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Roger A. Royse

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TAXATION — INTEREST-FREE LOANS FROM A CORPORATION TO A SHAREHOLDER

W. L. Hardee had a running loan account with a corporation in which he was the majority shareholder.[1] He had been borrowing money from the corporation since the 1950s. The balance of the loan account was approximately $503,000 at the end of 1972 and approximately $474,000 at the end of 1974. Hardee had never paid any interest on these loans.[2] The Commissioner of the Internal Revenue Service (IRS) increased Hardee's gross income by $38,745.13 for 1973 and $37,775.70 for 1974,[3] asserting that Hardee had received taxable benefits to this extent from the free use of corporate funds.[4] The IRS assessed a tax deficiency of $24,926.61 for 1973 and $24,675.02 for 1974.[5] Hardee paid the assessed deficiencies and brought suit in the United States Court of Claims for the payments, claiming that the interest value of the loans was nonincludable in the borrower's gross income.[6] The court *held* that the value of an interest-free loan is includable in the borrower's gross income.[7] *Hardee v. United States,* [1982] 2 U.S. Tax Cas. (CCH) ¶ 9459 (Ct. Cl. 1982).[8]

1. Hardee v. United Staes, [1982] 2 U.S. Tax Cas. (CCH) ¶ 9459, at 84, 656 (Ct. Cl. 1982), rev'd, 708 F. 2d 661, 662 (Fed. Cir. 1983). Hardee owned 52% of the outstanding stock of Sea Garden Sales Co., Inc. 1982-2 U.S. Tax Cas. (CCH) at 84, 656 n.1.

2. 1982-2 U.S. Tax Cas. (CCH) at 84, 656 n.1.

3. *Id.* at 84,657, n.2. The government based these figures on a seven percent interest factor. *Id.*

4. *Id.* at 84,656-57.

5. *Id.* at 84,657.

6. *Id.*

7. *Id.* at 84,656.

8. *Id.* at 84,659. This was the only issue on which the *Hardee* court ruled. The court did not address questions of valuation and timing but did order further proceedings to reduce Hardee's loan

In the *Hardee* ruling the Court of Claims departed from twenty years of case law. The Tax Court has considered the value of interest-free loans to be nonincludable in income since the case of *Dean v. Commissioner*[9] first presented the issue. Nevertheless, the IRS has continued to litigate the matter.

In *Dean* the Tax Court considered a series of cases involving the recognition of income by a shareholder or employee through the rent-free use of corporate property.[10] The Tax Court determined that these cases were not controlling in the interest-free loan situation.[11] The distinguishing factor was that interest on the use of money is ordinarily deductible to the borrower,[12] whereas rent on the use of property is not deductible.[13] If the taxpayer actually pays rent to a corporation for the use of corporate property, the payments are not deductible.[14] In contrast, if a borrower pays interest to the corporation for the use of corporate funds, the interest paid is deductible.[15]

The rent-free use of property is analogous to receiving extra compensation and immediately paying that amount back to the corporation as rent. If the taxpayer actually receives an increase in compensation and pays it back as rent, he would have extra income but no extra deductions.[16] If the taxpayer pays the increase in compensation back as interest, however, he would have a deduction exactly offsetting and nullifying the increase in income.[17] This factor prompted the Tax Court to rule that the interest-free use of corporate funds, unlike the rent-free use of corporate property, results in no additional income to the borrower.[18]

The concurrence noted that it may be too broad a

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balance for amounts attributable to salary. *Id.* at 84,660.

9. 35 T.C. 1083 (1961). The facts in *Dean* were similar to those in *Hardee*. The taxpayers recognized no income from their interest-free running loan accounts with a controlled corporation. Dean v. Commissioner, 35 T.C. 1083, 1087, 1090 (1961). The *Dean* court noted that the issue had its origin in dictum from a memorandum opinion of the Tax Court involving a gift tax question concerning the same taxpayers. *Id.* at 1089. The Tax Court commented that the interest-free lending of funds might be a means of passing on earnings of the corporation in lieu of dividends to the extent of reasonable interest on the loans. Dean v. Commissioner, 29 T.C.M. (P-H) 314 (1960).

10. Dean v. Commissioner, 35 T.C. 1083, 1089 (1961). The court cited a series of cases holding that the value of a rent-free use of corporate property was includable in gross income. *Id.*

11. *Id.* at 1090.

12. *Id.* Section 163 of the Internal Revenue Code allows a deduction for interest paid or accrued in the taxable period. I.R.C. § 163(a) (West 1983).

13. 35 T.C. at 1090. Rent on the use of property for personal use is not deductible. Rent is deductible, however, on property used in business or for the production of income. *See* I.R.C. §§ 212, 162(a) (West 1983).

14. 35 T.C. at 1090.

15. *Id.*

16. *Id.*

17. *Id.* The *Dean* court left this analogy to inference saying only that in the cases cited the taxpayer would not have had a deduction for rent if he had paid it, whereas in the *Dean* case the taxpayer would have had a deduction for interest if he had paid it. *Id.*

18. *Id.*

generalization to state simply that an interest-free loan results in no taxable gain to the borrower.[19] In some situations, the borrower may not be entitled to the corresponding deduction that would justify noninclusion.[20]

Suttle v. Commissioner[21] and *Greenspun v. Commissioner*[22] refined the rule of noninclusion further. In *Greenspun* the Tax Court held *Dean* to be controlling and reiterated its position that interest-free loans are distinguishable from rent-free uses of property.[23] The *Greenspun* court reasoned that excluding the interest value of an interest-free loan from income would equate the tax treatment of the interest-free borrower with that of a similarly situated interest-paying borrower.[24] For example, if an employee of a corporation receives an increase in compensation of $1,000 and pays the corporation $1,000 in interest on a loan from the corporation, he would have extra income and a deduction of like amount.[25] The transaction would be a wash. If another employee receives no extra compensation but pays no interest on a similar loan from the corporation, he is in the same economic position as the first employee.[26] Receiving extra compensation and paying that amount back as interest is economically equivalent to receiving no extra compensation and paying no interest.[27] Since the transactions are economically equivalent, the Tax Court stated that the tax law should afford them the same treatment.[28]

In *Greenspun* the Tax Court indicated that it might not follow *Dean* when the nonrecognition rule would result in disparate tax

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19. *Id.* at 1091 (Opper, J., concurring).

