Florida State University Law Review

Volume 9 | Issue 2

Spring 1981

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OF NO INTEREST: TRUTH, SUBSTANCE, AND BARGAIN BORROWING

JOSEPH W. JACOBS*

INTRODUCTION

The steeper the tax rate, the greater the incentive to avoid it. Algorithms for avoidance of a 4% sales tax will not keep bread on a tax lawyer's table.1 But where the tax rates soar to 84%, taxpayers become eager, sometimes obsessed, to find ways to keep more than their statutory 16%.

The sovereign, standing on the other side of the taxing transaction, finds steep rates of tax harder to enforce. For example, suppose King Arthur wishes to impose effectively an 84% tax on the "value of all horses in the realm." If the tax is to be effective, King Arthur must anticipate at least three schemes of avoidance. Some subjects will move their horses out of the jurisdiction on the day the tax is reckoned.2 Others will declare their horses to be of an unrealistically low value. Finally, some may take to painting stripes on their steeds and declare them to be zebras.3

Suppose, now, that just one of these schemes is effective to avoid Arthur's 84%. For example, Arthur's decree is interpreted by the courts to apply only to horses "physically living in the realm on April 15th." One might expect massive migration to the adjoining country on April 14th, followed by an equally massive return on April 16th. So long as the total cost of the temporary excursion was less than the tax sought to be imposed, we would expect most tax-savvy subjects to join in this charade. The 84% tax would then become nominal, or theoretical, for everyone in the realm would learn to structure his affairs so as to avoid it. Only one such "loop-hole" need exist for the bite of the tax to be eroded. Restated,

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1. When the amount of sales tax becomes significant, some tax planning may become useful. For example, on large consumer purchases, the local tax can often be avoided by going to a neighboring state and having the merchandise delivered back home.

2. Many unsuccessful attempts have been made to avoid property taxes by simply moving the property outside the jurisdiction on the eve of tax day. See New York ex rel. N.Y. Cent. & H.R.R.R. v. Miller, 202 U.S. 584, 597 (1906) ("[T]he state of origin remains the permanent situs of the property, notwithstanding its occasional excursions to foreign parts."); see also Brock & Co. v. Board of Supervisors, 65 P.2d 791 (Cal. 1937); City of Dallas v. Texas Prud. Ins. Co., 291 S.W.2d 693 (Tex. 1956); George F. Hazelwood Co. v. Pitsenbarger, 141 S.E.2d 314 (W. Va.), appeal dismissed, 382 U.S. 201 (1965).

3. This assumes, of course, that zebras are subject to a lower tax rate, or none at all.
Arthur must be constantly vigilant in plugging all loopholes as they arise if his tax is to be a real one.4

Returning to the twentieth century, we find that the Internal Revenue Code (the Code) in fact seeks to impose, in two steps, a tax reaching 84% on the profits realized by a corporation before they are consumed by the owner-shareholders. If a corporation (X) and its sole shareholder (A) are each in the highest applicable tax bracket, $10,000 of corporate profit is taxed like this:

\[
\begin{align*}
\$10,000 & \text{ business profit} \\
-4,600 & \text{ corporation's income tax (46%)^e} \\
\$5,400 & \text{ corporation's after-tax profit}
\end{align*}
\]

If this is distributed to A as a dividend, then:

\[
\begin{align*}
\$5,400 & \text{ dividend to } A \\
-3,780 & \text{ income tax on } A's \text{ dividend (70%)^e} \\
\$1,620 & 
\end{align*}
\]

The government gets a total of $8,380 (84%) while the owner-shareholder keeps only $1,620 (16%).

Predictably, taxpayers subject to this tax seek ways to avoid it. Predictably, the Internal Revenue Service (the Service) resists avoidance. Taxpayers might instinctively respond like King Arthur's subjects. If so, they find that it does no good to flee the country on April 15th,8 and that it is difficult to argue in earnest

4. If a second "loophole" opens, one would expect price competition between the two species of loopholes. Suppose, for example, a corrupt collection system, where a bribe of two gold pieces will result in the assessor's valuing the horse at 10% of fair market value. Citizens have three options: first, pay the tax; second, take the two day excursion; and third, pay two gold pieces plus 10% of the "real" tax bill. A rational taxpayer would choose whichever option minimized his out-of-pocket costs. The tour group operators would, in a perfect market, find that their "original" loophole could be packaged and sold for no more than two gold pieces plus 10% of the "real" tax.

In any event, the first loophole alone is sufficient to erode fully the tax, so long as the "tour package" cost was less than the "real" tax.

5. See I.R.C. § 11(b)(5). Corporate taxable income in excess of $100,000 is taxed at a 46% rate.

6. See I.R.C. § 1(a). Individual taxable income in excess of $215,400 (for married people filing joint returns) is taxed at a 70% rate.

7. Eighty-four percent is the high-water mark of the Code's ambition. Higher rates, such as the 100% tax imposed in § 507(c)(for organizations flagrantly abusing the tax-free private foundation status), are more akin to penalties than taxes.

8. The Code imposes a tax on the worldwide income of all U.S. citizens, wherever resident, on April 15th or any other day. A citizen must expatriate, and also avoid "residence" in the United States, if he is to avoid the U.S. income tax. Even expatriation is fraught with
that the value of a $5,400 dividend is anything but $5,400. They are left to seek ways to paint convincing stripes on the horse.

Stripe painting describes, albeit roughly, most popular schemes designed to avoid this 84% tax. Their common denominator is disguise. The dividend to the owner, the second of the two-steps, is masqueraded as something else, a “zebra” subject to a lower tax rate (or none at all). The most common forms of these “disguised” dividends are: payment of excessive salaries to employee/shareholders; transfers of property between corporation and shareholder at a price favoring the latter; direct corporate payment of shareholder expenses and obligations; and uncompensated use of corporate property by shareholders.

Rules have emerged facilitating the detection, valuation, and taxation of disguised dividends. The rules are by no means perfect. For example, a closely held corporation may successfully disguise some dividend income as additional compensation income paid to employees who are also shareholders. These schemes break down, however, under the weight of too much disguise. Yet it is precisely firms which are capable of generating “too much” dividend income, those which are highly prosperous and which share that prosperity with their owners, in which the tax rate reaches 84%.

All this leaves professional tax advisors in an uncomfortable peril, see I.R.C. § 877, and is in any event a remedy too extreme for most taxpayers, regardless of the depth of their hatred towards the Service.

9. Property dividends offer some hope of circumvention, but this depends on declaring the dividend property to be of an unrealistically low fair market value. See I.R.C. § 301(b)(1)(A). Taxpayer efforts here seem largely unsuccessful. See 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 9.18.

10. Section 301(c)(1) of the Code provides that a distribution by a corporation to its shareholders shall be included in the shareholders’ gross income, but only to the extent that the distribution is treated as a dividend under § 316(a). That section states that any distribution to shareholders is treated as a dividend, but only to the extent of the amount of the corporation’s current, or accumulated, earnings and profits. Earnings and profits, a term not defined in the Code, means roughly retained earnings.

If a distribution exceeds earnings and profits, § 301(c)(2) and (3) specify how the excess shall be treated: first, as a return of capital to the extent of the shareholder’s basis in his stock; and second, as capital gain, once basis has been reduced to zero.

It is assumed throughout this article, except where explicitly stated to the contrary, that all distributions are made from earnings and profits and will, therefore, be includible in the shareholder’s gross income as a dividend. This permits the use of the term “dividend” instead of the more cumbersome phrase “distribution to which section 301 applies.”

12. See 1 MERTENS, supra note 9, at § 9.22 and cases cited therein.
13. See id. at § 9.08 and cases cited therein.
The listed schemes of circumvention are extremely vulnerable to attack by the Service. Tax lawyers think of themselves as theoreticians, not cosmeticians. They yearn for a structurally sound method of avoiding the 84% tax.

They find it in the interest-free shareholder loan (IFSL). An IFSL is a presently invulnerable means of transferring corporate wealth to shareholders without the imposition of a shareholder level dividend tax. Even if an IFSL is detected and zealously pursued by the Service, the shareholder risks only his defense costs.

This article is about interest-free shareholder loans, the safest means of avoiding the stiffest tax rate in the Code. It begins with a close look at interest-free loans and a tentative method for quantifying their economic benefit. Part II argues that excluding the IFSL's economic benefit cannot be justified on traditional policy grounds. Part III reviews the case law mandating the exclusionary treatment and may be conveniently skipped by readers familiar with the subject. Finally, Part IV offers a simple proposal for taxing their economic benefit.

I. THE VALUE OF INTEREST-FREE BORROWING

That interest-free loans have some value is painfully obvious in days of high interest rates. If a consumer is offered the option of borrowing from either Lender A at 18% interest or Lender B at no interest, he has little difficulty in selecting his creditor. The value of bargain loans is recognized by the federal government, which has turned increasingly towards low- or no-interest loans as a mechanism for delivering federal subsidies. For the last two de-

15. Above all things, a tax attorney must be an indefatigable skeptic; he must discount everything he hears and reads. The market place abounds with unsound avoidance schemes which will not stand the test of objective analysis and litigation. The escaped tax, a favorite topic of conversation at the best clubs and the most sumptuous pleasure resorts, expands with repetition into fantastic legends. But clients want opinions with happy endings, and he smiles best who smiles last. It is wiser to state misgivings at the beginning than to have to acknowledge them ungracefully at the end. The tax adviser has, therefore, to spend a large part of his time advising against schemes of this character. I sometimes think that the most important word in his vocabulary is "No"; certainly he must frequently use this word most emphatically when it will be an unwelcome answer to a valuable client, and even when he knows that the client may shop for a more welcome answer in other offices which are more interested in pleasing clients than they are in rendering sound opinions.


16. See generally cases discussed in Part III infra.
decades subsidized housing legislation has relied heavily on the de-
vice of below-market-rate mortgage loans as the means for provid-
ing housing at below-market rents. Closer to the topic at hand, it
is becoming more widely recognized that tax shelter investments
are at bottom nothing but large interest-free loans from the gov-
ernment to the tax shelter participants. The price commanded
for the right to participate in these investments is strong evidence
of the intrinsic value of an interest-free loan.

The intuitive observation that interest-free loans have some ab-
stract value is a necessary, but not a sufficient, condition to sup-
port their inclusion in the borrower's gross income. If the interest-
free borrower is to be taxed, some dollar amount must be listed
somewhere on the borrower's Form 1040.

A. The Quantification of Value

A persuasive method for quantifying the economic benefit of an
IFSLS has been suggested in a massive article by Professors Joyce
and Del Cotto, and is illustrated in the following example. Bor-
rower (B) finds Lender (L) offering to lend $100,000 for ten years,
without interest. B accepts, and receives $100,000 cash in exchange
for his note promising to pay L $100,000 a decade hence. Now let
us suppose for the moment that there exists one, and only one,
interest rate at any given time which all lenders charge all bor-
rowers in arm's-length lending transactions. This assumption, of
course, is at variance with economic reality, for interest rates in
commercial transactions made on a given day vary depending upon
the creditworthiness of the borrower (if there is some doubt as to

17. See, e.g., Housing Act of 1961, Pub. L. No. 87-70, 75 Stat. 149 (1961); H. AARON,
18. "Tax postponement is equivalent to an unsecured, interest-free loan of indefinite
maturity made by the Treasury to the taxpayer." G. BREAK & J. PECHMAN, FEDERAL TAX
19. Joyce and Del Cotto, Interest-Free Loans: The Odyssey of a Misnomer, 35 TAX. L.

Odyssey begins at roughly the same starting point as does this article, but the paths soon
diverge. Odyssey gives great emphasis to the estate and gift tax consequences of intra-family
interest-free loans. This article largely ignores gratuitous transactions, and emphasizes the
income tax consequences of business-motivated IFSLS's.

The difference in paths involves more than fine pedagogical differences. The bottom line
results are exactly opposite. Odyssey, at 504-05, ultimately concludes that a demand IFSL
produces no adverse tax consequences to the borrower. See note 155, infra. This article
stresses that a demand IFSL produces dividend income to the borrower. See text accompa-
nying notes 137 to 170 infra.

20. This assumption is removed in Part IV.
his ability to repay, then the lender imposes a higher interest rate to compensate himself for the risk of repayment\textsuperscript{21} and on the term of the loan (under recent market conditions long-term loans are obtainable at an interest rate lower than that charged for short-term loans).\textsuperscript{22} But for the moment the point to be made requires a suspension of disbelief and the assumption that a single True Interest Rate (TIR) exists on a given day.

\textit{B} may now figure out how much money he must place in a passbook savings account today such that it will grow to $100,000 in ten years if all earned interest is accumulated. This, of course, depends on the TIR. The higher the TIR, the more interest his initial deposit will earn, and the less money is needed to reach the $100,000 goal. To illustrate, if the TIR is today 12.794\%, a deposit of only $30,000 today will grow to $100,000 in a decade.\textsuperscript{23}

By making this deposit, \textit{B} may fully fund his obligation to repay \textit{L}. Indeed, he might wash his hands of the affair by delivering the passbook to \textit{L} and authorizing him to present it for payment a decade hence.\textsuperscript{24} \textit{B} may now consume, without worry or obligation to repay, the remaining $70,000.

Viewed another way, \textit{L} could acquire a similar asset (someone's

\textsuperscript{21} [Bond] ratings are made by two major statistical organizations, Moody's and Standard & Poor's, and they have been accorded official recognition. The ratings designate the "intrinsic risks" which exist in a security, i.e., the degree of security of principal and the likelihood of prompt payment of interest over a term of years. Moody's Investors Service has 9 ratings running from the highest, Aaa, down to the lowest, C. Standard & Poor's has 11 ratings previously running from A1 down to D, and now from AAA down to D.

