family members was not properly designated as a taxable transfer.⁴³ The *Crown* decision was influenced, in part, by the decision in *Dean v. Commissioner*.⁴⁴ The *Dean* case was filed when the IRS sought to impute taxable income to the petitioners who had outstanding interest-free loans from a corporation they controlled.⁴⁵ The outcome of the *Dean* case also favored the taxpayer as the court held that there could not be taxable income attributable to below-market loans.⁴⁶

Though the Service had lost many key battles in the courts, its argument finally prevailed in *Dickman v. Commissioner*.⁴⁷ The Service successfully argued that bargain loans were a transfer of a valuable property right resulting in gift tax liability to the lender.⁴⁸ The United States Supreme Court, in

by taxpayers to their children, repayable upon demand, did not constitute gifts of the value of the use of the money." *Id.* at 408.

39. *See id.* at 408. The IRS made apparent its position by stating "the right to use property, in this case money, is itself an interest in property, the transfer of which is a gift." *Id.* at 408; *see also* Harrison, *The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 68 (May-June 1984) (treatment afforded term and demand below-market loans discussed).

40. 585 F.2d 234 (7th Cir. 1978).

41. *See id.* at 235. The IRS contended that "the granting of a loan over a period of time at less than the true economic rate of interest bestows an economic benefit on the recipient." *Id.* at 235.

42. *See id.* at 235.

43. *See id.* at 235.

44. *See id.* at 240. *Crown* cited *Dean*, 35 T.C. 1083 (1961), as the leading case demonstrating rejection of IRS assertions that taxable income should be imputed to interest-free loans. *See Crown v. Commissioner*, 585 F.2d 234, 240 (7th Cir. 1978); *see also* Harrison, *The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 69 (May-June 1984) (*Crown* decision influenced by earlier judgments, such as *Dean*, rejecting Service's efforts to impute taxable income to recipients of interest-free loans).

45. *See Dean v. Commissioner*, 35 T.C. 1083, 1088 (1961). The loans were in excess of two million dollars. *See id.* at 1083.

46. *Compare id.* at 1090 (below-market loans do not result in income tax liability from imputed interest where taxpayer would have interest deductions equal to income imputed) *with Silverman v. Commissioner*, 28 T.C. 1061, 1064 (1957) (since personal expenses not deductible, dollar amount to borrower not offset and thus tax liability exists), *aff'd*, 253 F.2d 849 (8th Cir. 1958).

47. *See* ___ U.S. ___, ___, 104 S. Ct. 1086, 1087, 79 L. Ed. 2d 343, 343 (1984) (taxation of intra-family interest-free demand loans permissible for value of use of loan).

48. *See id.* at ___, 104 S. Ct. at 1087, 79 L. Ed. 2d at 343.

affirming the Eleventh Circuit, based its holding on the committee reports for the Revenue Act of 1932,⁴⁹ which the Court argued made “plain that Congress intended the gift tax statute to reach all gratuitous transfers of any valuable interest in property.”⁵⁰ A strong dissent by Justice Powell reasserted a common theme found in lower court decisions, that Congress should take action to clarify legislative intent as to the proper scope of gift taxation.⁵¹

Section 7872 of the Internal Revenue Code of 1954 is, in fact, an effort by the legislature to redefine the scope of tax laws and their impact on below-market rate loans.⁵² The new statute seems to apply only to money loans,⁵³ with the term “loan” being broadly interpreted.⁵⁴ The first two subsections of the new provision recharacterize below-market loans as transactions made

49. See Revenue Act of 1932, ch. 209, § 501, 47 Stat. 169, 245 (amended 1939). Section 501(b) reads: “The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible” *Id.* at § 501(b).

50. See *Dickman v. Commissioner*, ___ U.S. ___, ___ 104 S. Ct. 1086, 1089, 79 L. Ed. 2d 343, 348 (1984). The United States Supreme Court noted a parallel between § 2501(a) and § 61 of the I.R.C. (which defines gross income), and thus suggested that the *Dean* case, which disallowed income taxation of imputed interest from below-market loans, would be overruled. See *id.* at ___, 104 S. Ct. at 1089, 79 L. Ed. 2d at 349; see also Harrison, *The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 73 (May-June 1984) (“it seems likely that, when and if presented with the opportunity, the Court would also overturn the longstanding rule of law represented by *Dean*”).

51. See, e.g., *Dickman v. Commissioner*, ___ U.S. ___, ___ 104 S. Ct. 1086, 1097, 79 L. Ed. 2d 343, 357 (1984) (Powell, J., dissenting) (courts not best forum for changing policy respecting gift taxation since Congress best equipped to determine rules that should govern); *Commissioner v. Greenspun*, 670 F.2d 123, 126 (9th Cir. 1982) (previous decisions establish no tax consequences with below-market loans, and for this firm rule to change, Congress must take action); *Beaton v. Commissioner*, 664 F.2d 315, 317 (1st Cir. 1981) (Congress better equipped than courts to define conduct resulting in tax liability) (quoting *United States v. Byrum*, 408 U.S. 125, 135 (1972)).

52. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172, § 7872, 98 Stat. 699, 699 (to be codified at I.R.C. § 7872); see also A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984).

53. See Horsley, *Interest-Free and Below-Market Interest Loans (or “It’s a jungle out there!”)*, 10 PROB. NOTES 122, 122 (1984) (§ 7872 does not seem to apply to use of property, except money). But see *Dickman v. Commissioner*, ___ U.S. ___, ___ 104 S. Ct. 1086, 1089, 79 L. Ed. 2d 343, 348 (1984) (allowed tax liability on property suggesting gift tax reached “all gratuitous transfers of any valuable interest in property”).

54. See Horsley, *Interest-Free and Below-Market Interest Loans (or “It’s a jungle out there!”)*, 10 PROB. NOTES 122, 122 (1984) (quoting H.R. REP. NO. 4170, 98th Cong., 2d Sess. 1018 (June 23, 1984)). This source states that: “It is intended that the term ‘loan’ be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans.” *Id.* at 122 (quoting H.R. REP. NO. 4170, 98th Cong., 2d Sess. 1018 (June 23, 1984)).

at arms length.⁵⁵ This recharacterization is the legislature's method by which to calculate a loan's value.⁵⁶ First, the legislature explains the treatment that should be given gift loans⁵⁷ and demand loans⁵⁸ if made at below-market interest rates.⁵⁹ The Act treats these loans as below-market loans if there is no interest due, or the interest payments due are less than the applicable federal rate.⁶⁰ The approach set forth in subsection (a) allows for the valuation of such loans in a specific manner; that is, the loan's value is equal to its foregone interest.⁶¹ This foregone interest is the value of the *use* of the

55. See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1651 (Prentice-Hall 1984); see also Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 328 (to be codified at I.R.C. § 7872). The conference committee stated that their "bill recharacterizes interest-free and below-market interest rate loans as arms-length transactions." *Id.* at 328.

56. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(a), (b), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(a), (b)) (subsections identify valuation methodology applied to demand and term loans respectively); see also *Crown v. Commissioner*, 67 T.C. 1060, 1061 (1978) (Service applied rates deemed reasonable under circumstances). *But see Harrison, The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 72 n.34 (May-June 1984). The issue of valuation was further confused when the Assistant Secretary of the Department of the Treasury, on February 11, suggested the rates from § 482 be used, but on April 4, 1984, he asked that the lower of short-term T-bill rates and the rate under § 6621 be used in valuing below-market interest rate loans. See *id.* at 72 n.34.

57. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(f)(3), 98 Stat. 699, 702 (to be codified at I.R.C. § 7872(f)(3)) (gift loan defined as "any below-market loan where the foregoing of interest is in the nature of a gift"); see also A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984) (House clearly states that "family loan is any below-market loan with respect to which the deemed payment by the lender to the borrower is in the nature of a gift").

58. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(f)(5), 98 Stat. 699, 702 (to be codified at I.R.C. § 7872(f)(5)). A demand loan is "any loan which is payable in full at any time on the demand of the lender." *Id.*

59. See *id.* § 7872(a)(1).

60. See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984); see also Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(e)(1)(A), 98 Stat. 699, 701 (to be codified at I.R.C. § 7872(e)(1)(A)) (demand loan is below-market loan if "interest is payable on the loan at a rate less than the applicable Federal rate"). The applicable federal rate is also instrumental in the valuation of both term and demand loans. See *id.* § 7872(f)(2). The applicable federal rate for evaluating term loans is the rate in effect under § 1274(d) compounded semi-annually. See *id.* § 7872(f)(2)(A). The applicable federal rate for evaluating demand loans is the federal short-term rate under § 1274(d) for the period of the loan. See *id.* § 7872(f)(2)(B).

61. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(e)(2), 98 Stat. 699, 701 (to be codified at I.R.C. § 7872(e)(2)). The new statute provides:

The term "foregone interest" means, with respect to any period during which the loan is outstanding, the excess of—

“(A) the amount of interest which would have been payable on the loan for the period if

loan.⁶² Furthermore, the imputed interest is deemed by the legislature to have been transferred from the lender to the borrower and then retransferred back to the lender.⁶³

The second subsection describes the treatment to be extended to all below-market loans, not included in the scope of subsection (a), that are the subject of section 7872.⁶⁴ For the most part, this recharacterization describes the kind of treatment to be afforded term loans.⁶⁵ Any loan that is neither a gift loan⁶⁶ nor a demand loan is evaluated under subsection (b).⁶⁷ The House of Representatives describes a term loan as a below-market loan when the amount transferred by the lender is greater than the present value⁶⁸ of all payments to be made under the conditions of the loan.⁶⁹ The value of the

interest accrued on the loan at the applicable Federal rate and were payable annually on the [last day of such calendar year,] over

“(B) any interest payable on the loan properly allocable to such period.

Id.

62. See *Dickman v. Commissioner*, ___ U.S. ___, ___, 104 S. Ct. 1086, 1091, 79 L. Ed. 2d 343, 350 (1984). The majority held that the:

right to use money is plainly a valuable right, readily measurable by reference to current interest rates; the vast banking industry is positive evidence of this reality. Accordingly, we conclude that the interest-free loan of funds is a “transfer of property by gift” within the contemplation of the federal gift tax statutes.