20. *Id.* The concurrence noted that interest on indebtedness incurred to purchase or carry tax-exempt securities is not deductible. I.R.C. § 265(2) (West 1983). Because the facts of *Dean* did not indicate that the taxpayer would not have had a deduction if he had actually paid interest, the concurrence considered it unnecessary to decide the issue as broadly as the majority did. 35 T.C. at 1091 (Opper, J., concurring).

21. 47 T.C.M. (P-H) 1627 (1978), *aff'd*, 625 F.2d 1127 (4th Cir. 1980). In *Suttle* the taxpayer borrowed money interest-free from a closely held corporation. Suttle v. Commissioner, 47 T.C.M. (P-H) 1627, 1628 (1978), *aff'd*, 625 F.2d 1127, 1127 (4th Cir. 1980). The Tax Court declined to accept the Commissioner's assertion that the value of the loans was taxable, just as the value of a rent-free use of property. 47 T.C.M. at 1628.

22. 72 T.C. 931 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982). In *Greenspun* the taxpayer received a loan at a bargain rate of interest in return for giving the lender favorable press coverage in his newspaper. Greenspun v. Commissioner, 72 T.C. 931, 934-35 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982). The Tax Court held that the transaction resulted in no taxable income to the borrower. 72 T.C. at 946.

23. 72 T.C. at 946. Since the interest would have been deductible had the taxpayer paid it, the court could find no reason to depart from *Dean*. *Id.* at 952.

24. *Id.*

25. *Id.* at 948.

26. *Id.*

27. *Id.*

28. *Id.* The *Greenspun* court reasoned that even though the parties eliminate the formalistic steps of a corporation paying compensation to the borrower and the borrower, in turn, paying interest to the corporation, the result should not change. *Id.* at 951.

treatment among similarly situated taxpayers.[29] The purpose of the *Dean* rule is to place the interest-free borrower in the same tax position as though he had received extra compensation and paid that amount back to the lending corporation as deductible interest.[30] The deductibility of interest is the factor that justifies the *Dean* rule and distinguishes interest-free loans from rent-free uses of property.[31]

If the interest would not be deductible had the taxpayer actually paid it, there would be no basis for treating interest-free loans differently from rent-free uses of corporate property.[32] For example, if the taxpayer had used the loan proceeds to purchase or carry tax-exempt securities, any interest paid on that loan would not be deductible.[33] In that situation treating the interest-free borrower as though he had received extra compensation and paid deductible interest would imply to him a deduction he otherwise would not have.[34] The Tax Court has not yet ruled on a case involving such a situation.[35]

Another area in which the *Dean* rule would lead to an inequitable result is when the amount of a deduction depends on the amount of adjusted gross income.[36] For example, the Internal Revenue Code allows a medical deduction only to the extent that deductible medical costs exceed five percent of adjusted gross income.[37] Casualty losses are deductible only to the extent that the loss exceeds ten percent of adjusted gross income.[38] The effect of not imputing income equal to the value of a loan is to understate

29. *Id.* at 949-50.
30. *Id.* at 947-48.
31. *Id.* at 946.
32. *Id.* at 948.
33. *Id.* Interest paid on indebtedness to purchase or carry tax-exempt securities is not deductible. I.R.C. § 265-1(a)(1) (West 1983). Interest paid on indebtedness incurred to carry a single premium life insurance or endowment contract or a single premium annuity contract is also not deductible. I.R.C. § 264-1(a) (West 1983). Interest may also be nondeductible under I.R.C. § 163, which limits the amount of investment interest that is deductible to the sum of $10,000, net investment income, and excess deductions for business expenses, I.R.C. § 163 (d) (1) (West 1983).
The taxpayer in *Hardee* did carry tax-exempt securities during the loan period. This may have been the reason the case was brought in the Court of Claims instead of the Tax Court, which probably would have followed *Dean*. The taxpayer possible was concerned that the Tax Court would depart from *Dean* when the taxpayer carries tax-exempt securities. *See* Hardee v. United States, [1982] 2 U.S. Tax Cas. (CCH) § 9459, at 84,656 (Ct. Cl. 1982).
34. *Greenspun*, 72 T.C. at 949. If a taxpayer receives a salary of $1,000 from a corporation, pays interest of $1,000 to a corporation, and uses the loan proceeds to purchase tax-exempt securities, he will have taxable income of $1,000 and no interest deduction. *Id.* Under *Dean* the taxpayer will have no taxable income from an interest-free loan regardless of what he does with the proceeds. *Id.* at 949-50.
35. *But see* Baker v. Commissioner, 75 T.C. 166, 172 (1980), *aff'd*, 677 F.2d 11 (2d Cir. 1982) (mere simultaneous existence of the taxpayer's indebtedness and the ownership of tax-exempts was not enough to establish that the taxpayer incurred the indebtedness to carry the tax-exempts.)
36. *Greenspun*, 72 T.C. at 949.
37. I.R.C. § 213 (West 1983).
38. I.R.C. § 165-67 (West 1983).

the interest-free borrower's adjusted gross income in relation to that of his interest-paying counterpart.[39] Because the interest-free borrower's adjusted gross income is smaller, his medical or casualty loss deduction will be larger. As a result, the interest-free borrower would be allowed a greater deduction than if he had paid interest and received extra compensation.[40] It is in a situation such as this[41] that the *Greenspun* court indicated that it might not follow *Dean*.[42]

One week after *Greenspun* the Tax Court applied the doctrine of stare decisis in refusing to overrule *Dean* in *Zager v. Commissioner*.[43] The taxpayers in *Zager*, as controlling stockholders, received interest-free loans on open accounts from a corporation.[44] The *Zager* court held that the value of the loans was nonincludable in gross income.[45] The *Zager* court noted that *Dean* had approved of a corporate practice that had existed for forty-eight years prior to *Dean*.[46] The IRS had not challenged the holding in *Dean* until twelve years later.[47] The *Zager* court also noted that Congress was considering legislation in the related area of taxation of fringe benefits.[48] Thus, the *Zager* court concluded that a legislative solution would be more appropriate than a judicial departure from the current law.[49]

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39. 72 T.C. at 949.