\textsuperscript{22} See, e.g., Wall St. J., Apr. 10, 1981, at 35, col. 2. Presumably this reflects the market's judgment that it is more likely than not that interest rates will fall in the future, so that the short-term rates now available will later be unavailable to investors.

\textsuperscript{23} If $30,000 were invested in a passbook savings account guaranteeing a 12.794\% annual rate of interest, the $30,000 deposit would grow to $100,000 in ten years if each year's interest is added to principal, and if the income tax imposed on the interest is disregarded. On an annual basis the account would grow thusly: $30,000; $33,838; $38,167; $43,051; $48,559; $54,772; $61,780; $69,684; $78,600; $88,657; $100,000. This ignores \textit{B}'s increased tax liability resulting from the interest income. See note 24, infra.

\textsuperscript{24} At least two problems arise. The first is the risk of the Bank's solvency a decade hence. \textit{B} remains primarily liable on his $100,000 note, and if for some reason the Bank failed to pay the $100,000 on maturity, \textit{B} would be called upon to do so. \textit{B} may minimize this risk by careful choice of obligors (or ultimately by the purchase of Treasury bills). A still skeptical \textit{B} could probably procure insurance against the event of the Bank's nonpayment. A second problem is that \textit{B} would, under the facts supposed, realize income each year in the amount of interest credited to his account, and would be forced to pay the resulting tax liability from his other assets. This might be avoided by purchasing a note issued by an individual satisfying the solvency considerations just raised. There is no original issue discount on notes issued by individuals. I.R.C. § 1232(a).
promise to pay $100,000, without interest, in ten years) for far less money than the $100,000 he paid for B's note. The discipline of finance tells us that under an assumed TIR of 12.794% "flat" notes maturing for $100,000 in ten years would sell for $30,000. Under the TIR assumption, all non-interest bearing notes — including B's — maturing for $100,000 in 10 years have a fair market value of $30,000.

Such "flat" notes seem to be enjoying a real world vogue on Wall Street. On April 23, 1981 J.C. Penney Co. issued "zero coupon" bonds, the first such public offering of non-interest bearing, long-term corporate obligations. Each bond promised to pay the holder a stated redemption price in 100 months, and nothing more. The issue price was approximately 33% of redemption price (a $1000 bond would sell for $330), for a yield to maturity of approximately 14.25%.

25. The discipline of finance holds that a promise to pay money in the future will have a market price equal to its "present value." For any interest-free obligation of a face amount F, its present value (and therefore its fair market value) will be:

\[
\text{Present Value} = \frac{F}{(1 + K)^N}
\]

where K is the discount rate expressed as a decimal, and N is the number of years until maturity.

Under the assumption of a TIR, the discount rate would necessarily be the TIR. Thus, the price of a 10 year, $100,000 note would be, at a TIR of 12.794%:

\[
\text{Present Value} = \frac{\$100,000}{(1 + 0.12794)^{10}} = \frac{\$100,000}{1.12794^{10}} = \frac{\$100,000}{3.333} = \$30,000
\]

The higher the TIR, the larger the denominator and, for any given N, the smaller the present value. In short, the higher the prevailing TIR, the lower the fair market value of B's note. See generally ALCHIAN & ALLEN, UNIVERSITY ECONOMICS 179-185 (3d ed. 1972) [hereinafter cited as ALCHIAN & ALLEN].


27. See, Wall St. J., Apr. 23, 1981, at 45, col. 2. The Penney zero-coupon bonds suggest a neat exploitation of the rules timing the borrower's deduction for interest. Under Code § 1232(b)(1), each bond contains original issue discount (OID) of $670, or $6.70 per month. The discount is deductible on a straight line basis by the issuer under Treas. Reg. § 1.163-4 (1971), while economically the interest expense accrues exponentially over the 8½ year
This conclusion might be drawn: the loan transaction between \( L \) and \( B \) is not what it first appeared to be, but is instead a loan of $30,000. The transfer of the other $70,000 from \( L \) to \( B \) is something else — maybe a gift, or a bribe, or a dividend. Whatever its identity, this "side payment" of $70,000 is connected only cosmetically, and not integrally, with the loan. Indeed, it is no more a part of the loan transaction than the quarter left by the tooth fairy is a consideration paid for the acquisition of a molar. Loans are like lunches: there is no such thing as a free one.

B. Discretionary vs. Compulsory Fragmentation

The last paragraph suggested one possible way of looking at the transaction between \( B \) and \( L \). It is now argued that courts should take this view of bargain loan transactions.

One apparent impediment to the suggested treatment is this well-established rule of law: Borrowing is not a taxable event. \(^2^8\) Restated, when \( A \) borrows $10,000 from the Zed National Bank (\( Z \)), \( A \) does not realize gross income of $10,000. Notwithstanding \( A \)'s enhanced purchasing power, and notwithstanding the fact that these $10,000 mix fungibly with taxable salary and investment dollars in \( A \)'s checking account, the law focuses on the fact that \( A \) has incurred an obligation to repay $10,000 in concluding that he has not enjoyed any real "accession to wealth." \(^2^9\) The act of borrowing might give rise to later tax consequences. If \( A \) uses the $10,000 to buy stock which he later sells for $15,000, his $5,000 profit is inter-

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\(^2^8\) Penney gets $330 today for its promise to pay $1,000 in 100 months. The market yield is 14.25\%. Economically, $330 times 14.25\% (= $47) of interest obligation accrues in year one. Penney's current deduction, however, is 12 x $6.70 = $80.

The Penney bondholder realizes $6.70 per month ($80 per year) of gross income under Code § 1232(a)(3)(A) despite the fact that the holder receives no cash until 1989. One assumes that pension funds and other tax exempt persons would be the most prominent purchasers of the Penney bonds.


Practical, not conceptual, difficulties prevent a contrary approach. If loans were gross income (and a corresponding deduction were allowed in the year of repayment), lenders would be forced to "gross up" the loan proceeds. To illustrate, if \( A \) were in the 50\% tax bracket and needed $10,000, then he must make provision for the $5,000 tax on his $10,000 of gross income. If he borrows this $5,000, then he would owe an additional $2,500. If he is to borrow an amount sufficient to pay his tax bill and leave $10,000, he must borrow $20,000. See also Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929); I.R.C. § 902.

Presumably this would make borrowing much more expensive. Moreover, such a rule could be manipulated by taxpayers with fluctuating incomes borrowing in loss years and repaying in good years. This would produce de facto income averaging in contravention of the specific (and limited) rules contained in I.R.C. §§ 1301-4. Although it is by no means clear that these two results are undesirable, it is clear that the proposal is revolutionary.
cluded in his gross income. And if A is released from his obligation to repay for a consideration less than $10,000 (Z, for example, might release A for $5,000 if A is in financial peril and an attempt to enforce payment of $10,000 would not be wholly successful), then A might be charged with discharge of indebtedness income in the year of settlement.\footnote{30}

It is not suggested that the no-income-from-borrowing rule be ignored or suspended. To the extent the transaction between L and B is economically a loan (and not a side payment), the no-income-from-borrowing rule prevails. It is here that an analogy from the compensation area is helpful.

\section*{C. LoBue's Rule of Fragmentation}

Another well-established tax rule is that the purchase of property is not a taxable event. When the careful antique shopper buys a Louis XIV commode from a seller ignorant of its value, he does not recognize gross income in the amount by which the commode's value exceeds its purchase price.\footnote{31} This result is tolerable because the shopper will be taxed on the bargain element (and any post-acquisition appreciation) when he sells or otherwise disposes of the commode, for his basis in the commode is his cost, not its fair market value.\footnote{32}

This basic rule is partially displaced when the seller turns out to be the employer of the purchaser. The leading case is \textit{Commissioner v. LoBue}.\footnote{33} The taxpayer, LoBue, was permitted, through the exercise of an option, to purchase stock of his employer for $1,700 when the fair market value of the stock was $9,930.\footnote{34} The basic question was whether LoBue realized $8,230 of compensation income (the spread between fair market value and purchase price) in the year of purchase.

\begin{itemize}
  \item \textit{I.R.C. § 1012}. To illustrate, Shopper buys commode for $1,000. Its fair market value is $10,000. Not taxing the buyer now is tolerable because when he sells for, say, $12,000, his gain will be $11,000 ($12,000-$1,000 cost). \textit{I.R.C. § 1001(a).}
  \item \textit{351 U.S. 243 (1956).}
  \item \textit{351 U.S. at 245.}
\end{itemize}
The Tax Court (the trial court in *LoBue*)\(^8\) had frequently considered the question of gain upon the exercise of employee stock options. A peculiar test had emerged, turning on the "intention" of the employer when it originally granted the option. If the employer intended to grant the employee a proprietary interest — giving him a piece of the rock with a view to obtaining the loyalty of a co-owner — then the exercise of the option produced no gain. But if the employer intended to compensate the employee, the latter realized income in the amount of the bargain spread when he exercised the option.\(^8\)

Soon after this test was announced, lawyers began drafting stock option plans with elaborate recitations of the employer's intention to grant a proprietary interest in the firm. A brisk traffic in tax avoidance on compensation income emerged. While it is true that the employee would eventually pay tax on the bargain element,\(^7\) he could both defer payment of the tax until he sold the stock and then report his eventual profit as long-term capital gain.\(^5\)

When the Tax Court was presented with *LoBue*’s case, it dutifully looked to the intention of the employer, found it to be proprietary and not compensatory, and held that the $8,230 bargain was not income to *LoBue*. It admitted to some discomfort with its own test: "[I]n practically all such cases as the one before us, both the element of additional compensation and the granting of a proprietary interest are present."\(^39\) The Third Circuit, applying a clearly erroneous standard, affirmed.\(^40\)

The Supreme Court reversed in an opinion by Mr. Justice Black, holding that the $8,230 spread was includible in *LoBue*’s gross income. He reasoned:

1. The Code, through its definition of gross income,\(^41\) seeks to "Tax all gains except those specifically exempted."\(^42\)

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36. This "proprietary stock option rule," and its companion "compensatory stock option rule," were established in Geeseman v. Commissioner, 38 B.T.A. 258 (1938). It flourished until the Supreme Court's decision in *LoBue*.
37. *See supra* note 32.
38. Section 1202 of the Code allows the taxpayer to deduct 60% of net capital gain from his gross income.
39. 22 T.C. at 445.
41. The definition of gross income was then contained in § 22(a) of the 1939 Code. The current definition is contained in I.R.C. § 61.
42. 351 U.S. at 246 (*quoting* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-30 (1955)).
2. The only arguable exemption is that of a gift, but to call such a commercial transaction a gift strains credulity. Therefore, 3. "Since the employer's transfer of its stock to its employee Lo-Bue for much less that the stock's value was not a gift, it seems impossible to say that it was not compensation."43

When it was objected that this holding upset years of settled case law and ignored the proprietary stock option doctrine, Mr. Justice Black responded simply and elegantly: "In our view there is no statutory basis for the test established by the courts below."44 Re-stated, the Supreme Court will correct long-standing misapplications of the Code without doing violence to the idea of stare decisis.45

The fundamental rule, no-income-from-the-purchase-of-property, is undisturbed by LoBue. The Court holds that LoBue bought $1,700 worth of stock for $1,700. But in addition, he received $8,230 worth of stock as compensation, in recognition of his value as an employee. ("It makes no difference that the compensation is paid in stock rather than in money.")46 LoBue treated the transaction as if it were just a purchase of stock. Mr. Justice Black, attuned to the incestuous potential of employer-employee transactions, comminutes,47 or breaks apart, the formally unitary transac-

43. 351 U.S. at 247.
44. Id.
45. See Helvering v. Hallock, 309 U.S. 106 (1940). Mr. Justice Frankfurter there stated:

We recognize that stare decisis embodies an important social policy. It represents an element of continuity in law, and is rooted in the psychologic need to satisfy reasonable expectations. But stare decisis is a principle of policy and not a mechanical formula of adherence to the latest decision, however recent and questionable, when such adherence involves collision with a prior doctrine more embracing in its scope, intrinsically sounder, and verified by experience.

. . . .

. . . . But certainly such inaction by the Treasury can hardly operate as a controlling administrative practice, through acquiescence, tantamount to an estoppel barring reexamination by this Court of distinctions which it had drawn. . . . Various considerations of parliamentary tactics and strategy must be suggested as reasons for the inaction of the Treasury and of Congress, but they would only be sufficient to indicate that we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.

This Court, unlike the House of Lords, . . . has from the beginning rejected a doctrine of disability at self-correction.

Id. at 119-21 (footnotes omitted).

46. 351 U.S. at 247.

47. This descriptive, if rare, word enters tax law in Learned Hand's famous opinion in Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945), "We have to decide only whether upon the sale of a going business . . . [the purchase price] is to be comminuted into its fragments." 152 F.2d at 572.
tion into its two component parts: a purchase of stock and a compensatory side payment.

D. LoBue's More General Rule

From LoBue we may extract a more general rule for handling incestuous property dealings, that is, transfers of property between related parties. The parties to an incestuous transfer have no incentive to set the formal transfer price at fair market value. The law must in these circumstances:

1. Determine the fair market value of the property being transferred.
2. Compare that value with the consideration being paid (generally the dollar amount flowing from one party to the other).
3. If the value of the property exceeds the cash consideration, then only that portion of the property's value equal to the cash changing hands is being purchased. The remainder of the property is a side payment made in kind. Its existence must be explained by looking beyond the terms of the property transfer to the relationship of the parties.
4. If the cash consideration exceeds the value of the property, then so much of the cash as equals the property's value is paid to acquire the property. The excess is a side payment, and its existence must be explained by looking beyond the terms of the property transfer to the relationship between the parties.