Id. at ___, 104 S. Ct. at 1091, 79 L. Ed. 2d at 350-51; see also *Catalano, Inc. v. Target Sales, Inc.*, 446 U.S. 643, 648 (1980) (per curiam) (extending interest-free credit same as allowing discount equal to value of use of purchase price for time period in question); *Passailaigue v. United States*, 224 F. Supp. 682, 686 (M.D. Ga. 1963) (“the right to use the physical thing to the exclusion of others is the most essential and beneficial”) (emphasis in original). See generally Rev. Rul. 73-61, 1973-1 C.B. 408 (value of gift equals value of borrower’s right to use money loan).

63. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(a)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(a)(1)). With a demand or gift loan, “the foregone interest shall be treated as— (A) transferred from the lender to the borrower, and (B) retransferred by the borrower to the lender as interest.” See *id.* The transfer and retransfer of foregone interest under subsection (a)(1) is deemed to have occurred “on the last day of such calendar year” in which the loan was made. See *id.* § 7872(a)(2) (Secretary may prescribe otherwise as to when transfer deemed to have occurred).

64. See *id.* § 7872(b)(1).

65. See *id.* § 7872(f)(6). A “term loan” is “any loan which is not a demand loan.” *Id.* § 7872(f)(6).

66. See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1651 (Prentice-Hall 1984). The Senate amendment makes clear that all gift loans (including term gift loans) should be treated as the House treats family and demand loans. See *id.* at 1651.

67. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(b)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(b)(1)).

68. See *id.* § 7872(f)(1). “The present value of any payment shall be determined in the manner provided by regulations prescribed by the Secretary— (A) as of the date of the loan, and (B) using a discount rate equal to the applicable Federal rate.” *Id.* § 7872(f)(1).

69. See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984); see also Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a),

use of a term loan is equal to the difference between the amount loaned and the present value of all payments due under the terms of the loan.⁷⁰

Subsection (c) provides direction for the new tax provision by describing exactly which below-market loans are subject to section 7872.⁷¹ Generally, the new tax rules apply to gift loans, compensation-related loans, corporation-shareholder loans, tax-avoidance loans, and other below-market loans.⁷² The key, therefore, to a proper application of section 7872 is in matching the correct treatments, as described in subsections (a) and (b), to the types of loans described in subsection (c).⁷³

With below-market gift loans, there are both gift and income tax consequences.⁷⁴ The transfer and retransfer of foregone interest is deemed to have occurred as outlined in subsection (a).⁷⁵ For income tax purposes, the lender is regarded as having received interest income from the borrower at a constant rate of interest over the entire life of the loan.⁷⁶ The borrower's income taxes are also affected as section 7872 treats the transaction as though the borrower has made interest payments over the life of the loan.⁷⁷ The supposed interest thus supplements the lender's taxable income⁷⁸ and allows the borrower an interest deduction.⁷⁹ For income tax purposes, term

§ 7872(e)(1), 98 Stat. 699, 701 (to be codified at I.R.C. § 7872(e)(1)) (defining term loan as below-market loan if "amount loaned exceeds the present value of all payments due under the loan").

70. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(b)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872 (b)(1)). Below-market term loans are treated as though the borrower has received "cash in an amount equal to the excess of— (A) the amount loaned, over (B) the present value of all payments which are required to be made under the terms of the loan." See *id.* The transfer is deemed to have been made by the lender and received by the borrower "on the date the loan was made." See *id.*

71. See *id.* § 7872(c).

72. See *id.* § 7872(c).

73. See *id.* § 7872(a)-(c).

74. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 2-4 (Aug. 8, 1984) (both gift and income tax consequences of gift loans discussed).

75. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(a)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(a)(1)). For gift loan income tax purposes, "[f]oregone interest . . . is the excess of the amount of interest that would have been payable on the loan for the period if interest accrued on the loan at the applicable federal interest rate and was paid annually on the last day of the calendar year involved." See 71 STAND. FED. TAX REP. (CCH) No. 34, at 3 (Aug. 8, 1984).

76. See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984).

77. See *id.* at 1650.

78. See *id.* at 1650. The interest income would then be considered for income tax purposes in accordance with § 61. See I.R.C. § 61 (1980) (definition of gross income).

79. See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984). No deduction for interest payments deemed made may be taken unless the

gift loans and demand gift loans receive this identical treatment.⁸⁰

Section 7872 affords gift loans special tax consideration by way of a number of narrowly defined exceptions.⁸¹ In effect, below-market gift loans between individuals will have no tax impact for any day that the aggregate amount of the loan outstanding is \$10,000 or less.⁸² However, this bar to taxation does not apply where the loan made is used by the borrower to purchase an income-producing asset if taxes applicable to the assignments of income or grantor trusts are evaded.⁸³ The legislature has also eliminated income tax consequences for each day that the amount loaned has an annual net investment income of less than \$1000 if the aggregate amount of the outstanding loan to the borrower is less than \$100,000.⁸⁴ Where the borrower's net investment income⁸⁵ is greater than \$1000, the new provision

borrower itemizes all deductions for that year. *See id.* at 1650; *see also* I.R.C. § 163(d) (1984) (description of items recognized as deductible).