40. *Id.* Likewise, when a deduction cannot exceed a percentage of adjusted gross income, the effect of noninclusion may be to decrease the amount of deductions available to a taxpayer and, thus, increase his taxable income in relation to his interest-paying counterpart. For example, a deduction for payments made to an individual retirement account cannot exceed the greater of $1,500 or 15% of adjusted gross income. I.R.C. § 219 (6) (1) (West 1983). Deductions for contributions to public charities are limited to a percentage of adjusted gross income. *See* I.R.C. §§ 170 (b) (1) (A); (b) (1) (B); (b) (1) (C) (West 1983).

The foregoing examples do not apply, however, when the interest is deductible as an expense from gross income rather than as a deduction from adjusted gross income. In this situation the amount of the increase in adjusted gross income is offset by the interest deduction from gross income. Adjusted gross income is thus left unaffected. *See* I.R.C. § 62(1) (West 1983). Note, however, that if the interest would be deductible as a business expense, § 482 may come into play to allow the IRS to impute interest to the transaction. For a discussion of the relationship of § 482 to the interest-free loan transaction, see *infra* notes 101-09.

41. Other disparities could result from the effective implication of a deduction. If a taxpayer does not itemize deductions, noninclusion implies to him a deduction he would not otherwise have because interest can be taken only as an itemized deduction. *See* I.R.C. § 163 (West 1983).

42. 72 T.C. at 950. In *Greenspun* the Tax Court stated, "[w]hen and if we are confronted with such a case, we will decide at that time whether *Dean* is applicable, and if so, whether we shall continue to adhere to our decision in *Dean*." *Id.*

43. 72 T.C. 1009 (1979), *aff'd sub nom.* Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981).

44. Zager v. Commissioner, 72 T.C. 1009, 1010 (1979).

45. *Id.*

46. *Id* at 1013. The Tax Court noted that the practice of a corporation giving interest-free loans to its shareholders or employees has existed at least since the inception of our income tax laws. *Id.*

47. *Id.* The commissioner did not announce his nonacquiescence in *Dean* until 1973. 1973-2 C.B. 4.

48. 72 T.C. at 1014. The *Zager* court noted that Congress forbade the promulgation of new treasury regulations in the fringe benefit area for a limited time. *Id. See* Act of Oct. 7, 1978, Pub. L. No. 95-427, § 1, 92 Stat. 996.

49. 72 T.C. at 1014. The *Zager* court said that the taxability of interest-free loans was "sufficiently related to [the area of fringe benefits] that if a change is desired, a legislative solution would appear to be more appropriate than a judicial departure from the rule of stare decisis." *Id.*

The federal appellate courts that have ruled on the issue have upheld the Tax Court position of noninclusion.[50] Like the *Zager* court, the federal courts have been unwilling to overrule such a firmly established rule of tax law.[51]

Section 61 of the Internal Revenue Code defines gross income as all income from whatever source derived, unless specifically exempted.[52] The courts have construed this language broadly to include any economic benefit conferred, by whatever form.[53] Thus, the economic benefit a shareholder or employee obtains from the rent-free use of corporate property is includable in gross income.[54] The use of funds at no interest is an economic benefit just as is the rent-free use of corporate property.[55]

The Tax Court has refused to recognize the benefit of an interest-free loan as income because there is ordinarily a deduction available that would, if paid, offset the amount of the benefit in taxable income.[56] The availability of a deduction is a consideration in determining whether an item is to be taken into income.[57] For example, the receipt of a receivable that a taxpayer had previously written off as a bad debt is includable in gross income precisely because the taxpayer took a deduction for that item in a prior period.[58] Thus, the relationship of a benefit to a deduction may affect the quality of a benefit as income.[59]

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50. Hardee v. United States, 708 F.2d 661, 662 (Fed. Cir. 1983) (there is a longstanding precedent against treating interest-free loans as a taxable event); Parks v. Commissioner, 686 F.2d 408, 409 (6th Cir. 1982) (the *Dean* rule of noninclusion is a well-established principle of law that should not be changed by the courts); Baker v. Commissioner, 677 F.2d 11, 12 (2d Cir. 1982) (reversal of the *Dean* rule would inject nonuniformity into our national tax law); Commissioner v. Greenspun, 670 F.2d 123, 126 (9th Cir. 1982) (Congress, not the courts, is the proper body to modify the *Dean* rule); Beaton v. Commissioner, 664 F.2d 315, 317 (4th Cir. 1981) (to depart from *Dean* would result in uncertainty and the uneven application of the tax law); Martin v. Commissioner, 649 F.2d 1133, 1134 (5th Cir. 1981) (modification of the *Dean* rule would result in a loss of national uniformity in the application of our tax law); Suttle v. Commissioner, 625 F.2d 1127, 1128 (4th Cir. 1980) (interest-free loans from a corporation result in no income to the borrower).

51. *See, e.g., Greenspun*, 670 F.2d at 126. In *Greenspun* the Ninth Circuit Court stated that "[t]oo much water has passed under the bridge to warrant judicial re-examination [of *Dean*]." *Id.* at 125-26.

52. I.R.C. § 61(a) (West 1983).

53. Commissioner v. Smith, 324 U.S. 177, 180-88 (1945) (the difference in value of an employee stock option price and the market price of the stock at the time of exercise of the option is an item of income).

54. Gardner v. Commissioner, 613 F.2d 160, 162 (6th Cir. 1980) (rental value of company-provided car includable in income); Walker v. Commissioner, 362 F.2d 140, 143 (7th Cir. 1966) (rental value of company-owned house includable in taxpayer's income).

55. *See Greenspun*, 72 T.C. at 947.

56. Dean v. Commissioner, 35 T.C. 1083, 1090 (1961). That interest is deductible and rent is not distinguishes interest-free loans from rent-free uses of property. *Id.*

57. *Zager*, 72 T.C. at 1012. The *Zager* court stated, "[I]t is not accurate to suggest that the availability of a related deduction is wholly irrelevant in determining whether the benefit involved should be treated as realized income." *Id.* n.1.