Paragraph 3 is, of course, the generalization describing the result in LoBue. Paragraph 4 is the companion, symmetrical generalization, not articulated in LoBue because the facts did not require it, which should be applied to IFSL's.

Note that the Supreme Court holds that this comminution is required by the broad language of section 61. If an heretical practice (such as the proprietary stock option doctrine) has developed in the lower courts in contravention of this mandatory comminution approach, it is the duty of appellate courts to suppress the heresy. Restated, it is not a job for the legislature, for the legislature has said all that need be said by enacting section 61.48

48. This is not to say that the legislature may not act. It obviously may amend the Internal Revenue Code or even repeal it. Compare, I.R.C. §§ 482 and 483, discussed infra note 90. It is suggested only that there is a co-extensive power in the appellate courts, especially in the Supreme Court, and in Congress to effect the advocated changes. See, Mr. Justice Frankfurter's opinion in Helvering v. Hallock, 309 U.S. 106 (1940), supra, note 45.

It would seem, however, that even though both branches of government share the power...
E. Rethinking Bargain Loans

Applying the rule generalized from LoBue requires that we com- minate the bargain loan into the "real" loan transaction and the side payment.49 The property in question is the borrower's note; the consideration is the amount of the loan proceeds.50 Returning to \( L \) and \( B \), the first question is the value of \( B \)'s note promising to pay \( L \$100,000 \) in a decade. This was shown to be \( $30,000 \) if the TIR is 12.794%. Next, we compare this to the cash consideration changing hands — \$100,000, the amount which \( B \) transfers to \( L \) in exchange for his note. Applying Step 4, the cash exceeds the property's value by \$70,000. That is the side payment.

The structural similarity between LoBue and the IFSL transac- tion is illustrated in Figure 1. The \( \text{LoBue} \) transaction is mapped in the top pair of diagrams, with \( Ee \) designating LoBue the employee and \( Er \) designating his employer. The bottom pair maps the \$100,000, 10-year, 12.794% IFSL transaction just described.

to make these structural adjustments to the tax laws, the courts are in a better position to do so. Legislative intervention in this area would involve political considerations perhaps not well suited to the resolution of highly technical questions of tax structure.

49. Odyssey, supra note 19, at 462-69, arrives at this point by seeking to accomplish the commination under imputation of interest principles analogous to those found in Code § 483: "The main burden of this portion of the article will be to state the position that the theory of section 483 should be used to implement the [commination] analysis . . . ." Odyssey at 462. This article argues that the imputation of interest is both unnecessary and mis- leading. See note 51 and accompanying text, infra..

50. It is perhaps strange to think of the borrower's note as "property." A borrower about to acquire other property (here cash) in exchange for his promissory note is in a position analogous to that of the corporate employer in LoBue. The consideration paid in \( \text{LoBue} \) to acquire the benefit of LoBue's services was stock of the employer, which has no value in the hands of the issuer-employer. Similarly a promissory note has no real value in the hands of a borrower prior to its issuance. There is no doubt, however, that both the note issued by the borrower and the stock issued by the employer have value, and are property, in the hands of the transferee. This issue is discussed again in note 141, infra.
It must be stressed that this comminution analysis does not involve the imputation of interest on B's note. It does not attempt to describe what would happen if the loan bore an arm's-length interest rate. Instead, it simply reflects the reality that a "flat" note has a value less than its face amount and then acknowledges that the flow of consideration in excess of value must be explained by looking at factors external to the loan transaction — specifically, to the identity of the parties.

It is useful now to leave the assumed numbers (10-year term and 12.794% TIR), and see how comminution works for other terms.
and TIR's. The admixture of real loan and side payment depends on two things: the term of the loan \((N)\) and the TIR. We know that the loan amount and the side payment added together produces the dollars changing hands:

\[
L + SP = \text{Dollars}
\]

\(L\), the fair market value of B's note, is:

\[
L = \text{Fair Market Value} = \frac{\text{Dollar Amount}}{(1 + \text{TIR})^N}
\]

The effect of changing the two variables, \(N\) and TIR, is best displayed graphically. First the mixture of loan and side payment at the assumed TIR of 12.794%, over different values of \(N\):

**FIGURE 2**
Mixture of Loan and Side Payment for $100,000 IFSL of N-Year term 
(TIR = 12.794 percent)
Shaded portion = Loan

The shaded area indicates the portion which is the loan amount; the white portion indicates the side payment. For any assumed term of the loan \((N)\), simply draw a line up to the curve, and then back over to the vertical axis. As shown, a five-year loan is 55% loan and 45% side payment. A fifteen-year loan is only 16% loan. The remaining 84% is side payment.

The next graph holds the term constant at 10 years and shows the different admixtures resulting from changes in the assumed TIR:
The lower the TIR, the greater the proportion of loan to side payment.

As a general rule, then, the longer the term, or the higher the TIR, or both, the more pronounced is the side payment. Indeed, at high values for $N$ or TIR, the loan component becomes trivial, the tail wagging the dog of the side payment. This makes a certain intuitive sense: How much would you, the reader, be willing to pay now for the right to get $100,000 in 2001?

Finally, notice that this compulsory comminution rule does not characterize the side payment. To do so we must examine the relationship between $B$ and $L$. The following table becomes useful:

<table>
<thead>
<tr>
<th>Nature of Relationship Between B &amp; L</th>
<th>Probable Identity of Side Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Father-Child</td>
<td>Gift(^{52})</td>
</tr>
<tr>
<td>Employer-Employee</td>
<td>Compensation(^{54})</td>
</tr>
<tr>
<td>Government Contractor-Bureaucrat</td>
<td>Bribe(^{55})</td>
</tr>
<tr>
<td>Corporation-Dominant Shareholder</td>
<td>Dividend.(^{56})</td>
</tr>
</tbody>
</table>

52. The right-hand column is intuitive. Experience suggests these as the most likely explanations (although in some cases it might be shown to be otherwise). Recall that Justice Black resorted to intuition and commonsense in maintaining that "[i]t seems impossible to say that it was not compensation." 351 U.S. at 247.
56. See Part III, infra.
F. The Logical Consequents — The Other Shoe Drops

Having comminuted the earlier property acquisition transaction, one must be careful to remember this fact when the property is sold. Consider first LoBue. The court held that he bought some stock for $1,700, and received $8,230 worth of stock as compensation. Since his receipt of the compensatory stock was included in gross income, he gets a "tax cost basis" in these shares equal to their fair market value. He gets a $1,700 basis in the stock he bought. The two bases together total $9,930, the fair market value of all the shares on the date of their acquisition. If LoBue later sells all the stock for $12,000, his gain will be $2,070 ($12,000 less basis of $9,930). In the absence of earlier comminution his gain would be $10,300 ($12,000 sales proceeds less pure cost basis of $1,700).

A similar adjustment must be made if the bargain loan transaction is comminuted. Returning to $L$ and $B$, the loan amount is $30,000; the other $70,000 is a side payment to be characterized in accordance with the relationship between $L$ and $B$. $B$, of course, is called upon to repay $100,000 even though he borrowed only $30,000. This additional $70,000 is simply interest accrued for ten years, at the TIR, on his $30,000 loan (remember that $B$ pays no interest during the loan term). $B$ then receives a $70,000 interest deduction when he repays the loan at maturity, and $L$ receives that much interest income at the same time. Notice that the amount of $B$'s eventual interest deduction ($70,000) in the year of repayment is the same as the amount of the side payment in the year of borrowing. If $B$ remains in a constant tax bracket of, say, 50%, then he should pay a tax of $35,000 on the $70,000 side payment and realize a tax savings of $35,000 a decade hence when he pays $70,000 of interest. Economically, he is forced to make an interest-free loan to the government!

58. See I.R.C. § 1001.
59. See supra note 23.
60. I.R.C. § 163(a). It is assumed that both $L$ and $B$ use the cash basis of accounting.
61. I.R.C. § 61(a)(4). A more complex way to account for the interest is to characterize the $70,000 difference as original issue discount and give a deduction to $B$ (and charge income to $L$) at the rate of $7,000 per year. This would happen if $B$, the borrower, were a corporation. See I.R.C. § 1232(a).
II. POLICY CONSIDERATIONS

Justice Black's statement, quoted earlier,62 concerning Congress' desire to tax all economic benefits except those specifically excluded, is a theme often sounded in Supreme Court tax cases.63 If some economic benefit escapes tax, it must be because of either a specific statutory mandate or some Other Compelling Reason. The Code does not provide for the exclusion of IFSL's; the fact of their exclusion must be based on some other compelling reason.

The Tax Court has found that the tax treatment of IFSL's is "somewhat akin"64 to the exclusion of certain fringe benefits. These, too, are examples of economic benefits which escape taxation in apparent defiance of the Supreme Court's mandate of inclusion. An IFSL is not, strictly speaking, a fringe benefit, for this term describes compensatory benefits. An IFSL is, by definition, received by a shareholder as an incident of his investment activities, not his labor. Since there is no body of law governing fringe benefits ancillary to income derived from capital,65 the analogy suggested by the Tax Court seems a useful starting point in the search for the other compelling reason.

It has long been observed that certain fringe benefits realized by employees escape taxation.66 The department store employee who receives a 20% "courtesy discount" realizes no gross income when he purchases merchandise at a discount notwithstanding the obvious parallel to LoBue.67 Nor is the airline employee taxed when he flies for free.68 Considerable intellectual effort has gone into explaining these results in terms of the underlying policies of the law.

The intellectual effort is nowhere more apparent than in an un-

62. See supra note 42 and accompanying text.
64. Zager v. Commissioner, 72 T.C. 1009, 1013 (1979), appeal pending (6th Cir.).
65. Probably because the IFSL is the only significant example of this category. Compare, "free" toasters for depositing $500 in a savings account.
67. Id. at ¶ 65,668. Cf. Discussion of Proposed Regulations on Fringe Benefits, [1980] STAND. FED. TAX REP. (CCH), ¶ 8991 at 77,844 [hereinafter cited as 1981 Discussion] (Proposed § 1.61-19(b)(1) would exclude these discounts only if: (1) They are available to all employees. (2) Prices paid cover employer's costs. (3) Total purchases don't exceed a certain amount.).
68. 1975 Discussion, supra note 66, at ¶ 65,668. Cf. 1981 Discussion, supra note 67, at ¶ 77,840 (The value of the ticket minus the price paid is includable in gross income. Proposed § 1.61-17(d), example 1.)
usual discussion draft of proposed regulations on fringe benefits issued by the Treasury in 1975. After candidly noting the disparity between pronouncement and practice, the preface proposes that:

The statutory language (of section 61) should be viewed . . . as broad authorization to reach such items as may be appropriate, in the context of our overall system. It is clearly broad enough to encompass almost any economic benefit, but it is equally clear that it has not been construed to do so.

The preface continues to articulate several policy considerations to be applied in determining whether a particular fringe benefit should be taxed or not.

A prominent policy factor is equity among taxpayers. "If all taxpayers had fringe benefits or other benefits in kind and those benefits were roughly in proportion to their other income, then the uniform exclusion of all such benefits from tax would be as equitable as tax matters are likely ever to be . . . ." Free employee airline travel and merchandise discounts are cited as the kinds of benefits which may equitably be excluded from section 61's broad sweep. This policy would tend to demand taxation of the IFSL's benefit. The reported cases, as one would expect, suggest that such loans are made only to dominant shareholders. There is no hint that the bookkeepers and laborers are customarily given the opportunity to join the boss in borrowing without interest.

A second prominent factor in the Treasury's preface concerns valuation problems. Many fringe benefits are very difficult to value, and for that reason alone exclusion is warranted. "What is the value to a stewardess of riding in an otherwise empty seat?" As will be shown in Part IV of this article, it is a relatively simple exercise to measure the benefit conferred by bargain borrowing. The exclusion of IFSL's may not be justified on this ground.

Of the six listed policy considerations, the law's present treat-
ment of IFSL's is supported only by the notion of continuity of practice.\textsuperscript{74} This is a slender thread indeed upon which to base the continued exclusion of IFSL's from the broad sweep of section 61. To recapitulate the ground thus far covered:

-- IFSL's confer an economic benefit.
-- Under idealized conditions (an assumed TIR and a certain term) this benefit may be quantified and thereby introduced onto Form 1040.
-- The benefit is available only to a small segment of society, those who are dominant shareholders in prosperous concerns. (Only such firms having surplus cash to lend are in a position to make IFSL's.)
-- The benefit is excluded from gross income, notwithstanding the absence of either express authorization or strong policy justifications.
-- The exclusion permits circumvention by the prosperous of the 84% tax on a shareholder's consumption of his firm's business profits. And since it is only the prosperous who are subject to this highest of tax rates, this rule of exclusion must seriously erode the statutory mandate of an 84% tax.

We next turn to the case law in search of the missing other compelling reason for the existence of this perplexing state of affairs.