80. *See* Harrison, *The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 74 (May-June 1984). “[F]amily term loans—defined as all loans where the foregone interest is a gift (rather than a dividend or compensation)—would be treated as demand loans.” *Id.* at 74; *see also* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1655 n.11 (Prentice-Hall 1984) (conference agreement states term gift loan treated as demand loan for income tax purposes).

81. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(2), (c)(3), (d)(1), 98 Stat. 699, 700-01 (to be codified at I.R.C. § 7872(c)(2), (c)(3), (d)(1)).

82. *See id.* § 7872(c)(2)(A).

83. *See id.* § 7872(c)(2)(B). The conference committee stated that the “de minimus rule does not apply, however, if the loan is directly attributable to the purchase or carrying of income producing assets” and, further, that the “conferees wish to emphasize that this is an anti-abuse provision, and should be interpreted in light of its purpose of preventing the avoidance of the assignment of income rules and the grantor trust rules.” *See* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1655 (Prentice-Hall 1984).

84. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(d)(1)(E)(ii), 98 Stat. 699, 701 (to be codified at I.R.C. § 7872(d)(1)(E)(ii)); *see also* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (committee bill explains new provision not applicable to non-abusive transactions). The treatment of “loans to purchase consumables, such as residences, cars, or higher education, would not generate income tax liability for the lender (or an interest deduction for the borrower) unless the borrower had net investment income.” Harrison, *The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 74 (May-June 1984).

85. *See* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1651 (Prentice-Hall 1984). “[N]et investment income is the excess of investment income over investment expenses.” *Id.* at 1651. “[I]nvestment income is the sum of: (1) gross income from interest, dividends, rents and royalties; (2) net short-term capital gain attributable to the disposition of property held for investment; and (3) amounts treated under” §§ 1245, 1250, and 1254 as ordinary income. *Id.* at 1652. Net investment income also includes “any amount included in income under the original issue discount provisions of the Code, and any amount that would be included if such provisions were applicable to all ‘deferred payment obligations.’” *Id.* at 1652; *see also* I.R.C. § 163(d) (factors determining net investment income) & 162, 164(a), 167,

limits the taxpayer's income tax liability with gift loans to the actual net investment income of the borrower.⁸⁶ In keeping with legislative objectives, the above exceptions or limitations determined by net investment income do not apply where the principal purpose of the loan arrangement is evasion of federal taxes, or if the gift loan is used to purchase marketable securities.⁸⁷

For gift tax purposes, gift loans are treated differently depending upon their status as a demand or term loan.⁸⁸ With a gift demand loan, the interest deemed to have been paid is determined by application of subsection (a).⁸⁹ The gift is the use of the cash transferred, and its value is equal to the amount of the foregone interest.⁹⁰ If the demand loan is outstanding for more than one calendar year, there will be yearly gift tax consequences for the value of the use of the money transferred to the borrower.⁹¹

A gift term loan also has gift tax consequences, but is approached in a different manner.⁹² Subsection (b) determines the value for this type of transfer by measuring the difference between the amount of the loan itself against the present value of all borrower's payments under the terms of the

171, 212, 611 (amounts that are deductions that may be summed to figure net expenses) (1980).

86. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(d)(1)(D), 98 Stat. 699, 701 (to be codified at I.R.C. § 7872(d)(1)(D)) (limitation applicable only where aggregate amount of loans does not exceed \$100,000); see also Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (to be codified at I.R.C. § 7872). With family loans, "the committee bill limits the amount of interest income that the lender is deemed to receive to the amount of income of the borrower that is attributable to the interest-free or below-market interest rate loan." *Id.* at 328.

87. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(d)(1)(B), (E), 98 Stat. 699, 701 (to be codified at I.R.C. § 7872(d)(1)(B), (E)); see also Harrison, *The Dickman Decision—Consequences and Potential Legislative Responses*, 9 TAX MGMT. EST., GIFTS & TR. J. 68, 75 (May-June 1984). Furthermore, § 7872 is not to apply to loans subject to § 483 or § 1274; therefore, there is ambiguity as to what treatment such loans should receive. See *id.* at 75. But see A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1652 (Prentice-Hall 1984) (§ 7872 does not apply to loans subject to either § 483 or § 1274, as these later sections are given priority as explicitly stated in footnote 13).

88. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 4 (Aug. 8, 1984).

89. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(a)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(a)(1)); see also 71 STAND. FED. TAX REP. (CCH) No. 34, at 4 (Aug. 8, 1984).

90. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 4 (Aug. 8, 1984). "If the loan is a demand loan, the lender is deemed to have made a cash transfer to the borrower of the annual foregone interest . . . on the last day of the year." *Id.* at 4; see also A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984) (transfer of value from lender to borrower for less than adequate consideration is taxable gift).