58. *Id.* The tax benefit rule of § 111 provides generally that recovery of a previously written-off bad debt is includable in gross income in the year received to the extent that the item resulted in a prior reduction of tax. I.R.C. § 111 (West 1983).

59. *Zager*, 72 T.C. at 1012.

The Tax Court analysis does not impute both income and a corresponding deduction equal to the interest value of the loan in arriving at no net taxable gain. Rather, the Tax Court position did not recognize this benefit in income at the outset because of the deductible feature of interest.[60]

In taking this approach, the Tax Court avoids the problem of construing section 163 of the Internal Revenue Code.[61] Section 163 only allows a deduction for interest that the taxpayer pays or accrues.[62] The interest-free borrower does not pay or accrue any interest. Because the tax law only allows a deduction where there is a clear statutory provision,[63] the interest-free borrower cannot have an imputed deduction for interest that he does not pay or accrue. Sections 163 and 61, when read together, would demand the recognition of income but disallow the imputation of a deduction.[64] Had *Dean* and its progeny included the value of an interest-free loan in gross income, the paid or accrued language of section 163 would have precluded allowing a corresponding deduction.[65] This was the inequitable result the *Dean* court sought to avoid.[66]

The unexpressed fear of the Tax Court in being bound to a strict construction of section 163 is not without authority. The United States Supreme Court has said that economic equivalence is not a valid reason for allowing a deduction.[67] Rather, a statute must make an express provision before a taxpayer may take a deduction.[68]

An exception to a strict reading of section 163 may not,

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60. *Greenspun*, 72 T.C. at 946. The Tax Court position can be characterized as the no-income, no-deduction rule. The *Greenspun* court stated that the result of no net taxable gain to the interest-free borrower was not based on the imputing of income and deduction of like amount. *Id.* Rather, it "was based on the conclusion that an interest-free loan results in no taxable gain to the borrower." *Id.* (citing *Dean*, 35 T.C. at 1090).

61. I.R.C. § 163(a) (West 1983). Section 163 states, "There shall be allowed as a deduction all interest paid or accrued within the taxable year of indebtedness." *Id.*

62. *Id.*

63. Commissioner v. National Alfalfa Dehydrating, 417 U.S. 134, 148-49 (1974). The Supreme Court stated that deductions are allowed only as there is "clear provision therefor." *Id.* at 148.

64. Keller, *The Tax Consequences of Interest-Free Loans from Corporations to Shareholders and From Employers to Employees*, 19 B.C.L. REV. 231, 238 (1978). The commentator explains the *Dean* analysis as attempting to reach the equitable result of similar tax treatment of economically equivalent situations by not including the value of the interest-free loan in gross income. *Id.*

65. *Id.*

66. *Id.*

67. Commissioner v. National Alfalfa Dehydrating, 417 U.S. 134 (1974). A corporation issued $50 face amount bonds to retire its outstanding preferred stock, which had a market value of $33 per share. *Id.* at 139-40. The corporation sought to take a deduction for this difference in value, $50 - $33, because the transaction was equivalent to selling the bonds for $33 and retiring the stock at that price. *Id.* at 148. Because no real costs were paid or incurred, the Supreme Court denied the deduction. *Id.* at 148-49.

68. *Id.* The Supreme Court rejected the economic equivalence argument stating that the taxability of a transaction does not depend on whether another form of the transaction would have been nontaxable. *Id.*

however, be contrary to accepted judicial standards of construction.[69] A dissenting opinion in *Martin v. Commissioner*[70] criticized the government's position as unjust and not mandated by the language of the tax code.[71] It also characterized the *Dean* rationale as achieving overkill in its analysis.[72] The view advocated by the *Martin* dissent would include the value of an interest-free loan in gross income in all cases. The taxpayer would then take an imputed deduction for that amount if he would have had a deduction had he actually paid interest to the corporation.[73] This reading of section 163 admittedly stretches the words "paid or accrued" beyond their literal meaning. The justification for this interpretation is that a court has a duty to give the tax code a quality of rationality.[74] The tax law would, thus, treat like situations alike. To do otherwise would be neither equitable nor rational.[75]

Revenue Ruling 73-13[76] is an example of the IRS giving the statutes an expanded meaning to allow a deduction when it would be unjust not to do so. In Revenue Ruling 73-13 an executive received company-paid financial services.[77] The IRS ruled that the executive had received income equal to the value of the services, but that he could also take a deduction for that very amount.[78] This was so even though the executive did not pay or incur any expense, which the wording of the statute required.[79] Because the taxpayer did not pay or incur the expense but was allowed a deduction, the ruling supports the view of the *Martin* dissent that would allow an imputed interest deduction.[80]

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69. Keller, *supra* note 64, at 241. The commentator believes the phrase "paid or accrued" of § 163 should be applied flexibly to achieve a rational tax result. See *infra* notes 78-86 and accompanying text for examples of nonliteral constructions of similar provisions.

70. 649 F.2d 1133 (5th Cir. 1981) (Goldberg, J., dissenting).

71. Martin v. Commissioner, 649 F.2d 1133, 1137 (5th Cir. 1981) (Goldberg, J., dissenting).

72. *Id.* at 1142. The dissent stated that *Dean*, as applied by the majority in *Martin*, would allow an effective implied interest deduction even when the interest would not be deductible if paid. *Id.* The dissent commented, "[T]he *Dean* court's overkill has been transformed into mass annihilation by the majority opinion." *Id.*

73. *Id.* The dissent stated that an imputed deduction approach would tax like situations alike in all cases involving a loan from a corporation. *Id.*

74. *Id.* at 1143. The dissent in *Martin* noted that the courts should give a logical and sensible interpretation to the tax code when faced with a situation not contemplated by the drafters of the code. *Id.* n.17.

75. *Id.* at 1144.

76. Rev. Rul. 13, 1973-1 C.B. 42.

77. *Id.*

78. *Id.* at 43.