\section*{III. The Case Law}

\textbf{A. The Early Authority — Dean's Seductive Analogy}

The Commissioner's first reported attack on the federal income tax consequences of the IFSL surfaced in 1961, in the celebrated opinion of \textit{Dean v. Commissioner}.\textsuperscript{75} The stakes were high, for the

\textsuperscript{74} The 1975 Discussion listed six policy considerations which were to be taken into account when determining which economic benefits were to be taxed: (1) Present practices in general are codified. (2) Equity among taxpayers. (3) Valuation problems. (4) Statutory authority is broad but not mandatorily all-encompassing. (5) Withholding considerations. (6) Retroactivity. 1975 Discussion, \textit{supra} note 66, at ¶ 65,668.3-.5. The first three considerations have been discussed in the text, with only continuity of practice supporting the present treatment of IFSL's. See \textit{supra} notes 71-73 and accompanying text. Of the remaining considerations, the magnitude of these IFSL transactions and the resulting taxes can easily offset any practical difficulties associated with imposing these taxes. Reporting requirements, similar to those now in effect for dividend distributions, can remedy any collection difficulties associated with the inability to collect through a withholding mechanism. And, as has already been discussed, retroactivity, like stare decisis, "is a principle of policy and not a mechanical formula of adherence." \textit{Hallock, supra} note 45, at 119.

\textsuperscript{75} 35 T.C. 1083 (1961), \textit{appeal dismissed per stipulation} [1980] \textit{STAND. FED. TAX REP. (CCH)} ¶ 90,735.
taxpayers were duPonts and the deficiency exceeded $100,000 for each of the two years in question. Briefly, Paulina duPont Dean organized Nemours Corporation in 1924, receiving all its stock in exchange for a variety of investment assets she conveyed to Nemours. Her husband, J. Simpson Dean, later became a 20% Nemours shareholder. Beginning in 1929 and continuing through the years in issue, 1955 and 1956, the Deans established a pattern of drawing interest-free loans from Nemours, always evidencing their indebtedness with promissory notes payable upon Nemours' demand. By 1955 their total combined borrowing from Nemours totaled some $2.05 million; in 1956 this figure swelled to some $2.66 million.

The Commissioner argued that the loans produced income to the Deans. He cited the well-established rule that uncompensated use by a shareholder of corporate property results in constructive dividend income measured by the fair rental value of the property for the term of the shareholder's use. For example, if X Co. owns a house in which it permits A, its shareholder, to live rent-free, then A is deemed to receive dividend income in the amount which he would have paid as rent to an unrelated owner in an arm's-length leasing situation.

Money, continued the argument, is corporate property, just like houses, cars, yachts, and hunting lodges. An interest-free loan gives the shareholder use of the money without charging him "rent" in the form of interest. Thus, the Deans should be charged with constructive dividend income equal to the "fair rental value" of the $2 million-plus used by them in 1955 and 1956. This fair rental value was stipulated to be the then 3-to-4% prime interest rate.

The Tax Court, at the Deans' urging, distinguished the rent-free cases as follows:

In each of [the rent-free cases] a benefit was conferred upon the stockholder or officer in circumstances such that had the stock-

76. Id. The deficiencies—the Commissioner's formal determination of a tax owed in addition to that reported in a taxpayer's return—were later reduced as a result of the parties' stipulation of the controlling interest rate. Id. at 1087.
78. Id. at 585-86.
79. 35 T.C. at 1083. The numbers used here, and throughout this article, are generally rounded-off to three significant figures.
80. Id. at 1089.
82. 35 T.C. at 1088.
holder or officer undertaken to procure the same benefit by an expenditure of money such expenditure would not have been deductible by him. Here, on the other hand, had petitioners borrowed the funds in question on interest-bearing notes, their payment of interest would have been fully deductible by them under section 163, I.R.C. 1954. Not only would they not be charged with the additional income in controversy herein, but they would have a deduction equal to that very amount.88

Restated, interest is always deductible while rent (if paid for personal, as distinguished from business, purposes) is not.84 From this observation, and without further explanation, the court concluded broadly that "an interest-free loan results in no taxable gain to the borrower."85

The court, before reaching its conclusion, might profitably have explored another ramification of its hypothetical interest-bearing note. If the Deans had borrowed $2 million at 4% interest, they would have been obligated to pay $80,000 of interest each year. True, they would then receive no income as a result of their borrowing (although Nemours would),86 and true they would receive an interest expense deduction of $80,000 under section 163 of the Code. But they would — and this the court fails to mention — be out-of-pocket the $80,000 paid to Nemours, less the amount of taxes saved by getting an $80,000 interest deduction.

To illustrate, if the Deans were in the 70% tax bracket, then their annual out-of-pocket cost of arm’s-length loan would be:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 80,000</td>
<td>Interest paid to Nemours (4% of $2 million)</td>
</tr>
<tr>
<td>- 56,000</td>
<td>Value of an $80,000 deduction to a 70% taxpayer</td>
</tr>
<tr>
<td>$ 24,000</td>
<td>Net Annual Loan Expense</td>
</tr>
</tbody>
</table>

Under the interest-free loan, the Deans have no annual loan expense. They are ahead by $24,000.

Had the court focused on this ramification, the next question would have been: Now what? Charge the Deans with gross income of $24,000? Or, if the point of the exercise were to simulate the Deans’ after-tax “bottom line” in an arm’s-length loan, charge them with just enough income to increase their tax bill by $24,000?87

83. *Id.* at 1090.
84. Compare I.R.C. § 163(a) with I.R.C. § 262.
85. 35 T.C. at 1090 (footnote omitted).
86. See I.R.C. § 61(a)(4).
87. This would require “grossing up.” To achieve a $24,000 tax increase for a taxpayer in
But these are things the court might have done. What it did was to invoke a flawed analogy to justify its holding that an interest-free loan results in no taxable gain to the borrower. The flawed analogy was the only explanation given, and we are set to wondering whether the flaw in the premise infects the validity of the court's conclusion.

B. The 1979 Cases

The Commissioner waffled after losing Dean. An appeal was taken to the Third Circuit, but a year later that was dismissed by stipulation of the parties.88 Thirteen years after the opinion was published, the Commissioner first announced his nonacquiescence.89 During the intervening years Congress passed legislation imputing interest in certain kinds of transactions, but bargain loan transactions were unaffected.90 In the meantime Dean had taken root as good law.

But not without controversy: Many commentators criticized the

the 70% bracket, taxable income must be increased by the formula:

\[
\text{Increase} = \frac{\text{Tax}}{0.70}
\]

\[
= \frac{24,000}{0.70} = 34,286
\]

See also note 29 supra.

88. See supra note 75.


90. Section 483 of the Code was enacted February 26, 1964. Pub. L. No. 88-272, § 224. This section governs deferred-payment sales of property, where the deferred payments contain either no provision for interest or interest at a below-normal rate. The "safe harbor" rate, the minimum interest rate which must be charged on deferred payments to avoid § 483, is adjusted from time to time by the Secretary of the Treasury. It is currently 6%. Proposed Treasury Regulation § 1.483-1(c)(2)(C) will, if adopted in final form, increase this rate to 10% for sales occurring after September 29, 1980. 45 Fed. Reg. 57,739, 57,740 (1980).

If less than the safe harbor rate is specified by the parties to a deferred sales contract, § 483 operates to recast a portion of the payments as interest. See generally, S. Rep. No. 830, 88th Cong., 2d Sess., reprinted in 1964-1 (Part 2) C.B. 505, 605-08. The legislation did not encompass bargain borrowing, although it easily could have. The Committee Reports contain no suggestion that this was even contemplated.

The other Code Section which might apply to recast bargain loans on an arm's length basis is § 482. This section applies to impute an arm's-length interest rate, Treas. Reg. § 1.482-2(a)(1976), but only if the loan is between "two or more organizations, trades, or businesses . . . owned or controlled . . . by the same interests." I.R.C. § 482. The common control requirement is apparently not satisfied when the two "units" are an individual shareholder and his controlled corporation. See B. Bittker & J. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, at ¶ 15.06, pp. 15-20. For the view that § 483 principles should govern IFSL's, see Odyssey, supra note 19.
decision\textsuperscript{91}; others embraced it and recommended exploitation of

\textsuperscript{91} Both the concurring and dissenting opinions in \textit{Dean} expressed concern with the majority's conclusion that the "payment of interest would have been fully deductible." \textit{Dean} at 1090. Both judges felt that this was an overgeneralization and both cited Code § 265, which excludes from deductibility interest on indebtedness incurred to carry obligations which pay tax-exempt interest, as an example of exceptions to the "wash" rule. See also Duhl & Fine, \textit{Interest-Free Loans and the Tax Court: Is Dean Weakening Under IRS Attacks?}, 51 J. Tax 322 (1979); Keller, \textit{The Tax Consequences of Interest-Free Loans from Corporations to Shareholders and from Employers to Employees}, 19 B.C.L. Rev. 231 (1978); \textit{Tax Consequences of an Interest Free Loan}, 24 Loy. L. Rev. 33, 47 n. 76 (1978). But advancing these no wash situations as exceptions to the basic rule is a mistake. The recognition of exceptions requires the tacit admission that the rule itself is valid. The purpose of this article is to show that there should be no such rule. Discussion of possible uses of the interest-free funds and deductions the borrower may become entitled to merely cloud the basic issue: The beneficiary of an interest-free loan receives an economic benefit. This benefit should be taxed.

Even assuming that the discussion of the § 265 nonwash is germane, the occurrence of this situation is unlikely. Only the most daring of taxpayers would enter into a transaction so clearly at cross purposes with § 265.

A more subtle, yet probably more pervasive failure to wash results when § 1348's "maxi-tax" provisions come into play. If the recipient of the interest-free loan has compensation income high enough to avail himself of the benefits of the 50\% maximum tax on personal services income, then as a general matter the inclusion-deduction approach will produce a higher tax bill.

This results from the allocation mechanics of § 1348. Assume an individual has both substantial personal service income (salary), which is subject to the 50\% maximum marginal tax rate, and also substantial other income, subject to the 70\% maximum marginal tax rate. His itemized deductions are charged against personal service income (and therefore not against the other income) by a ratio of personal service income to adjusted gross income. I.R.C. § 1348(b)(2)(A). This allocation produces the failure to wash.

To illustrate, assume a married individual has $300,000 of personal service income (salary) and $300,000 of dividend income. In addition, he has received substantial interest-free shareholder loans from his closely-held corporation, which would produce an additional $100,000 of constructive dividend income each year were the Commissioner's position in \textit{Dean} inflicted upon him. He has $100,000 of excess itemized deductions. Assuming his adjusted gross income to be $600,000, half or the excess itemized deductions are deducted from his personal service income in arriving at personal service taxable income, the thing which is subject to the maxi-tax. The other half reduces his dividend (other) income to $250,000, all of which will be taxed at a 70\% marginal rate. All but the first $60,000 of his salary will be taxed at a flat 50\% rate. Ignoring the lower bracket relief, his tax is:

\begin{align*}
50\% \times (300,000 - 50,000) &= 125,000 \\
70\% \times (300,000 - 50,000) &= 175,000 \\
\hline &= 300,000
\end{align*}

If he is now charged with $100,000 of constructive dividend income and given an "offsetting" interest deduction under § 163, everything changes. The critical ratio for allocating deductions becomes $300,000 (personal service income) to $700,000 (adjusted gross income, now reflecting the addition of $100,000 of dividend income). His tax, again ignoring the lower brackets, is:

\begin{align*}
50\% \times (300,000 - 86,000) &= 107,000 \\
70\% \times (400,000 - 114,000) &= 200,000 \\
\hline &= 307,000
\end{align*}
the interest-free loan as a device to avoid income and gift taxes.92 The Commissioner still levied an occasional attack, but was answered with Tax Court Memorandum decisions finding the controversy controlled by Dean.93 Then, beginning in late 1979, a half-dozen cases appeared in rapid succession.94 Most simply affirm Dean, but two, Greenspun v. Commissioner and Creel v. Commissioner merit separate attention.

The first case came from Las Vegas.95 The borrower was Herman Greenspun, a Las Vegas newspaper/television magnate, who needed cash to replace printing presses destroyed in an uninsured fire. The lender was Hughes Tool Company (Toolco), the corporate entity which Howard Hughes used to purchase, as the court put it, "friendly press coverage"96 on the occasion of his celebrated 1966 move to Las Vegas.

The $4 million loan amount was agreed upon quickly; the repayment provisions and the interest rate were the product of extended negotiations. After the Hughes people rejected an interest-free loan because "the Internal Revenue Service might . . . question the transaction,"97 the parties agreed to a 3% interest rate, half of the 6% rate which the court found a bank would have charged.

The change in tax liability here is more subtle than in the § 265 example. There the failure to wash resulted from a supposed failure of deductibility of the constructive interest payment. Here, the deduction is allowed, but the effect is to change the marginal tax rate on a certain tranche of income from 50 to 70%.


96. Id. at 934. Greenspun's editorial policy found no fault with Hughes. The passages quoted in the court's opinion are almost embarrassing in their lack of objectivity. Compare, W. SHIRER, RISE AND FALL OF THE THIRD REICH 118-49 (1960).

97. Greenspun at 934. The opinion does not discuss the basis of the Hughes people's concerns. Dean was good law in 1966, and would suggest that the interest-free loan was permissible. Even if Dean did not control (either because Greenspun borrowed on a term note, or because his disguised side payment was compensatory in nature), the risk that interest would be imputed would be borne by Greenspun, not Hughes. It may well be that the Hughes people were imagining tax problems where none existed, so as to negotiate at least some interest on the Greenspun loan.
Greenspun. The original 1967 repayment schedule was amended in 1969, as a part of Toolco's purchase of certain Greenspun real estate holdings.\textsuperscript{98} Under the more generous amended schedule, repayment of principal began 13 years and ended 33 years from the anniversary of the original 1967 loan transaction.\textsuperscript{99}

The Service did not question the bona fides of Greenspun's promise to repay Toolco, or otherwise deny that the transaction involved a legitimate loan. Instead, the Service maintained that the $4 million loan proceeds \textit{included} a disguised compensatory side payment, made in consideration of Greenspun's friendly press coverage of the Advent of Hughes. It was this compensatory side payment which, in the Service's view, produced gross income to Greenspun.\textsuperscript{100}

More precisely the Service maintained that Greenspun's compensatory side payment came in two chunks, one in 1967 when Greenspun received the $4 million loan proceeds, and another in 1969 when the repayment schedule was extended into the 21st century.