91. See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984).

92. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 4 (Aug. 8, 1984).

loan.⁹³ The amount of the gift is represented by the above disparity and is taxed, thereafter, according to appropriate gift tax laws.⁹⁴ Since the gift transfer occurred at the time the loan was made, there is only one taxable event.⁹⁵

Compensation-related loans made at below-market rates are also subject to section 7872⁹⁶ and are treated according to their status as either a term or demand loan.⁹⁷ If an employer-employee bargain loan is a demand loan, the new statute imputes interest income (under subsection (a)) to the employer-lender and then deems such interest paid to the employee-borrower as wages.⁹⁸ The employee is viewed as having paid to the employer an amount equal to the value of the foregone interest and may take an itemized deduction for all interest deemed paid.⁹⁹ The employee must also report, as wages earned, an amount equivalent to the foregone interest.¹⁰⁰

Compensation-related term loans are treated in a similar fashion, except the valuation and transfer of money is figured in line with the approach set forth by subsection (b).¹⁰¹ The employee-borrower is treated as receiving

93. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(b)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(b)(1)); see also 71 STAND. FED. TAX REP. (CCH) No. 34, at 4 (Aug. 8, 1984). “[T]he amount of cash deemed transferred is an amount equal to . . . the excess of the amount loaned over the present value of all payments that are required to be made under the terms of the loan.” *Id.* at 4.

94. See I.R.C. §§ 2501-2524 (1980).

95. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(b)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(b)(1)); see also 71 STAND. FED. TAX REP. (CCH) No. 34, at 4 (Aug. 8, 1984) (“lender is deemed to have made a cash gift of the foregone interest to the borrower on the date when the loan is made”).

96. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(1)(B), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(c)(1)(B)) (compensation-related loans now deemed taxable event); see also Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (to be codified at I.R.C. § 7872) (loans to those providing services from those benefitting from such services have been utilized to avoid rules calling for payment of employment taxes).

97. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 2-3 (Aug. 8, 1984).

98. See *id.* at 2 (payment deemed made by lender to borrower treated as wages for purposes of chapters 21, 22, and 23); see also A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1653 (Prentice-Hall 1984) (business deductions for wages paid is allowed).

99. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 2 (Aug. 8, 1984); see also A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1653 (Prentice-Hall 1984) (payment to borrower must be calculated into gross income even if borrower entitled to offsetting deduction).

100. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 2 (Aug. 8, 1984) (though not subject to income tax withholding, compensation to employee subject to employment taxes (FICA, FUTA, and RRTA)); see also A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1653 (Prentice-Hall 1984) (wage withholdings for chapter 24 not necessary, but employee must properly report wages received).

101. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(b)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(b)(1)).

compensation in an amount equal to the disparity in values, represented by the difference between the amount loaned and the present value of all payments due under the loan.¹⁰² Unlike the "demand loan" approach, the full value of the term loan is deemed to have passed to the employee "on the date the loan was made."¹⁰³ However, the interest income to the lender and interest expense (and deduction) to the borrower is figured by considering the excess of the subsection (b) valuation and amortizing this amount as original issue discount over the life of the loan.¹⁰⁴ Therefore, the employee may make only those deductions for imputed interest deemed paid during that year and may not deduct the full amount of the valuation.¹⁰⁵ This is a substantial tax burden, as the employee is deemed to have been compensated this whole amount (and thus must add it to his gross income), while he is only allowed to deduct an amount equal to the original issue discount amount of interest deemed paid during that taxable year.¹⁰⁶

The employer-lender, on the other hand, is not treated so harshly.¹⁰⁷ The employer is deemed to have paid wages in an amount equal to the subsection (b) valuation¹⁰⁸ and thus receives a business deduction for this entire sum.¹⁰⁹ Essentially, this is a deduction equal to the full value of the loan made.¹¹⁰ The employer receives this tax benefit in full, while also being allowed to spread the imputed business income over the life of the loan as original issue discount.¹¹¹

102. *See id.*

103. *See id.*; *see also* 71 STAND. FED. TAX REP. (CCH) No. 34, at 2 (Aug. 8, 1984).

104. *See* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984). "[T]he excess of the amount of the loan over the present value of the payments due is treated as original issue discount." *Id.* at 1650; *see also* Keydel, *Interest-Free and Below-Market Interest Loans*, 13 PROB. & PROP. 33, 36 (1980) (example given for figuring and applying original issue discount).

105. *See* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984) (borrower treated as having paid interest at constant rate over loan's life); *see also* 71 STAND. FED. TAX REP. (CCH) No. 34, at 2 (Aug. 8, 1984) (employee spreads imputed interest amount over term of loan and takes annual itemized deduction only for interest amount deemed paid that year).

106. *See* 71 STAND. FED. TAX REP. (CCH) No. 34, at 2 (Aug. 8, 1984). The compensation amount deemed paid to the employee "may not be spread out over the term of the loan." *See id.* at 2.

107. *See id.* at 2.

108. *See id.* at 2. The employer is "treated as having paid compensation in an amount equal to the excess of the amount of the loan over all principal (and any interest payments required under the loan terms)." *Id.* at 2.