79. *Id.* I.R.C. § 212 allows a deduction for expenses paid or incurred for tax or investment counsel. I.R.C. § 212 (West 1983); Treas. Reg. § 1.212-1 (1960). Although § 212 uses the words "paid or incurred" rather than "paid or accrued" as § 163 does, there would seem to be little significance in distinguishing these words as a matter of construction. *See* DeSoto Securities Co. v. Commissioner, 235 F.2d 409, 411 (7th Cir. 1956) ("accrued" relates to the incidence of a tax or interest obligation while "incurred" relates to the incidence of any other obligation).

80. Martin v. Commissioner, 649 F.2d 1133, 1143 n.17 (1981) (Goldberg, J., dissenting). In

Offered as another example of a nonliteral reading of the Internal Revenue Code is the assigning of a cost basis to property acquired at no cost.[81] A taxpayer's basis in such property is the amount at which he takes the property into income.[82] The legal fiction that assigns a cost basis to property acquired at no cost gives an expanded meaning to the word "cost" in section 1012 to achieve an equitable result.[83] The *Martin* dissent would expand the words "paid or accrued" in section 163 for the same reason.[84] The Tax Court obtains the same result as the *Martin* dissent without reaching the problem of construing the language of section 163.

The Court of Claims in *Hardee* rejected both the rationale and result of the Tax Court.[85] First, the *Hardee* court asserted that the value of an interest-free loan is an economic benefit, just as is the rent-free use of property. The tax law regards such a benefit as income.[86] That interest is deductible, which was considered the dispositive factor in *Dean*, did not affect the initial determination in *Hardee* that the benefit from an interest-free loan is an item of gross income within the meaning of section 61.[87]

The *Hardee* court, after determining that the benefit was includable in gross income, declined to impute a corresponding deduction.[88] The court read the "paid or accrued" language of

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Greenspun the Tax Court noted that even though the Revenue Ruling approach differs in imputing both income and deduction, when the Tax Court would impute neither, the two situations reach the same result and are indistinguishable in principle. Greenspun v. Commissioner, 72 T.C. 931, 952 (1979).

81. *See* Brown, *The Growing 'Common Law' of Taxation*, 34 S. CAL. L. REV. 235 (1961). The author hypothesizes the situation in which a taxpayer wins a car that has a fair market value of $5,000 in a lottery. This results in income to the taxpayer of $5,000. If he sells the car, his basis for determining gain on the sale is not his cost, which was the price of the lottery ticket. *Id.* at 239. His cost basis is the amount at which he took the car into income — $5,000. The term "cost" is "stretched out of recognizable shape" to give the tax code a "quality of rationality." *Id.* at 240.

The Internal Revenue Code provides that a taxpayer's basis in property is its cost. I.R.C. 1012 (West 1983).

82. Smith v. Russell, 76 F.2d 91, 92 (8th Cir. 1935), *cert. denied*, 296 U.S. 614 (1936) (employee's basis in property that is acquired as compensation is the amount of income resulting from the receipt of the item). The Internal Revenue Code provides that a shareholder's basis in property received as a property dividend is its fair market value at the time of the distribution. I.R.C. § 301(d) (West 1983). Property received in return for services has a cost basis of its fair market value at the time of receipt. Treas. Reg. § 1.61-2(d)(2) (1960).

83. Keller, *supra* note 64, at 241-42. The commentator cites the example given by Brown, *supra* note 81, at 239-40 to be the law treating the transaction as though the taxpayer had received cash from the lottery of $5,000 and purchased the car for $5,000. The law should likewise expand the words "paid or accrued" to treat the interest-free borrower as though he had received cash compensation or dividends and paid interest. Keller, *supra* note 64 at 241-42.

84. Martin v. Commissioner, 649 F.2d 1133, 1137 (5th Cir. 1981) (Goldberg, J., dissenting).

85. Hardee v. United States, [1982] 2 U.S. Tax Cas. (CCH) ¶ 9459, at 84, 658 (Ct. Cl. 1982).

86. *Id.* In *Hardee* the Court of Claims considered it beyond dispute that an interest-free loan constitutes a benefit that is includable in gross income. *Id.* Concerning this contention, the *Hardee* court stated, "[I]n truth, the Tax Court has never said otherwise." *Id.*

87. *Id.*

88. *Id.* at 84,659. In refusing to impute a deduction, the *Hardee* court noted that it is an "established principle that tax consequences should be gauged according to the facts as they are," and not as they might have been. *Id.*

section 163 strictly to preclude a deduction when a taxpayer had not actually paid or accrued any interest.[89]

The *Hardee* court stated further that even if it could impute an offsetting interest deduction, it would not make economic sense to do so.[90] The interest-free borrower avoids the borrowing costs that an interest-paying borrower must pay.[91] Thus, he has an economic benefit that his interest-paying counterpart does not have.[92] The taxpayer should include this benefit in income.[93] To exclude the interest value of the loan from income places the interest-free borrower in a better economic position than his interest-paying counterpart.[94]

In *Hardee* the government applied a seven percent interest factor to arrive at an interest-not-charged figure.[95] Hardee did not contend that a different rate would have been a more proper basis of valuation.[96] The government's position has been that the taxpayer's individual borrowing rate determines the value of the interest-free loan.[97]

A basic problem in this approach is the difficulty of finding the taxpayer's individual rate.[98] When the taxpayer can borrow money from a financial institution, the IRS can determine an interest factor by reference to the lending rate of the institution at the time of the loan. When the taxpayer can obtain a loan in the open market only at a usurious rate of interest, the bank rate would not

89. *Id.* The *Hardee* court cited Commissioner v. National Alfalfa Dehydrating, 417 U.S. 134, 148-49 (1974), as being dispositive of the core issue of whether a taxpayer could take an interest deduction when he incurred no cost of borrowing. *Id.* The Supreme Court held that he could not. See *supra* notes 67-68 for a discussion of the facts of *National Alfalfa Dehydrating.* It is arguable whether the dictum cited from *National Alfalfa Dehydrating* should apply beyond its exact facts. The Supreme Court limited its holding to the narrow issue of whether amortizable discount arises from a pre-1969 exchange of debt for outstanding preferred stock of the issuing corporation. 417 U.S. at 147. For a discussion of the case, see Note, *The Original Issue Discount Deduction in Bonds-for-Non-Cash Property Exchanges,* 27 VAND. L. REV. 1179, 1201-05 (1974). The relevance of the case is that the Supreme Court would not allow an interest deduction when the taxpayer incurred no real costs of borrowing. 417 U.S. at 154-55.