The 1967 chunk was measured at some $700,000, "by first computing the annual difference, or savings, between the 3\% rate charged by Toolco and a 6\% rate taking into account projected payments of principal. Respondent then totaled the present value of the expected annual savings over the term of the loan."\textsuperscript{101} The 1969 chunk of some $1.5 million was figured the same way.\textsuperscript{102}

By this discounting of the present value of the interest savings over the term of the loan the Service has, in effect, resorted to the valuation approach suggested in Part I of this article. This point is best illustrated by returning to a variation of the $100,000 ten-year loan transaction between $B$ and $L$. The variations are: first, an assumed TIR of 6\% (instead of 12.794\%); and second, $B$'s assumed obligation to pay interest of 3\% (instead of 0\%) per year. The $B \& L$ transaction now more closely parallels the Greenspun/Toolco loan.

$B$'s promise to repay $100,000 is now enhanced by his further agreement to pay $3,000 per year in interest for each of the ten years in which the principal is outstanding. Clearly, $B$'s note evidencing this undertaking is more valuable than one providing for

\textsuperscript{98}. \textit{Id.} at 937.
\textsuperscript{99}. \textit{Id.}
\textsuperscript{100}. \textit{Id.} at 940-41.
\textsuperscript{101}. \textit{Id.}
\textsuperscript{102}. \textit{Id.} at 941.
no interest payments over the loan term, but equally clearly it is less valuable than a note providing for annual interest payments at the TIR of 6%. The discipline of finance tells us that the value of B's 3% note will be the sum of: (i) the present value of the right to receive $100,000 in ten years (this is the same as the present value of a noninterest bearing note); plus (ii) the present value of the right to receive a 10-year annuity of $3,000 per year. Under the TIR assumption, the discount rate must equal 6% so that B's note will be worth: $55,800 + $22,000 = $77,800. Invoking LoBue's rule of comminution, we would find that the $100,000 transfer from L to B consisted of a loan of $77,800, plus a side payment of $22,200.

The Service's approach in Greenspun produces the same dollar amount of side payment. The Service would focus on B's annual "interest savings." At the TIR of 6%, B would have paid $6,000 per year interest. Under the loan as drafted B pays $3,000 per year interest. The difference, $3,000 per year, is B's "expected annual savings." The present value of this savings is, discounted at the TIR of 6%, $22,000. The drawback of this approach is that we are not told why this present value calculation is being made.

If the Service had phrased its attack by emphasizing the value of Greenspun's note, not the value of the interest savings, then perhaps the court would have been persuaded to find gross income under a comminution approach. But the argument, as presented, failed. The court agreed with the Service that the loan transaction included a side payment and apparently agreed with the Service's measurement of that side payment. It held, however, that the side payment did not give rise to gross income. Its conclusion was based squarely upon Dean.

The court returned to Dean's seductive analogy, but this time it added a new twist to the hypothetical arm's-length loan:

Underlying this reasoning [in Dean] was the idea that, economically speaking, an interest-free loan from a corporation to its shareholder or employee is in substance no different from the making of a loan on which interest is charged accompanied by an increase in dividends or compensation in an amount equal to the interest charged. Consequently, to give effect to the economic reality of the situation, we attempted in Dean to equalize the tax treatment of the two loan transactions.
The new twist is the "increase in dividends or compensation." If the Deans had caused Nemours to declare dividends sufficient to pay an arm's-length interest charge on their $2 million plus loan balance, then the Deans would in fact incur no out-of-pocket loan expense. They would receive funds from Nemours as dividend income, and return the same funds to Nemours as interest expense. The Deans would be out-of-pocket nothing. Moreover, for tax purposes the two transactions would "wash": the dividend income of $80,000 would be offset by an interest deduction of $80,000. This new twist seems, then, to cure the flaw in *Dean*.

Closer inspection demonstrates otherwise. The court in *Greenspun* states that *Dean* "attempted . . . to equalize the tax treatment of the two loan transactions."107 The "equalizer" is the added twist of the hypothetical dividend. But by "equalizing" the borrower's side of the transaction, the lender's side is thrown into severe disorder. Using the same facts, the interest expense paid by the Deans (and deductible by them) is interest income to Nemours. But the dividend income realized by the Deans is not deductible by Nemours. A corporation does not receive a deduction for dividends paid to it shareholders. The net effect of the transaction is an $80,000 increase in Nemour's taxable income, as compared with its taxable income in an IFSL situation. The asserted equivalence simply isn't so. But again, in the tradition of *Dean*, the Tax Court stops one step short in exploring the ramifications of its analogy, thereby conveniently ignoring the structural dissimilarity between the two "equivalent" loan transactions.108

The court's reasoning is flawed in another, more fundamental, respect. To effect the alternative loan transaction, the lawyers must draft both: (i) a compensation agreement ("In consideration for services performed, Toolco will pay Greenspun (or his heirs) $120,000 per year until 1980, and then specified lesser amounts until 2004.") and (ii) a note bearing 6% interest.

The risk that both series of payments would continue without

106. See supra note 91.
107. 72 T.C. at 948.
108. *Greenspun* was the ideal case to introduce the added twist. The additional payment to Greenspun would be compensatory; the additional payment to the Deans would be classified as a dividend. Toolco could deduct the additional compensation payment to Greenspun under I.R.C. § 162(a)(1). As stated in the text, Nemours could not deduct dividends paid to the Deans.
109. The loan amount was $4 million, on which Greenspun promised to pay 3% interest, at a time when the going prime rate was 6%. The additional compensation would be 3% of the total loan amount of $4 million.
interruption for thirty years—presumably beyond the lives of both Hughes and Greenspun—seems substantial. The two promises are independent. For example, after Hughes' death, Toolco might factor Greenspun's note to an independent bank and stop paying on the deferred compensation agreement raising the defenses of ultra vires, unconscionability, failure of consideration, and public policy. On the other hand, Greenspun (and his heirs) would be unsecured creditors of Toolco, and would bear a long-term risk of its solvency. Either series of payments is subject to a real risk of interruption.

If the two documents — the note and deferred compensation agreement — were so well drafted as to preclude the mutual independence of their promises to pay, it is more appropriate to characterize the resulting arrangement as being in substance a 3% loan from Toolco to Greenspun, with the rococo filigree of a check — immune to all creditor's claims — making a quick loop out from Toolco, through Greenspun's account and back to rest in Toolco.\textsuperscript{110}

\textsuperscript{110} The classic authority for ignoring such "shuffling" of payments is Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970). Waterman resolved to sell to McLean businesses conducted through two wholly-owned subsidiaries, Pan-Atlantic and Gulf Florida, with which it filed a consolidated return. The negotiated purchase price was some $3.5 million, a figure less than the subsidiaries' basis in their own assets but far in excess of Waterman's $700,000 basis in the subsidiaries' stock. Non-tax considerations prevented Waterman from first liquidating the subsidiaries and then selling the assets to McLean, a structure which would produce no tax liability. Instead the deal was structured as a sale of stock to McLean, potentially resulting in a taxable long-term capital of some $2.8 million to Waterman. To avoid this gain, Waterman caused Pan-Atlantic to distribute to it, as a dividend, the subsidiary's promissory note for some $2.8 million. Immediately afterwards, Waterman sold the Pan-Atlantic Stock to McLean for some $700,000 (its basis) and then McLean (now Pan-Atlantic's owner) advanced Pan-Atlantic $2.8 million, which it in turn used to pay off its promissory note. The form of the transaction, if respected, would result in no tax liability to Waterman: its receipt of the note would be excluded from income as an inter-company dividend under Treas. Reg. § 1.1502-14(a) (1969); the stock sale would produce no gain realized (since the amount realized of $700,000 equaled Waterman's adjusted basis); and the satisfaction of the note in cash would likewise be non-taxable.

The Fifth Circuit, in reversing the Tax Court's opinion upholding the structure of the deal, held "that in substance Pan-Atlantic neither declared nor paid a dividend to Waterman, but rather acted as a mere conduit for the payment of the purchase price to Waterman." 430 F.2d at 1192. In other words, the quick excursion of the funds into, and then out of, corporate solution was ignored. For a thoughtful criticism of Waterman, see Kingson, \textit{The Deep Structure of Taxation: Dividend Distributions}, 85 \textit{Yale L.J.} 861 (1976).

Another illustration is found in Flower v. Commissioner, 61 T.C. 140 (1973). Flower, a traveling salesman, incurred substantial away-from-home expenses for travel, meals and lodging. He paid for these expenses out of his own pocket, but with an understanding that the manufacturer whose wares he peddled would reimburse Flower upon his retirement in ten equal annual installments. Flower claimed the expenses as deductions under § 162 of the Code (and presumably was prepared to include the reimbursements in gross income upon retirement). The court disagreed, holding that the understanding with respect to reimburse-
The court's analogy is flawed in a third respect. If the court were to hold that Greenspun realized 1967 compensation income measured by the present value of his "interest savings," no offsetting 1967 interest expense deduction results. Even if there were a nullification of gross income in cases like Dean, where the Commissioner argues that the income is realized by the taxpayer year-by-year over the term of the loan, Greenspun involves something else. This theoretical problem was addressed towards the end of the opinion:

[Respondent] asserts that petitioner was in full realization of the total economic benefit to be derived over the original 8-year term of the loan in 1967, the year the loan was first granted . . . . [R]espondent [further] argues petitioner is not entitled to any offsetting deductions under section 163(a) because he has not actually paid any interest.\footnote{111}

To support its argument, the Service invoked an analogy containing a self-destructive seed. Again, in the best tradition of Dean, the Service attempted to demonstrate the economic reality of the Greenspun/Toolco transaction by analogizing it to something else. If after borrowing the $4 million from Toolco, Greenspun had "subsequently entered into an arm's-length agreement allowing a third party the use of $4 million under the same repayment schedule on which he had agreed with Toolco," then the proceeds (argued the Service) would be income to Greenspun.

The court agreed with the Service that "if petitioner were to accelerate the realization process by selling his rights under the loan agreement to a third party, the sale proceeds would be immediately subject to taxation."\footnote{112} Just why this is true is left unexplained.\footnote{113} No matter, however, for the court disposed of the entire

\footnotetext{111}{72 T.C. at 950.}
\footnotetext{112}{Id. at 950-51.}
\footnotetext{113}{This analogy is flawed in several respects. Presumably the assignment of loan proceeds contemplated by this example would not work a novation of the obligation, so that Greenspun would remain liable on the original Toolco note. Greenspun's premium received from the third party would be encumbered by a contingent liability to Toolco. Moreover, the sale of rights under the Toolco note should produce short-term capital gain (instead of compensation income) to Greenspun. Finally, if the relending of proceeds by Greenspun is logically relevant to the issue of whether or not the original borrowing is a taxable event, then why does the court fail to address the fact that about one-third of the proceeds were in fact lent by Greenspun to his newspaper company?}
argument with: "[T]hat is not what occurred."  

C. Joseph Creel

A month after Greenspun, with another unfavorable decision in the interim, the Tax Court finally gave the Commissioner some semblance of a victory in Creel v. Commissioner. The case, assigned to Judge Sterrett, was factually unexceptional. Creel and Jonnie Parkinson conducted active businesses through three separate corporations. The two shareholders owned between them all of the stock of each firm. During 1973 and 1974 Creel and Parkinson maintained open account interest-free loan balances from each of the three entities, the lion's share coming from Gulf Paving. The indebtedness to Gulf Paving fluctuated from month to month without discernible synchronization between the two shareholders; the indebtedness to the other two corporations remained substantially level during the two disputed years. The loan proceeds were used to pay shareholder living expenses and other personal obligations. By Dean standards the loans were small, never aggregating more than $400,000.

The Commissioner calculated the deficiency as in Dean: constructive dividend income measured by the product of the loan balance times a stipulated interest rate, realized ratably over the term of the loans. He advanced two arguments: first, Dean is wrong and should be reversed; and second, Dean should be distinguished because of "the existence of corporate obligations guaranteed by petitioners for amounts in excess of the amounts petitioners borrowed from the corporations." This second argument was supported by a showing that Gulf Paving owed - and the shareholders guaranteed repayment of - some $750,000 to banks and

114. 72 T.C. at 951. In the course of three paragraphs the court considers one real transaction (the actual three-percent loan transaction), and two hypotheticals: First, the Service's accelerated realization hypothesis; and second, the court's own additional compensation/additional interest deduction hypothesis. The reality is compared to both hypotheticals. The first is rejected because it didn't happen; the second is embraced as the true substance of the deal. We are left to wonder why.

115. Zager v. Commissioner, 72 T.C. 1009 (1979), appeal pending (5th Cir.).
116. 72 T.C. 1173 (1979), appeal pending (5th Cir.).
117. Id. at 1175.
118. Id. at 1175-76.
119. Id.
120. Id. at 1177.
121. Id. at 1175-76.
122. Id. at 1178 (Creel Ct. quoting respondent).
finance companies.\textsuperscript{123}

Judge Sterrett disposed of the first argument in short order: "We again decline . . . respondent's invitation to reverse our decision in \textit{Dean}. Since that holding, Congress has not passed any enabling statute (a la section 482) creating income where none exists."\textsuperscript{124} Were the opinion to end there with the customary Rule 155 benediction,\textsuperscript{128} the Commissioner would simply be armed with three fresh defeats useful in demonstrating to Congress the need for corrective legislation.