109. *See id.* at 2. The employer receives a business deduction for the full amount of wages deemed paid based on imputed interest on the loan. *See id.* at 2.

110. *See id.* at 2.

111. *See id.* at 2; *see also* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1650 (Prentice-Hall 1984) ("lender is treated as receiving interest income at a constant interest rate over the life of the loan").

Corporation-shareholder loans are also subject to section 7872.¹¹² Below-market loans made by corporations to shareholders are usually loans made to persons holding a controlling share in the corporation.¹¹³ Such loans are subject to treatment similar to that extended to compensation-related loans.¹¹⁴ The new statute treats the imputed interest on a corporation-shareholder loan as interest income to the corporation with a dividend paid to the shareholder.¹¹⁵ Other Code provisions provide for the proper treatment of dividend and corporate incomes.¹¹⁶ The valuation of the loan transferred is based on the nature of the loan; that is, whether the money transferred is a term or demand loan.¹¹⁷

Below-market loans to an independent contractor by one for whom services are being provided are also the proper object of section 7872.¹¹⁸ The approach detailed with respect to compensation-related loans is also applicable to this form of loan.¹¹⁹ As before, the tax consequences associated with such arrangements depend upon whether a term or demand loan is involved.¹²⁰ Treatment of loans to independent contractors differ only in that the imputed interest deemed transferred to the contractor is regarded as remuneration in exchange for services provided.¹²¹

The legislature also included a "de minimus" exception for compensation-related loans and corporation-shareholder loans.¹²² These loans create no tax liabilities where the aggregate amount of the loan is \$10,000 or less.¹²³

112. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(1)(C), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(c)(1)(C)); see also Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (corporate loans to shareholders used to avoid taxation at corporate level).

113. See *Hardee v. United States*, 708 F.2d 661, 662 (Fed. Cir. 1983) (corporation disregarded payments due on debt and any interest payments due as debtor was majority shareholder in corporation completely owned by family members); *Silverman v. Commissioner*, 28 T.C. 1061, 1062 (1957) (expenses paid on wife's trip to Europe from closely held family corporation), *aff'd*, 253 F.2d 849 (8th Cir. 1958).

114. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 3 (Aug. 8, 1984).

115. See *id.* at 3.

116. See I.R.C. § 301 (1980).

117. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(a)(1), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(a)(1)) (subsection (a) deals with demand and gift loans; subsection (b) applies for valuation of term loans).

118. See *id.* § 7872(c)(1)(B). Section 7872 applies to below-market loans "directly or indirectly between (ii) an independent contractor and a person for whom such independent contractor provides services." *Id.* § 7872(c)(1)(B).

119. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 3 (Aug. 8, 1984).

120. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(a), (b), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(a), (b)).

121. See 71 STAND. FED. TAX REP. (CCH) No. 34, at 3 (Aug. 8, 1984).

122. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(3), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(c)(3)).

123. See *id.* § 7872(c)(3)(A).

This exclusion does not, however, apply to loans designed primarily for the purpose of circumventing tax liabilities.¹²⁴ In applying this exception, care must be taken to sum all loans between the same parties.¹²⁵ With non-gift term loans, a special effort must be made to insure that tax liability attaches as of the first day that the sum of different loans is greater than \$10,000.¹²⁶

Section 7872 also applies to tax-avoidance loans.¹²⁷ Any loan subject to section 7872 because of this provision in the new statute would, like the loans previously discussed, receive treatment according to its status as either a demand or term loan.¹²⁸ This particular provision is valuable for an acute understanding of section 7872, as it makes clear the new statute's anti-abuse objective.¹²⁹ In pursuit of tax equity, section 7872 applies similar treatment to all transfers of cash, which is a practice directly contrary to the special tax treatment previously extended to carefully structured below-market loans.¹³⁰ Furthermore, Congress has explicitly recognized the Service's authority to prescribe regulations to prevent abuse or distortion of the new tax

124. *See id.* § 7872(c)(3)(B) ("Subparagraph (A) shall not apply to any loan the interest arrangements of which have as 1 of their principal purposes the avoidance of any Federal tax.").

125. *See* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1655 (Prentice-Hall 1984). "The conference agreement makes it clear that, for purposes of applying the exceptions and limitations, all loans between the same parties are aggregated." *Id.* at 1655.

126. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(3)(A), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(c)(3)(A)); *see also* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1655 (Prentice-Hall 1984). For example, if an employer makes a \$9000 compensation-related loan (no loans previously made) on date X and subsequently loans \$2000 more on date Y, then both parties are treated as though the employer made an \$11,000 loan to the employee on date Y. *See id.* at 1655. Moreover, if the amount of the outstanding loan becomes less than \$10,000, after having exceeded \$10,000, the provision applies to that amount still outstanding. *See id.* at 1655.

127. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(1)(D), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(c)(1)(D)). A loan is a:
tax avoidance loan if one of the principal purposes of the interest arrangement is the avoidance of any Federal tax by either the borrower or the lender. Tax avoidance is a principal purpose of the interest arrangement if it is a principal factor in the decision to structure the transaction as a below-market loan.

A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1654 (Prentice-Hall 1984).

128. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(a), (b), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(a), (b)).

129. *See* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1655 (Prentice-Hall 1984) (§ 7872 "anti-abuse" provision seeking to prevent avoidance of rules imposing tax on assignment of income and trusts); *see also* Horsley, *A Legislative Solution for Interest-Free Loans?—A Status Report on the Section of Taxation Project*, 9 PROB. NOTES 175, 177 (1983). With the legislature considering the need for new law to govern below-market interest rate loans, the many abusive practices employed acted as a final stimulus promoting legislative reform. *See id.* at 177.

130. *See* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1655 (Prentice-Hall 1984).

rules.¹³¹ The drive towards equity is further witnessed by some of the special provisions of the \$10,000 "de minimus" exception; that is, the exception will not shield the taxpayer from liability where a principal purpose of the loan arrangement is tax avoidance¹³² or where the loan is made for the purchase or carrying of income-producing assets.¹³³ Prior to this legislation, the tax laws, as interpreted, did provide taxpayers with a variety of opportunities to circumvent specific tax liabilities asserted by the Commissioner of the IRS.¹³⁴ This new statute, especially with the flexibility afforded the Secretary of the IRS for carrying out the legislature's intent, is an effort to seal the more offensive loopholes previously utilized by loans made at below-market rates.¹³⁵

The new statute also calls for the taxation of "other below-market" loans.¹³⁶ Such a loan, again, would be evaluated and would result in certain

Prentice-Hall 1984) (new statute imposes tax liability on below-market loans diminishing their utility as means to evade tax liabilities traditionally imposed on assignment of incomes and trusts).

131. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(g)(1), 98 Stat. 699, 702 (to be codified at I.R.C. § 7872(g)(1)); see also A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1656 (Prentice-Hall 1984) (legislature anticipated that Secretary of IRS would prescribe regulations preventing abuse of rules). The committee report also allows the Secretary authority "to issue regulations for the purpose of assuring that borrowers and lenders take consistent positions under this provision." See *id.* at 1656.

132. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(3)(B), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(c)(3)(B)).

133. See *id.* § 7872(c)(2)(B).

134. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (to be codified at I.R.C. § 7872). Several courts have ruled in favor of the taxpayer by not allowing taxation of below-market interest rate loans. See, e.g., *Crown v. Commissioner*, 585 F.2d 234, 234-35 (7th Cir. 1978) (taxpayers making below-market interest rate loans to close family members not required to pay gift tax on value of interest foregone); *Johnson v. United States*, 254 F. Supp. 73, 77 (N.D. Tex. 1966) (IRS collected taxes on interest-free loans but plaintiff prevailed as IRS ordered to refund all tax dollars received on such loans); *Dean v. Commissioner*, 35 T.C. 1083, 1090 (1961) (court found below-market interest rate loans do not result in taxable income).

135. Cf. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 327 (to be codified at I.R.C. § 7872). The conference committee commented on how interest-free and below-market interest rate loans are being used instead of more traditional means of transferring money. See *id.* at 327. For example, families and others are making below-market loans instead of making assignments of income or setting up trusts, as both of these have established tax consequences. See *id.* at 327; see also *Helvering v. Horst*, 311 U.S. 112, 120 (1940) (gift or assignment of interest coupons held still taxable to donor as even most skillfully devised arrangements cannot avoid income's first vesting in donor). See generally I.R.C. §§ 671-678 (1980) (tax treatment of trusts).

136. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c)(1)(E), 98 Stat. 699, 700 (to be codified at I.R.C. § 7872(c)(1)(E)). A loan may be subject to this section if the interest arrangement has a substantial effect on the tax liability of the borrower or the lender. "The interest arrangement of a below-market loan has an effect on the tax liability of the borrower or the lender if, among other things, it results in the conversion of a non-

tax liabilities depending upon the conditions of and circumstances surrounding the loan.¹³⁷ To allow taxation of "other below-market" loans gives the IRS the authority to impose a tax on any loan that has a significant effect on either the lender's or borrower's federal tax liability.¹³⁸ This provision illustrates the legislature's desire to stimulate tax revenues, as it is difficult to imagine any loan that would not potentially be subject to the new Code section.¹³⁹ The conference committee report further reveals the legislature's tax revenue objective since the Secretary is recognized as having the power to exempt transactions not having significant tax consequences.¹⁴⁰ The increased revenues that the legislature expects to collect because of the new provision also demonstrate a contemplative effort by Congress to enhance tax collections.¹⁴¹

With tax equity and tax revenue being an "end" that stimulated Congressional action, the "simplicity" of the "means" employed comes under scrutiny.¹⁴² Though careful study reveals the workings of the new statute, to be effective, the statute must be comprehensible to the average taxpayer.¹⁴³ A good tax law must be simple and easily understood.¹⁴⁴ To fail with respect to this "simplicity" criterion might well result in more harm than good, as enforcement problems emerge because of unreasonable compliance de-

deductible expense into the equivalent of a deductible expense." See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1654 (Prentice-Hall 1984).

137. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(a), (b), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872 (a), (b)) (tax treatment extended to loan depends on status as term or demand loan and on relationship between lender and borrower).