90. Hardee v. United States, [1982] 2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,659 (Ct. Cl. 1982).

91. *Id.*

92. *Id.* The *Hardee* court noted that to the interest-free borrower under the *Dean* rule "the borrowing is truly 'free.' " *Id.*

93. *Id.*

94. *Id.* The *Hardee* court did not believe it was valid to equate actual expenditures with payments-in-kind. *Id.*

95. *Id.* at 84,657 n.2.

96. *Id.* The parties stipulated that a seven percent rate was proper. Brief for the United States to the Trial Judge at 6, Hardee v. United States, [1982] 2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,656 (Ct. Cl. 1982).

97. *See, e.g.,* Commissioner v. Greenspun, 670 F.2d 123, 124 (9th Cir. 1982) (government asserted that the applicable rate was that at which the taxpayer could have borrowed a like sum from a commercial lending institution).

98. Keller, *supra* note 64, at 257-58. A borrower's individual rate may vary depending on, for example, the value of security given and the borrower's credit rating. *See* Rev. Rul. 61, 1973-1 C.B. 408, 409.

accurately measure the value of the loan to the taxpayer.[99] The taxpayer's actual borrowing rate would impute to him an amount of income greater than the market value of the loan.[100]

Reference to the Internal Revenue Code may provide a solution to the problem. The Internal Revenue Code provides a statutory rate in cases in which the Commissioner may impute interest, thus avoiding the problem of determining an individual rate. Sections 482 and 483 of the Internal Revenue Code allow the Commissioner to impute interest to certain transactions to more properly reflect income.[101] Under section 482 the Commissioner may impute a twelve percent per annum simple interest rate to loans made between controlled business organizations.[102] Section 483 allows the allocation of interest among payments made in a deferred payment sale or exchange of property.[103] The current section 483 rate is ten percent compounded semi-annually.[104] Section 482 limits the Commissioner's authority to transactions among commonly controlled organizations.[105] Section 483 is likewise inapplicable here, because no property is being sold or exchanged.[106] The IRS has not argued by analogy to sections 482 and 483 because they generally allow as a deduction the amount of interest imputed as income.[107]

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99. *See* O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. L. REV. 1085, 1090 (1974). The commentator questioned which rate the IRS would impute when the taxpayer could not obtain a loan in the open market at any rate. *Id.* The author noted that it is not reasonable to measure the value of a loan by reference to the rate of a loanshark. *Id.*

100. The market value, or bank rate, of a loan, unlike the rental value of property, will vary with each individual. The result is that different taxpayers receiving the same loan amounts will take different amounts into income, depending on their individual borrowing rate. Differing tax treatment of similarly situated interest-free borrowers would result from imputing to each taxpayer a different rate. This may be an area of concern because it is incompatible with the goal of uniformity in the application of the tax law. *See* Beaton v. Commissioner, 664 F.2d 315, 317 (1st Cir. 1981) (to overrule *Dean* would result in uneven application of the tax law).

101. I.R.C. §§ 482, 483 (West 1983).

102. *Id.* § 482. The IRS will impute an arm's length interest rate to loans carrying a rate of less than 11% or greater than 13% made between commonly controlled organizations. An arm's length rate for purposes of § 482 is currently set at 12% unless the taxpayer can establish that a different rate is more appropriate. Treas. Reg. § 1.482-2(a)(2)(iii)(B)(2) (1982).

103. I.R.C. § 483 (West 1983).

104. Treas. Reg. § 1.483-1(c)(2)(ii)(C) (1982).

105. Treas. Reg. §§ 1.482-1(a)(1), -2(b)(2) (1982). The regulations give a broad construction to the term "organizations" so that § 482 could be applicable to an interest-free loan transaction if the borrower is a business, trust, estate, or association controlled by the same interests as the lender. Roth, *Can A Lender Be Charged With Receiving Taxable Income as a Result of an Interest-Free Loan*, 52 J. TAX'N, 136, 137 (1980).

106. Roth, *supra* note 105, at 136.

107. Commerce Clearing House, *Income Generated by Interest-Free Loans: Court of Claims*, [1982] 10 STAND. FED. TAX REP. ¶ 8199, at 75,262 (July 28, 1982). Another reason the IRS has not argued by analogy to §§ 482 and 483 may be that the sections illustrate the concept that the IRS cannot take it upon itself to develop anti-interest-free loan laws. The Seventh Circuit Court of Appeals has noted that the courts refused to impute interest to §§ 482 and 483 transactions until the promulgation of Treas. Reg. § 1.482 and enactment of § 483. Crown v. Commissioner, 585 F.2d 234, 240 (7th Cir. 1978).

Since Hardee did not contend that a different rate should have been used, the Court of Claims accepted the government's method of valuation.[108] Given the difficulties in assigning an individualized rate and the government's practice of imputing a rate set by federal regulations to certain transactions, it would seem preferable that courts adopting the *Hardee* position apply a rate established under sections 482 or 483.[109]

The question of when to include the value of an interest-free loan in income presents little trouble in cases such as *Hardee* in which the note is payable on demand. The economic benefit is the use of the funds over the loan period.[110] Thus, the taxpayer should recognize income during each period in which the funds are outstanding.[111]

The matter is less clear when a note with a fixed date of repayment is given in exchange for the loan. A fixed date note, unlike a demand note, has a present value of less than the face amount of the note.[112] The taxpayer receives funds in exchange for a note that, in present value, is worth less than the amount of the loan. In such cases, the IRS has taken the position that the amount that should be taken into income is the difference between the loan proceeds and present value of the note given in exchange.[113] The reasoning is that the taxpayer is realizing the benefit of the transaction in the year in which the loan is made, because he is receiving funds in return for a note that is worth less than the amount of the funds.[114]

This immediate recognition approach has been accepted in other areas of taxation. A federal appellate court has applied a present value analysis in considering the deductibility of a

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108. Hardee v. United States, [1982] 2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,657 n.2 (Ct. Cl. July 6, 1982).