But Judge Sterrett continued. The Commissioner's other argument, that the presence of shareholder-guaranteed borrowings by Gulf Paving should be the basis of a legal as well as a factual distinction of \textit{Dean}, prevailed. After noting that Gulf Paving's total level of arm's-length borrowings substantially exceeded its total level of aggregate shareholder lending,\textsuperscript{126} Judge Sterrett's opinion concludes with a bombshell:

We think the conclusion inescapable that, to the extent that it had made interest-free loans to petitioners, Gulf Paving, Inc., was required to carry interest-bearing obligations to third parties. We believe and hold, therefore, that the substance of the transaction before us was that Gulf Paving, Inc., acted as petitioners' agent in obtaining loans from its various creditors to petitioners, and that it paid interest to these creditors on behalf of petitioner. The reality of this holding is made evident, or at least reinforced, by the fact that petitioners were required to guarantee Gulf Paving, Inc.'s loans during the taxable years before us. Thus, we conclude that Gulf Paving, Inc.'s payment of that amount of interest allocable to its interest-free loans to petitioners was actually a discharge by Gulf Paving, Inc., of petitioners' own obligations. To the extent that these \textit{actual} payments were \textit{in fact} made during the taxable years in issue, the taxpayers are deemed to have both received dividend income and made an interest payment. Of course, to the extent petitioners' total interest-free loans during the taxable years before us exceeded their interest-free loans from

\begin{footnotesize}
\begin{enumerate}
\item 123. \textit{Id.} at 1177.
\item 124. \textit{Id.} at 1179.
\item 125. U.S.T.C. R. \textsc{Prac.} \& \textsc{P.} 155. The court, after rendering its decision, leaves it to the parties to determine the exact amount of the deficiency or overpayment, within the parameters of the decision.
\item 126. At the end of 1973 and 1974 Gulf Paving's shareholder-guaranteed indebtedness was some $750,000 and $825,000, respectively. Total shareholder loans were some $150,000 at the end of 1973 and some $110,000 at the end of 1974. 72 T.C. at 1175-77.
\end{enumerate}
\end{footnotesize}
Gulf Paving, Inc., these loans have no direct tax effect.\textsuperscript{127}

To analyze the implications of this final paragraph would occupy several pages of an article already dangerously long. Thus, some questions are raised but not pursued.

The penultimate sentence suggests that the borrowers do realize dividend income as a result of their IFSL's, yet at the same time states that they are “deemed” to have made an interest payment. But on which loan? Are they deemed to have paid interest on the loans which they guaranteed, as is strongly implied in the second quoted sentence?\textsuperscript{128} Or are they deemed to have paid a hypothetical arm's-length interest charge on their IFSL's, in which case the dividend and interest payments would wash out. If the interest is paid on the guaranteed loans, then the dividend income and interest deduction would be different numbers, producing some “direct” tax effect. A third possible interpretation is that the dividend realized by the shareholders is measured by the payments made by Gulf Paving to its creditors, on the theory that Gulf Paving was paying its shareholders' bills (recall the second sentence suggesting that Gulf Paving acted as agent for its shareholders in arranging what are “in substance” loans by the outside creditors to the shareholders). Under this interpretation, the effect of the decision is to impose an excise tax on IFSL's measured by a wholly alien yardstick: The amount of annual debt service on shareholder-guaranteed corporate borrowing.

Pending clarification of this paragraph when the Fifth Circuit Court of Appeals issues its opinion in Creel, there is a strong suggestion of change in the law. Dean is now tarnished, for IFSL's made to shareholders who are also guarantors of corporate indebtedness may no longer be blessed with an unqualified opinion that they fit within Dean's loophole.

There is a certain irony here. A closely-held corporation normally borrows money, or receives credit. Creditors, having heard of the limited liability feature of corporations, more or less routinely request a shareholder guaranty of significant indebtedness.\textsuperscript{129} But

\textsuperscript{127} Id. at 1179-80 (emphasis supplied).
\textsuperscript{128} Compare Murphy Logging Co. v. United States, 378 F.2d 222, 224 (9th Cir. 1967) with Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), cert. denied, 409 U.S. 1076 (1972) and with Treas. Reg. § 1.385-9 (1980). These authorities all permit shareholder guaranteed corporate borrowing to be treated as “in substance” obligations of the shareholder, but only in cases of very thinly capitalized corporations. There is no suggestion of ultra-thin capitalization in Creel's findings of fact.
if the assets and net worth of the closely-held corporation are sufficiently great, the creditors presumably would be more receptive to a requested waiver of the guaranty. Creel, then, may simply remove access to the Dean loophole from all but the fabulously wealthy, those owning Nemours instead of Gulf Paving. This neatly stands on its head the prevailing tax policy that the more discriminatory the availability of a fringe benefit, the less justification for its exclusion from gross income.¹³⁰

IV. A TRACTABLE METHOD FOR VALUING IFSL'S

This article has argued that Dean is wrong, and that the law should change to require the bargain borrower to recognize his economic benefit as gross income. Taxing the bargain borrower requires that his benefit be valued, quantified in some fair and readily ascertainable way so as to permit the entry of a dollar amount on the borrower's Form 1040.

Part I demonstrated that a bargain loan may be comminuted into a real loan and a side payment by determining the fair market value of the borrower's promissory note, using the formula:

\[
\text{Value} = \frac{\text{Face Amount}}{(1 + \text{TIR})^N}
\]

The time has come to address two realities: first, there is no such thing as a TIR; and second, the formula does not tell us how to value a demand note.

Both of these are somewhat formidable barriers to the taxation of bargain borrowers. We must ask: Should the administrative difficulty of valuing real world IFSL's, especially demand IFSL's, justify their exclusion? The Treasury Department's 1975 policy analysis of fringe benefits once again offers guidance in answering the question:

Valuation of benefits in kind is extremely difficult in many, if not most cases, and the necessity for valuation vastly complicates the tax law . . . . In general it is desirable to avoid the complications of taxing such items, unless their omission constitutes a serious threat to the tax base or creates inequities that are significant in the context of the system as a whole.¹³¹

¹³⁰ See supra note 71 and accompanying text.
¹³¹ 1975 Discussion, supra note 66, at ¶ 65,668.4-.5 (emphasis added).
The emphasized portion could not better describe the treatment of IFSL's under Dean. They are now the one structurally sound way of avoiding the shareholder dividend tax. Only one loophole need exist if King Arthur's tax is to be avoided;\footnote{See supra note 4 and accompanying text.} similarly, IFSL's are now an extremely serious threat to the tax base. The administrative burden of valuation must be intolerably high if it is to outweigh the interest of preserving an uneroded tax base.

The remainder of this article suggests a surprisingly simple means of addressing the valuation question. Analysis now gives way to advocacy. The suggested approach to valuation admittedly is neither conceptually perfect nor logically ineluctable. Imprecision is introduced in order to achieve simplification. Alternative approaches are suggested in the footnotes.

A. The TIR Problem

The reason for valuing the borrower's note is to permit the bargain loan transaction to be comminuted into the "real" loan and the side payment. The real loan amount is the value of B's note. In an arm's-length market B's note would sell at a price such that the holder would receive adequate compensation for his initial investment (the price he pays for B's note) when B repays the $100,000 on the maturity date. This $100,000 must include interest on the original investment, plus interest on the interest which accrues (but is not paid) over the term of the loan. This requires, as stated earlier,\footnote{See supra note 25.} compounding under the formula:

\[
\text{Value} = \frac{\text{Face Amount}}{(1 + k)^N}
\]

The interest rate, \(k\), is the measure of the rate at which the holder of B's note is earning interest.

Earlier, we avoided the problem of assigning a value to \(k\) by assuming a nonexistent TIR. We must now decide how to determine, in some simple but accurate way, what value of \(k\) to use for a particular borrowing shareholder. Restated, how may we determine what \(k\) the market would assign to the particular shareholder?

This \(k\), or market interest rate, is a function of two factors: the current "rock bottom" interest rates being charged impeccable borrowers as a result of market forces governing supply and demand for money; and second, the credit-worthiness of the particu-
lar borrower. This second factor could only increase $k$ (and thereby produce *more* income to the borrower). It could never lower $k$, for by definition the starting point is the best market interest rate available.

The first element, the rock bottom interest rate is easily figured. It is universally conceded that the Treasury is the prime borrower in this country. The yield on long-term Treasury bonds is published daily in the *Wall Street Journal*. It is the second factor, the interest “add-on” for the particular borrower, that is troublesome. How may the Service determine, except on a case-by-case basis, the amount of this add-on?

In order to avoid the inevitable disputes over the magnitude of the borrower’s add-on, we should ignore it. The Treasury might simply take this position in its instructions accompanying Form 1040:

> If, during the taxable year, you borrowed funds for a certain term pursuant to an IFSL, then you must determine the fair market value of the promissory note you issued, and report the difference between the loan proceeds and the fair market value as dividend income. You may determine the fair market value of the note by using the formula:

$$\text{Value of your note} = \frac{\text{Amount Borrowed}}{(1 + \text{TBIR})^N}$$

$N$ is the term, in years, of your note. TBIR is the interest rate, expressed as a decimal, which the Treasury Department’s bonds of a term similar to that of your note were yielding on the date of your loan transaction.

The taxpayer borrower could not be prejudiced by this simplification. Analysis of his particular creditworthiness could only produce a higher $k$, and therefore, *more* dividend income. On the other hand, the Service would be slightly shortchanged, but it is

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134. *See, e.g.*, Wall St. J., Apr. 22, 1981, at 44, col.3. It is generally felt that loans to the Treasury are risk free as to default. Thus, the interest rate which the Treasury must pay need not include the “risk premium” that is present, in varying degrees, in all other interest rates. *See also supra* note 21 and accompanying text.

135. The TBIR, or Treasury Bond Interest Rate, should be the yield on Treasury Bonds having a principal amount and maturity similar to the IFSL being comminated. This is the same rate that is used in Treas. Reg. § 1.385-6(e)(2)(i)(A) (1980) to determine whether a principal shareholder is receiving “reasonable” interest on funds loaned to his corporation. The TBIR is generally a long-term rate, and should be distinguished from the TNIR which will be introduced in the next section for valuing demand notes.
doubtful whether the typical IFSL borrower is anything but a prime credit risk (so that the spread between his "real" k and the TBIR would not be intolerably great). More importantly, the imposition of any tax at all is a significant improvement over present practice. 136

B. The Demand Note

All of the reported cases, save two, 137 involve demand notes. The interest-free demand note is apparently commonplace. The term note is the exception. This apparent preference for demand notes is understandable. A term note commits the borrower to fixed repayment. A demand note gives the borrower maximum freedom of action, so long as he controls when the lender will make its demand. This, of course, is the beauty of an IFSL. The shareholder-borrower controls the corporation and therefore the timing of the demand. He repays when he wishes, perhaps when the corporation needs funds, or perhaps when minority shareholders complain, or perhaps when the Internal Revenue Service calls the loans into question. If the Simpson Deans and Joseph Creels are typical of shareholder-borrowers, it appears that demand may never be made by the controlled corporation.

If anything, the demand borrower's benefit may be greater than a term borrower's benefit. A greater benefit should result in a greater tax. Unfortunately, the valuation formula fails us here. A demand note, lacking a certain term, also lacks a value for N. Without a value for N, the formula is useless.

This difficulty could be met by inventing some presumptive term for the loan, and using that presumptive N in the valuation formula. 138 Or a wait-and-see approach could be devised whereby

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136. *Odyssey, supra* note 19, at 469-70 reaches precisely this point as the desirable economic result. It too concludes that Dean and Greenspun hold otherwise. See also, *Odyssey* at 482-86.

137. See *Marsh and Greenspun, supra* note 94.

138. One approach to finding a term would be to look to the repayment experience of the particular shareholders involved. By the time a case reaches litigation, or even the audit stage, the minimum term of the loan is ascertainable merely by seeing how much time has passed since the borrowing. If other demand loans had been made, one could determine the average length of time demand loans tended to be outstanding. The resulting figures could be used to generate a presumptive term, which in turn could be used to calculate the note's value. A sterner (but perhaps more realistic) approach would presume that the loan would remain outstanding as long as possible; that is, until the death of the borrower. A term, and the consequent value of the note, could be determined with reference to mortality tables.

An even more drastic approach is suggested, once again, by the regulations under § 385. There, if a principal shareholder advances funds to his corporation by means of a demand
actual repayment would be the occasion for amending the borrower's tax return for the year in which the loan was made. The former approach is unnecessarily arbitrary. The latter is burdensome and would require an amendment to the Code's statute of limitations.

There is an intuitive feeling that the benefit conferred by the demand note is a continuing benefit, instead of one fixed and realized at the moment the loan is closed. The lender's continued forbearance is the key to the demand borrower's benefit. A lender advancing a large sum on an interest-free demand note pulls an elaborate purse-on-the-string joke if, hours after the closing, it demands that the borrower immediately repay. The same initial transaction can, by the lender's lengthy abstinence, produce a benefit nearly equivalent to a no-strings cash grant. 9

All this means that the lender's inaction produces the economic benefit, so that inaction must be legally operative if the federal income tax consequences are to reflect an IFSL's economic realities. The point is this: At the inception of a demand IFSL one cannot predict what benefit will ultimately be realized by the borrower. It depends upon how long the loan remains outstanding and upon the TIR prevailing during that time.