138. See *id.* § 7872(c)(1)(E); see also Horsley, *Interest-Free and Below-Market Interest Loans (or "It's a jungle out there!")*, 10 PROB. NOTES 122, 122 (1984) (because of broad interpretation of "loan," new statute may reach any type transaction).

139. See Horsley, *Interest-Free and Below-Market Interest Loans (or "It's a jungle out there!")*, 10 PROB. NOTES 122, 122 (1984) ("At this early stage, it is hard to predict what money or credit transactions, no matter how innocent, will escape the reach of the new statute.").

140. See A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1655 (Prentice-Hall 1984) (regulations may be issued exempting any transaction if interest arrangements have no significant effect on tax liability of borrower or lender).

141. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 333 (to be codified at I.R.C. § 7872). The new statute is expected to increase receipts "by \$108 million in 1984, \$126 million in 1985, \$143 million in 1986, \$150 million in 1987, \$158 million in 1988, and \$166 million in 1989." *Id.* at 333.

142. See Horsley, *A Legislative Solution for Interest-Free Loans?:—A Status Report on the Section of Taxation Project*, 9 PROB. NOTES 175, 177 (1983) (in seeking to draft new legislation, simplicity must be guiding principal).

143. See *id.* at 177.

144. See *id.* at 177. The federal tax system depends heavily on taxpayers' self-assessment and voluntary compliance, and, therefore, the tax laws must be "easy to apply and understand." See *id.* at 177.

mands.¹⁴⁵ For a tax law's construction to be considered simple, it must be easy to compute.¹⁴⁶ Section 7872 may not succeed as the tax liabilities imposed by the new statute are difficult to fathom.¹⁴⁷ To comply, a taxpayer must be familiar with present value tables¹⁴⁸ and keep track of the constantly changing applicable federal rate.¹⁴⁹ The taxpayer must also keep current a detailed record of all loans outstanding.¹⁵⁰ To comply with section 7872, the average taxpayer must maintain a strong working knowledge of all the provisions of the new statute and understand the limitations and exceptions that apply to the different varieties of loans.¹⁵¹ The computations involved in determining a borrower's net investment income, for example, can be quite involved.¹⁵² Indeed, the statute's design is sufficiently complex to justify a prediction that many taxpayers will have difficulty in accurately applying the new provision.¹⁵³

Section 7872 of the Internal Revenue Code represents the legislature's response to the judiciary's uncertainty as to the treatment of below-market loans. The new provision redefines that which is deemed to have occurred with a below-market loan transaction and treats the transaction as though it has actually taken place for all purposes of the Code. The statute considers gift loans, compensation-related loans, corporation-shareholder loans, tax-avoidance loans, and other below-market loans. Section 7872 creates gift

145. *See id.* at 177. This source states that "[s]ince obvious audit difficulties will be involved in determining taxpayer compliance with any broad new provisions, it was felt to be essential tax policy not to overburden the self-assessment system with unreasonable compliance demands." *Id.* at 177.

146. *See id.* at 180.

147. *See* Horsley, *Interest-Free and Below-Market Interest Loans (or "It's a jungle out there!")*, 10 PROB. NOTES 122, 128 (1984) (simplicity goal not attained as new statute for taxation of bargain loans exceedingly complex).

148. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(b)(1), 98 Stat. 699, 699 (to be codified at I.R.C. § 7872(b)(1)) (difficult computations with present value must be made to find taxable value of term loan).

149. *See id.* § 7872(f)(1) (applicable federal rate fluctuates with market interest rates and further complicates valuation process).

150. *See* A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1984 ¶ 2625, at 1655 (Prentice-Hall 1984). The conference report gave a specific illustration demonstrating the necessity of keeping accurate records of all loans since tax liability attaches, with non-gift term loans for example, on the day the aggregate amount of the loans between the borrower and lender exceeds \$10,000.

151. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 172(a), § 7872(c), (d), 98 Stat. 699, 700-01 (to be codified at I.R.C. § 7872(c), (d)) (accurate record keeping required since application of limitations and exceptions determined by knowing exact dollar amounts of loans, type of loans involved, and use to which loans put).

152. *See id.* § 7872(d)(1)(E).

153. *See* Horsley, *Interest-Free and Below-Market Interest Loans (or "It's a jungle out there!")*, 10 PROB. NOTES 122, 128 (1984). "Few will be faulted if they cannot fathom the new rules. Even more may choose to disregard them. We will all be losers if they do." *Id.* at 128.

and/or income tax liabilities if below-market loans are utilized. Tax equity and the desire to increase tax revenues stimulated this legislative effort. These objectives may, in fact, be served, as the closing of loopholes promotes equal tax treatment of all taxpayers while making practiced tax evasion techniques ineffective. Though a substantial effort uncovers the new rule's workings, it may turn out that the average taxpayer is confused while trying to obey this tax law. Since a law's degree of success must ultimately be measured by its effectiveness, it may come to pass that this statute will be labeled a failure since its complexity makes it difficult, if not impossible, for the average taxpayer to comply.

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