109. *See* Keller, *supra* note 64, at 257. The author believes that applying a rate specified in the treasury regulations would avoid the procedural complexities of an individualized rate. *Id.*

110. Greenspun v. Commissioner, 72 T.C. 931, 951 (1979).

111. *Id.* For example, if the loan amount is $1,000, and the assessed interest factor is 10%, the taxpayer would recognize $100 each year in which the loan is outstanding. *Id.*

112. *See* Crown v. Commissioner, 585 F.2d 234, 238 (7th Cir. 1978). The right to receive money at a certain future date has a market value determined by discounting the note to its present value. The present value of a demand note, however, is equal to its face value, because it is payable on demand rather than at some future time. *Id.* Further, absent a definite date of repayment, a present discounted value approach cannot determine the value of a note. *Id.*

113. *See Greenspun*, 72 T.C. at 950. The taxpayer in *Greenspun* received a loan at three percent interest payable eight years from the date of issuance. *Id.* at 936. The government asserted that the taxpayer should recognize the benefit of the bargain rate in the year of receipt of the proceeds. *Id.* at 950. The IRS computed the benefit of the bargain interest rate by summing the present values of the differences between the actual interest payments made at the three percent rate and the payments that would have been made at the market rate. This sum is the value of the preferential rate of interest. *Id.* at 950-51.

114. *Id.*

charitable contribution. In *Mason v. United States*[115] a taxpayer transferred property to a charitable organization in exchange for a note that had a present value that was less than the fair market value of the property. The Seventh Circuit in *Mason* allowed a charitable deduction for this difference in value in the year of the transfer.[116] The Tax Court also has applied to present value analysis in finding a taxable gift equal to the difference between the value of property transferred and the present value of a note given in exchange for the property.[117] The Tax Court has rejected this analysis, however, in a gift tax case involving the transfer of an interest-free loan.[118]

The Tax Court has indicated that the taxpayer should recognize the benefit of an interest-free loan, if at all, ratably over the loan period even if the note given bears a fixed date of repayment.[119] Realization of the benefit from the use of funds occurs during each period in which the taxpayer uses the funds.[120] Since interest is thought of as a charge on the use of money, the taxpayer should allocate the benefit of not paying that charge over the years in which he uses the money.[121] This type of allocation

115. 513 F.2d 25 (7th Cir. 1975). The note received by the taxpayer in *Mason* had a face value of $112,689.42 and an appraised fair value of $81,000. The taxpayer received this note and $4,507.50 cash in exchange for property worth $117,000. Mason v. United States, 513 F.2d 25, 29 (7th Cir. 1975). The *Mason* court allowed a charitable deduction for the $31,492.50 difference in values. *Id.*

116. *Id.* The amount of the deduction was the difference in values between the property given and the consideration received in exchange. *Id.*

117. Blackburn v. Commissioner, 20 T.C. 204 (1953). When the taxpayer exchanged property for an annuity, the Tax Court found a taxable gift equal to the difference between the value of the property and the present value of the annuity. *Id.* at 207.

118. Crown v. Commissioner, 67 T.C. 1060 (1977), *aff'd,* 585 F.2d 234 (7th Cir. 1978); *contra* Dickman v. Commissioner, 690 F.2d 812 (1982). The taxpayer in *Crown* made interest-free loans to family members on open accounts and demand notes. 67 T.C. at 1060-61. The Tax Court refused to find a taxable gift in the granting of these loans. 67 T.C. at 1065. On appeal the Seventh Circuit Court of Appeals noted that I.R.C. § 2512 taxes the difference in values of property given and consideration received for the property. 585 F.2d at 238. The activity that § 2512 taxes differs from the activity to which the tax on income applies. The benefit of an interest-free loan is the use of funds for the loan period. It is the use of funds, rather than the exchange of a promissory note for funds, to which § 61 applies. *See* Greenspun v. Commissioner, 72 T.C. 931, 951 (1979).

119. *Greenspun,* 72 T.C. at 950-51. The *Greenspun* court noted that the economic benefit that the government sought to tax was the use of funds at a low rate or no rate of interest. *Id.*

120. *Id.*

121. *Id.* An analogous situation is the rule that allows an accrual basis taxpayer who buys a noninterest-bearing note at a discount to allocate the discount over the term of the note. *See* Vancoh Realty Co. v. Commissioner, 33 B.T.A. 918 (1936). An accrual basis taxpayer who buys a noninterest-bearing note at a discount recognizes interest income ratably as the discount is earned. *Id.* On the cash basis, however, the taxpayer includes the discount in income when he receives the loan proceeds because a cash basis taxpayer recognizes income in the year of actual or constructive receipt. Treas. Reg. §§ 1.451-1(a), -1 (c)(1)(i); 1.451-2 (1977).

Both accrual basis and cash basis taxpayers recognize prepaid interest income in the year of receipt. *Id.* § 1.451-1(a). If the benefit of an interest-free loan is the value of receiving funds to be repaid at a future date, the prepaid interest rules would seem especially relevant. The borrower receives the benefit in cash in the year of the loan, and this is analogous to receiving a cash prepayment of interest. The Tax Court, however, does not consider the benefit to be the initial receipt of funds, but the use of funds over the loan period. *Greenspun,* 72 T.C. at 950.

would prevent a material distortion of income.[122]

The *Hardee* position of inclusion further raises the question of how the benefit accruing from an interest-free loan should be classified. The income attributable to the taxpayer in *Hardee* was dividend income[123] rather than compensation.[124] A corporate distribution in-kind of property or services may be a constructive dividend.[125] Constructive dividends possess the same tax attributes as actual dividend distributions.[126] They are taxable only to the extent that the corporation has existing earnings and profits.[127] To the extent that the value of the distribution exceeds existing earnings and profits, the distribution is a return of capital rather than income.[128] Dividend income arising from a rent-free use of property is also subject to limitation by the corporation's earnings and profits.[129] Dividend income arising from an interest-free loan, since it is a rent-free use of money, should be subject to the same rules.[130] The necessary conclusion is that the receipt of an interest-free loan may not always result in income under *Hardee* but may be

122. *Greenspun*, 72 T.C. at 956 (Goffe, J., concurring). The *Greenspun* concurrence cited two cases that dealt with the deduction side of prepaid interest: Resnick v. Commissioner, 555 F.2d 634 (7th Cir. 1977) (prepayment of four year's interest disallowed as a deduction because it would materially distort income) and Sandor v. Commissioner, 539 F.2d 874 (9th Cir. 1976) (a prepayment of five years of prepaid interest disallowed as a deduction because it would materially distort income).