1. Inaction as a legally operative event.

To begin our analysis, we must acknowledge that the benefit of a demand IFSL accrues ratably over the period of its existence, whatever that period might eventually be. As a first step, let us
look at what happens economically when demand is not made. Assume a $100,000 demand IFSL between B and L with an understanding between B and L that L's demand may be made only upon anniversaries of the original borrowing. In other words, L grants B a one-year IFSL, with the possibility that the term may be extended (by L's inaction) for another one-year period, which in turn may be extended indefinitely in one year increments. If the TIR remains a constant 11.1% over the period of years in which the loan is outstanding, then the value of B's note in the hands of L looks like this:

**FIGURE 4**
Value of B's Demand Note in Hands of L

When L first advances $100,000 in exchange for B's note having a fair market value of $90,000, we have seen that this apparent loan of $100,000 is in substance two things: first, a real loan of $90,000; and second, a $10,000 side payment. Since the relationship between B and L is that of dominant shareholder and controlled corporation, the $10,000 side payment is characterized as a dividend.

The question to be answered now is: What happens on the first anniversary when L forgoes its right to demand repayment? L's inaction has extended the IFSL for at least another year. The value of L's property, (B's note), has fallen from $100,000 to

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140. See generally supra Part I(A).
141. Under the hornbook law of bills and notes it is firmly established that "[a] promissory undertaking to pay money is not property in the hands of the person who makes the promise . . . where the paper has never been negotiated." 11 Am. Jur. 2d Bills and Notes § 101, at 140 (1963). Common law notions equate this promise to pay as a "mere blank
$90,000. This decline in L's net worth is mirrored by an increase in B's net worth. On the anniversary date B could have been called upon to pay $100,000 at once, while on the next day he could make full provision for repayment by a current expenditure of only $90,000. It would seem that this transfer of $10,000 of net worth from L to B should be a dividend. The problem is that there is no transfer of cash or property or documents between L and B. Noth-

piece of paper.” Salley v. Terrill, 50 A. 896, 897 (1901). This ancient rule was the tool the courts used in resolving disputes between innocent holders of stolen negotiable instruments and the note maker's argument that the theft occurred before delivery. According to the courts all the innocent holder held was a blank piece of paper, therefore, the note maker would necessarily prevail. This result is justifiable in that in the absence of a delivery of a note, delivery being essential to negotiability, the risk of loss for policy reasons should fall on the purchaser.

This common law rule has been quoted in tax cases involving disputes resulting from employer's deductions for promissory notes delivered to a qualified retirement plan. Slaymaker Lock Co., 18 T.C. 1001, 1006 (1952), rev’d, Sachs v. Comm'r, 208 F.2d 313 (3d Cir. 1953).

The offhand reference to the common law rule should not become the tail wagging the dog. The law of dividend distributions shows that the Code and regulations presuppose that a promissory note is property in the moments before delivery by the maker. To illustrate, suppose that parent corporation (P) owns all the stock of subsidiary corporation (S). If S distributes a cash dividend to P then the amount of the dividend is the amount of cash distributed. I.R.C. § 301(b)(1)(B). But if S distributes a property dividend, say marketable IBM stock with a basis of $1,000 and fair market value of $10,000, then different rules apply. Under § 301(b)(1)(B) of the Code, the amount of the distribution is the lesser of the fair market value of the property, or the adjusted basis in the hands of S. To complete the pattern, under § 301(d)(2) of the Code, P's basis in the property dividend is, again, the lesser of fair market value of the adjusted basis of the property in the hands of S. Thus, if S distributes the IBM stock, then: (i) the amount of the distribution is $1,000; and (ii) P's basis in the IBM stock is also $1,000.

A second example is needed to make the point. If P receives a second property dividend from S, this time marketable shares of Exxon, and if we know that the basis of the shares in the hands of P is the $200,000 fair market value of the shares, then we may say confidently that S's basis in the Exxon shares was at least $200,000. If S's basis were less than $200,000 the lower of basis or market rule of § 301(d)(2) would operate to give P a less than $200,000 basis in the Exxon stock.

Treasury Reg. §§ 1.301-1(d) and 1(h)(1973) provide that the amount of a note dividend, and the basis of a dividend note in the hands of a corporate shareholder, respectively, are the fair market value of the note. If S distributes to P, as a dividend, its promissory note having a face amount and fair market value of $100,000, then under the quoted regulation the amount of the distribution and P's basis in S's note is $100,000. Under § 301's lesser-of-basis-or-value rule this can happen if, and only if, S's basis in its own note is at least $100,000.

A corporate taxpayer, then, has basis in its own obligations. Basis is something peculiar to property—indeed, one plausible definition of property is "that which has, or is susceptible of having, basis." If a promissory note is property in the hands of a corporate maker it should be property in the hands of an individual maker.

It is a matter of indifference whether the note is treated as property or is simply something very like property, which, for purposes of analyzing bargain borrowing, will be treated as if it were property.
ing happened.

Or did it? Again L has extended the note for at least a year. In other words, L has unilaterally modified the terms of the loan in a way benefitting B. If we view the modification as the granting of a new loan, then L has accepted property (B's note) worth $90,000 in satisfaction of a debt of $100,000. This should be treated no differently from B satisfying an obligation to pay $100,000 with a cash payment of $90,000. In either case B realizes cancellation of indebtedness income, which the regulations specify is treated as dividend income because the shareholder-corporation relationship is also one of debtor-creditor. 142

Thus, B should realize $10,000 of dividend income at the time the loan is made, and then again on each anniversary that passes without repayment. The first year's dividend income results from a $10,000 discrepancy between the purchase price of property ($100,000) and its fair market value ($90,000). Dividends received in subsequent years are of the same amount, $10,000, but arise for a different reason: B is being granted a partial cancellation of his indebtedness. This fact requires a collateral adjustment to reflect the fact that a portion of B's cancelled debt is interest, not principal. This is considered in the next section.

There are at least two objections that may now be raised. First, a real life demand note does not incorporate the demand-only-on-anniversary feature. Second, there is something troublesome about finding cancellation of indebtedness income where at all times B is obligated to repay the same $100,000.

The first objection may be cured by cutting the period which must pass before L may demand repayment to an arbitrarily small unit of time; for example, a day. Each day that passes without demand by L permits B to delay repayment until tomorrow. At some point each day (presumably the latest hour in which L could both

142. Treas. Reg. § 1.301-1(m)(1973) holds that the cancellation of shareholder indebtedness by a corporation is treated as a dividend to the borrowing shareholder. Cancellation of indebtedness income results when the debtor's obligation is worth less than its face value, a condition which may arise either because of a change in interest rates, or because of a change in the apparent ability of the debtor to repay (or by a combination of both factors). See note 30, supra. Cancellation of indebtedness in the latter context is often excluded from income, probably because the enhanced ability to pay is more apparent than real in the case of a financially distressed debtor. See, e.g. Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940); Lakeland Grocery Co., 36 B.T.A. 289 (1937). Cancellation of indebtedness income arising from changes in interest rates, where the debtor's ability to pay is not in question, remains unaffected by these exceptions, and is generally fully taxable. The interest-free shareholder loan situation generally involves no prospective insolvency of the shareholder-borrower, so none of the exceptions to the rule of full taxation should be available to him.
demand and receive payment) B's note falls in value from $100,000 to the present value of the right to receive $100,000 tomorrow. Very short term interest rates do exist. Indeed the Treasury Department is constantly borrowing in the short-term market to obtain cash necessary to run its day-to-day operations. Again, no prejudice to the taxpayer could result if we were to assume that market forces would cause the taxpayer's short term paper to be priced so as to yield the "TNIR," the current market interest on very short term Treasury notes. This daily interest rate is near 0.035% under current market conditions. Using the valuation formula, we find that:

\[
\text{Value} = \frac{\$100,000}{1 + 0.00035} = \$99,965
\]

When these daily dividends of $35 ($100,000 - $99,965) are added together for an entire year, B would have annual dividend income of $35 \times 365 = $12,775. The value of B's note over time would look like a very fine sawtooth curve:

The calculation of a daily dividend along the lines just suggested would involve intolerable complexity. Each day's dividend would be calculated by using that day's yield figure for the shortest term Treasury notes available, a number which tends to fluctuate during the course of an entire year. A very close approximation of the sum

of the daily dividends can be found much more simply by using the valuation formula for a one-year note setting N equal to one and k equal to the last year's average yield on short-term Treasury notes, a number which the Treasury could easily determine each year and publish in its instructions accompanying tax returns. It can be shown that very little error is introduced by this simplification.\textsuperscript{144}

144. Let the daily TNIR (current TNIR/365) on any day equal $x_i$. The daily dividend is

$$D = \text{Balance} \left(1 - \frac{1}{1 + x_i}\right),$$

For the year total dividend income would be:

$$D = \text{Balance} \cdot \frac{365}{\sum_{i=1}^{365} \left(1 - \frac{1}{1 + x_i}\right)} \quad (\text{Eq. 1})$$

Using an average TNIR, $\bar{x}$, would produce a yearly dividend of:

$$D = \text{Balance} \left(1 - \frac{1}{1 + \bar{x}}\right) \quad (\text{Eq. 2})$$

The question is whether fluctuations in $x_i$ will be so large as to make Equations 1 and 2 unequal to each other. If $x_i$ is constant over the years, Equation (1) becomes:

$$D = \text{Balance} \cdot \frac{365}{\sum_{i=1}^{365} \left(1 - \frac{1}{1 + x_i}\right)} = \text{Balance} \cdot \frac{1}{365 \cdot 365} = \text{Balance} \cdot \frac{1}{1 + 365x_i}$$

By algebraic manipulation, this reduces to $D = \text{Balance} \left(1 - \frac{1}{1 + 365x_i}\right)$. If $x_i$ does not fluctuate, then $\bar{x} = 365 \cdot x_i$. So, equation 2 becomes:

$$D = \text{Balance} \left(1 - \frac{1}{1 + 365x_i}\right).$$

In practice, to give an extreme example, suppose B owes $1 million for the first six months of the year when the TNIR was 2%. At midyear B repays $800,000 and the TNIR jumps to 16%. By averaging both the loan amount \(\frac{1}{2} ($1,000,000 + $200,000) = $600,000\) and the interest rate \(\frac{1}{2} (2\% + 16\%) = 9\%\) the borrower's dividend would be $600,000 \(1 - \frac{1}{1.09} = 49,500\). But if each half of the year were treated separately, the borrower's dividend would be only

$$\frac{1}{2} \left(\$1,000,000 \left(1 - \frac{1}{1.02}\right)\right) + \frac{1}{2} \left(\$200,000 \left(1 - \frac{1}{1.16}\right)\right) = \$19,600 + 27,600 = \$47,200.$$

The difference, even under these exaggerated suppositions is a modest $2,300.
The second objection is more subtle. How can we say that B experiences cancellation of indebtedness income when he is at all times obligated to repay $100,000? The answer lies in the fact that, while it is true that B must always pay $100,000, it is never true that all of the $100,000 is attributable to the repayment of a $100,000 loan. At the end of year 1, we may determine that B borrowed only $90,000, not $100,000. If he repays at the end of year 1, he is paying $90,000 of principal and $10,000 of interest (the amount of interest which would accrue on a $90,000 loan at a TNIR of 11.1%). If the loan is extended another year, then B has satisfied his obligation to pay $100,000 by giving property worth only $90,000; $10,000 of his debt is cancelled. At the time of cancellation his debt consisted of a 9:1 ratio of principal to accrued interest. Since all the dollars are fungible, for every $10 of debt discharged, $9 is attributable to principal and $1 to accrued interest. Immediately after the cancellation, B's note consists of $81,000 of principal and $9,000 of accrued interest. During the next year interest will accrue at the assumed TNIR of 11.1% on both principal and accrued interest, so that at the end of year two B's note will consist of $81,000 of principal and $19,000 of accrued interest.

In short, while the total indebtedness of $100,000 remains constant, the mixture of principal and interest keeps shifting. Principal grows smaller, and interest larger. It is the lowering of the principal amount owed which triggers discharge of indebtedness income. The tax law must treat reductions of the principal amount of indebtedness, as distinguished from the discharge of an obligation to pay interest, as a taxable event if the law is to be internally consistent in its treatment of borrowers.

To illustrate the need, suppose L1 advances B1 $100,000 on a demand note bearing an arm's-length interest rate. B1's note is worth a full $100,000. There is no initial side payment. B1 recognizes no gross income. Suppose some time later, just prior to L1's making demand for repayment, L1 modifies the terms of the note. Principal will be cut to $40,000, and the remaining $60,000 will be labelled additional accrued interest. If the law ignores this change, and contents itself with the fact that B1 must still repay $100,000, then B1 will receive an interest deduction under section 163 when he repays what is now $40,000 of principal and $60,000 of accrued interest. Since B1 realized no gross income when he borrowed
If a distinction is attempted on the grounds that $L$ physically changed the document while $L$, the demand IFSL lender, did nothing, the response must be that inaction is a modification. Note that if $L$ were to sell $B$'s interest-free demand note to an outsider, then there can be little question but that the outsider would make his call as soon as title passes. The decision not to seek immediate repayment of a demand loan on terms unfavorable to the lender must have a motive different from the desire of the lender to maximize his return.