123. Brief for the United States to the Trial Judge at 10, Hardee v. United States, [1982] 2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,656 (Ct. Cl. 1982). The IRS treated the benefit as a dividend from Sea Garden Sales Co., Inc. to Hardee. *Id.* The classification of the benefit as dividend income rather than compensation is important because the items carry different tax treatment. For example, under I.R.C. § 116 an individual may exclude from gross income the first $100 of dividends received from a domestic corporation during the taxable year. I.R.C. § 116(a) (West 1983). Dividend income, unlike compensation, is investment income for purposes of computing the investment interest deduction. I.R.C. § 163(d) (West 1983).

124. *Id.* An economic benefit is compensation to the extent that it is received for services rendered. I.R.C. § 162(a)(1) (West 1983). A concurrence in *Greenspun* indicated that the benefit of an interest-free loan may be more properly includable in income, if at all, under the broad compensation provisions of I.R.C. § 61 rather than under the specific provisions of the I.R.C. concerning dividends. Greenspun v. Commissioner, 72 T.C. 931, 957 (1979) (Goffe, J., concurring).

125. WEST'S FEDERAL TAXATION 137 (W. Hoffman ed. 1981). The rent-free use of corporate property by a shareholder is a constructive dividend to the shareholder in the amount of the fair rental value of the property for the period of the use. *Id.*

126. Simon v. Commissioner, 248 F.2d 869, 877 (8th Cir. 1957) (corporate income diverted directly to shareholders held to be dividend income and, thus, subject to the rules regarding corporate distributions generally).

127. I.R.C. §§ 301(c), 316(a) (West 1983). When a corporation makes a distribution to its shareholders, the amount that is dividend income may not exceed current and accumulated earnings and profits. Treas. Reg. § 1.316-1(a) (1983).

128. I.R.C. § 301(c) (West 1983). The amount of a distribution that is not income reduces the recipient's basis in his stock. Treas. Reg. § 1.301-1 (1983).

129. Grant v. United States, [1976] 38 A.F.T.R. 2d (P-H) ¶ 5203, at 5694 (E.D. Ark. May 14, 1976). In *Grant* the value of a rent-free use of property in excess of corporate earnings and profits was a return of capital that reduced the shareholders' basis in their stock. *Id.* at 5696.

130. *See* Keller, *supra* note 64, at 233 n.13. The author asserts that the corporate lender should recognize income equal to the value of the loan as though it had received interest payments from the borrower and paid cash dividends. Presumably, under this approach earnings and profits would be increased and decreased by the same amount and, thus, left unaffected by the interest-free loan transactions. *See id.*

treated as a capital distribution.

The Court of Claims decision in *Hardee* has been reversed by the United States Court of Appeals for the Federal Circuit.[131] If the decision of the United States Court of Appeals for the Federal Circuit is appealed, the longevity of the *Dean* rule as an administrative practice could encourage even the Supreme Court to defer resolution of the matter to Congress.[132] Taxpayers have relied on the nontaxability of interest-free loans since the inception of the income tax laws.[133] To overrule *Dean* would result in potentially far-reaching consequences.[134]

The *Greenspun* court stated that if the tax law as it relates to interest-free loans should be changed, the change should come from Congress.[135] The Supreme Court has noted that the courts should not readily undertake to change established rules of taxation. If a change in the tax law is desired, Congress is better equipped to enact a change.[136]

Congress has been reluctant to enact changes in the judicial handling of fringe benefits such as interest-free loans. Congress undertook a review of fringe benefits in 1977. Congress issued and extended until 1980 an enactment forbidding the IRS from promulgating new regulations in the area.[137] This moratorium was extended to December 31, 1983.[138] The Senate Appropriations Committee has urged the IRS to refrain from instituting cases asserting the taxability of the value of interest-free loans.[139]

Congress has since failed to legislate in the area of interest-free loans. In *Hardee* the Court of Claims, although reluctant to make uncertain two decades of case law, would not adopt a view it considered to be wrong.[140] Currently, *Hardee* stands alone in its opposition to the *Dean* rule, partly because of the judiciary's reluctance to sanction such a drastic change in the tax law. *Hardee*

131. Hardee v. United States, 708 F.2d 661, 662 (Fed. Cir. 1983).
132. Commerce Clearing House, *Income Generated by Interest-Free Loans: Court of Claims*, [1982] 10 STAND. FED. TAX REP. ¶ 8199, at 75,262 (July 28, 1982).
133. Zager v. Commissioner, 72 T.C. 1009, 1013 (1979).
134. Commissioner v. Greenspun, 670 F.2d 123, 126 (9th Cir. 1982).
135. *Id.*
136. United States v. Byrum, 408 U.S. 125, 135 (1972). The decision in *Byrum* was that a settlor of a trust who retained broad management powers did not retain rights that would subject the trust corpus to the federal estate tax. *Id.* at 150. The Supreme Court noted that taxpayers had relied on this rule since 1929. *Id.* at 133.
137. Act of Oct. 7, 1978, Pub. L. No. 95-427, § 1, 92 Stat. 996.
138. Act of Aug. 13, 1981, Pub. L. No. 97-34, § 801, 95 Stat. 349.
139. S. REP. No. 955, 96th Cong., 1st Sess. 30 (1980).
140. Hardee v. United States, [1982] 2 U.S. Tax Cas. (CCH) ¶ 9459, at 84,658 (Ct. Cl. 1982).

illustrates the need for a final and uniform resolution of the problem, whether it be by judicial or legislative means.

ROGER A. ROYSE