2. The Nature of the Obligation Being Discharged

It was just suggested that over the life of a demand IFSL, the admixture of principal and interest keeps shifting towards interest. Whether approached on a meticulous day-to-day basis (where each day $35 of total indebtedness is being cancelled) or instead approached on a simplified year-by-year basis (where each year $12,775 of indebtedness is cancelled) the result is the same. The real loan amount keeps shrinking, while more and more interest accrues at the current market rate, on whatever principal remains undischarged.

An example will help illustrate the changing admixture of principal and interest. Suppose that $L$ advances $100,000 to $B$ pursuant to a demand IFSL. The loan will remain outstanding for five years, at which time $L$ will demand repayment. Finally, assume that the TNIR will remain a constant 11.1% over this five-year period. In
each of the five years B will realize dividend income of $10,000. After the first year this constant $10,000 of dividend income arises because B's indebtedness is being cancelled. The total $10,000 discharge is applied pro rata between principal and then-accrued interest, a configuration which changes year-by-year. The results are expressed graphically.146

**FIGURE 6**
Mixture of Principal and Interest over Time for $100,000 Demand IFSL,
TNIR = 11.1%
Shaded portion = Principal; Lined portion = Interest

146. See notes 161-62, infra, and accompanying text. At the end of each year, the total discharge of $10,000 is apportioned between the then-existing components of principal and interest. The value of the note is always $100,000 at the end of a year, and $90,000 at the beginning of the next to reflect the $10,000 decline in value. In tabular form, the numbers over the entire five-year period look like this:

<table>
<thead>
<tr>
<th>Period</th>
<th>Principal</th>
<th>Accrued Interest</th>
<th>Discharge ($10,000) Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning of Year 1</td>
<td>90,000</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>End of Y1</td>
<td>90,000</td>
<td>10,000</td>
<td>9,000</td>
</tr>
<tr>
<td>BO Y2</td>
<td>81,000</td>
<td>9,000</td>
<td>8,100</td>
</tr>
<tr>
<td>EO Y2</td>
<td>81,000</td>
<td>19,000</td>
<td>17,100</td>
</tr>
<tr>
<td>BO Y3</td>
<td>72,900</td>
<td>17,100</td>
<td>27,100</td>
</tr>
<tr>
<td>EO Y3</td>
<td>72,900</td>
<td>27,100</td>
<td>34,400</td>
</tr>
<tr>
<td>BO Y4</td>
<td>65,600</td>
<td>24,400</td>
<td>31,000</td>
</tr>
<tr>
<td>EO Y4</td>
<td>65,600</td>
<td>34,400</td>
<td>41,000</td>
</tr>
<tr>
<td>BO Y5</td>
<td>59,000</td>
<td>31,000</td>
<td>31,000</td>
</tr>
<tr>
<td>EO Y5</td>
<td>59,000</td>
<td>41,000</td>
<td></td>
</tr>
</tbody>
</table>

The beginning of the year balances are reached by subtracting the listed "discharge" numbers from the preceding end-of-the-year balance.
All the while B’s promise to pay $100,000 remains evidenced by his original demand note, an instrument which by its terms allocated the entire $100,000 to principal. The continuing benefit approach simply fractures the $100,000 promise into its two economic components. The principal keeps decreasing (and the interest component increasing), but at an ever-slower rate. The numbers themselves may be familiar to some readers, for the note’s unpaid principal follows precisely the same course as the adjusted basis of an asset acquired for $100,000 and depreciated over a twenty-year period using the double-declining balance method.\(^{147}\)

With little more complication, the same analysis can be applied to TNIRs which change from year to year. For example, assume that same $100,000 loan and the same repayment at the end of the fifth year where the TNIR varies arbitrarily as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>TNIR (Year’s average yield on short-term Treasury notes)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>11.1 percent</td>
</tr>
<tr>
<td>2</td>
<td>20 percent</td>
</tr>
<tr>
<td>3</td>
<td>6 percent</td>
</tr>
<tr>
<td>4</td>
<td>10 percent</td>
</tr>
<tr>
<td>5</td>
<td>15 percent</td>
</tr>
</tbody>
</table>

The value of B’s note and the proportion consisting of principal is illustrated in Figure 7:

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147. Double-declining balance depreciation is authorized by I.R.C. § 167(b)(2) and described in Treas. Reg. § 1.167(b)-2(b)(1964). Under this method “a uniform rate is applied each year to the unrecovered cost or other basis of the property.” Id.. The rate is twice the reciprocal of the useful life (here, 2 times 1/20 = 10%). Salvage value is ignored. Id. Subtracting 10% of the unrecovered balance from the previous unrecovered balance is precisely the same process occurring here. In both cases, the previous balance is multiplied by 90%.
FIGURE 7
Mixture of Principal and Interest over Time
$100,000 Demand IFSL, TNIR Varying
Shaded portion = Principal; Lined portion = Interest

It has been shown that the cancellation of principal produces cancellation of indebtedness income. We must now consider the consequences of cancelling the obligation to pay interest. Crane v. Commissioner,148 the landmark Supreme Court case, holds that the cancellation of an obligation to pay interest gives rise to a deduction. Crane determined the role of nonrecourse liabilities in figuring an owner’s gain realized upon the sale of encumbered property. The taxpayer sold an apartment building — earlier inherited from her husband — for $3,000 cash, but subject to a mortgage lien of some $271,000 ($255,000 principal and $16,000 interest).149 The Commissioner successfully argued that the taxpayer’s amount realized included the $255,000 unpaid mortgage principal.150 Discussion of the accrued interest was relegated to footnote 6:

The Commissioner explains that only the principal amount, rather than the total present debt secured by the mortgage, was deemed to be a measure of the amount realized, because the difference was attributable to interest due, a deductible item.151

In short, cancellation of the obligation to pay interest produces off-
setting items of income and deduction. *Crane's* exclusionary treatment of accrued interest is applicable to *B*'s discharge from his obligation to pay interest.\(^{152}\)

When *L* fails to demand repayment, the decline in the value of *B*'s note in the hands of *L* amounts to a discharge of a portion of *B*'s debt. This produces cancellation of indebtedness income. Part of the debt cancelled is principal and part interest. Under *Crane* the discharge of interest creates an offsetting deduction. *B*'s *net* dividend income is simply the amount of *principal* discharged.

Two consequences of this treatment deserve attention. First, the tax consequences of a demand IFSL become very closely equivalent to those experienced by a term note borrower.\(^{153}\) Second, by giving *B* an annual interest deduction to the extent that his obligation to pay interest is cancelled, *B*'s aggregate *net* dividend income realized over the course of the demand loan's life will always exactly equal his interest deduction received in the year of repayment.\(^{154}\) This seems proper, because there is zero net passage of dollars between the parties in a repaid interest-free loan. The tax consequences, if they are to be correlated to real world dollars, should — and here do — follow economic consequences.\(^{155}\) This is

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152. The reader might well be alarmed by this assertion. After all, it is the Tax Court's use of a "wash" analysis in IFSL cases that has produced nearly twenty years of confusion in the law of interest-free borrowing. But this article has not waged war against the *Dean* rationale only to revive the error in a slightly transmuted form. The constructive interest deduction resulting from the cancellation of an obligation to pay interest admittedly does "wash out" the cancellation of indebtedness income. The flaw in *Dean* lies in its application of the wash rationale, not in the proposition that some pairs of transactions cancel one another.

153. Recall the example of the borrower receiving $100,000 pursuant to a demand note, which he repays in five years, when the TNIR is 11.1%. The principal of his note is reduced in five stages to $59,000. If the TBIR were also 11.1% at the time of the borrowing and if *B* had borrowed the same $100,000 on a five year note, his dividend would have been: $100,000 - \(100,000/(1.111)^5\) = $41,000.

154. In any year the borrower’s *gross* dividend income does two things: first, it discharges principal; and second, it discharges accrued interest. If the discharge of interest is held to produce no net tax effect pursuant to *Crane’s* exclusionary treatment, then any year’s net dividend income is simply the decline in principal. Restated, each year the principal declines by *net* dividend income. In the year of repayment the borrower receives an interest deduction measured by the excess of the face amount of his note over the amount of his note then consisting of principal. This difference is formed by, and must be exactly equal to, the sum of all prior years’ net dividend income.

155. *Odyssey*, supra note 19, begins its analysis of the demand note by considering gratuitous transfers. These are analyzed under the principles set forth in the Supreme Court’s decision in *Corliss v. Bowers*, 281 U.S. 376 (1930). The gratuitous demand loan is viewed as a revocable transfer, and the lender is subject to tax on the income generated by the loan proceeds. *Odyssey* at 489-92. Since the borrower’s actual income from the loan proceeds is usually difficult to trace, the authors suggest using a proxy: the going prime interest rate. *Id.*
not to be confused with a Dean wash. There, no tax is ever payable. Here, tax is paid in early years, only to be refunded by the government (assuming a constant marginal tax rate) in a later year. In the meantime the borrower makes an interest-free loan to the government. It seems intuitively proper to tax the interest-free borrower by causing him to make an interest-free loan to the taxing authority. This is what happens under the advocated analysis.

CONCLUSION

"[A]n interest-free loan results in no taxable gain to the borrower." This, Dean's holding, is the law. It is the law not because of the demands of either logic or policy, but instead because Dean's seductive analogy has captured the law of interest-free borrowing by twenty years of adverse possession. It is ludicrous, when "[s]oaring interest rates have all but destroyed the dream of home ownership for many Americans," for the law to

Non-gratuitous interest free loans are then considered, first the compensatory loan, Id. at 501-04 and then IFSL's. Id. at 504-05. After considering, but rejecting, a Corliss analysis, Odyssey views the compensatory loan as follows:

If a demand loan was interest bearing rather than interest free, the interest debt would accrue as each moment of time elapsed without demand for repayment. If, simultaneously with the accrual of interest on an interest-bearing demand loan, the interest debt was forgiven, that forgiveness would properly be viewed as the equivalent of an additional salary payment which is simultaneously repaid as interest when due. . . . An interest-free demand loan to an employee is thus the equivalent of a series of additional salary payments which are immediately paid to discharge continually accruing interest . . . . Put another way, it is the equivalent of the employee borrowing money on an interest-bearing demand note from a third party and the employer discharging the employee's interest obligation as it accrues.

Odyssey concludes its analysis of compensatory interest-free demand notes as follows: The employee realizes gross income measured by interest imputed at an arm's-length rate, but receives a deduction in the same amount (unless the facts of the case preclude the borrower's hypothetical interest deduction, presumably because the proceeds are invested in tax-exempt securities). In short, the transaction washes, both to the borrower and to the lender. Id. at 504.

Demand IFSL's receive similar analysis. The borrower realizes no net income (the imputed interest income is cancelled by a hypothetical interest expense deduction). Id. at 504. The corporate lender, however, is taxed under the principles of Corliss. Id. at 505.

This article stresses that the demand borrower does realize income, but under a cancellation of indebtedness income (partially offset by an interest deduction under Crane) theory. Odyssey, in finding a "wash" at the borrower level, agrees with the result in Dean.

157. See supra note 50 and accompanying text.
158. See supra note 71 and accompanying text.
say that a taxpayer borrowing large sums without interest has realized no taxable economic benefit. Yet this is Dean's result.

The Tax Court's 1979 Creel decision suggested a shifting of judicial attitude towards IFSL's. Subsequent events indicate otherwise. The first appellate decision considering IFSL's wholeheartedly embraces Dean's logic; Creel is not even cited. The Treasury Department itself now proposes Regulations which would adopt Dean hook, line and sinker, an action bewildering in view of the Service's recent aggressive litigating position and continued non-acquiescence in Dean.

This article has suggested a practical approach to the taxation of IFSL's, one based on the economic reality that the borrower's note must have a fair market value less than the amount of the loan. The key to understanding IFSL's lies in valuation. The bor-

160. See Suttle v. Commissioner, 625 F.2d 1127 (4th Cir. 1980).
161. Prop. Treas. Reg. 1.61-19(c), ex. 11, note 67 supra, holds that a bargain loan creates no gross income when the employee-borrower invests the proceeds in taxable obligations. Prop. Treas. Reg. § 1.61-17(d), ex. 5, holds otherwise when the proceeds are used by the borrower to purchase tax-exempt municipal bonds. This is, of course, Dean and its concurring opinion. See supra notes 72 and 88. It is ironic that these same proposed regulations are otherwise very aggressive. For the first time it is proposed that both employee merchandise discounts (if in excess of $200 per year) and discount travel by airline employees be subject to income tax. Prop. Treas. Reg. § 1.61-19(b)(1) and -17(d). See supra notes 68 and 69.
162. The reasoning applied in this article for the valuation and taxation of interest-free loans made by corporations to shareholders is equally applicable to interest-free loans in other situations, such as the compensation or gift tax situation. In the compensation area, the Tax Court in Greenspun applied the same rationale as in Dean, to find no taxable income to the recipient of the loan, even though the court found that the purpose for the low interest loan was clearly compensatory. In the gift tax area, for example, the side payment which is considered a dividend in the shareholder situation becomes a gift for gift tax purposes when interest-free loans are made between related individuals.

Presently, the question of whether an interest-free or low interest loan constitutes a taxable gift by the lender is unsettled. The Service's position is that such loans between related individuals constitute taxable gifts, regardless of whether the loan is repayable on demand or at a specified time. Rev. Rul. 73-61, 1973-1 C.B. 480. The courts, however, have disagreed with the Service's position when the loan is repayable on demand. Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978); Johnson v. U.S., 254 F. Supp. 73 (N.D. Tex. 1966). Where the loan between related taxpayers is at a rate below the prevailing rate at the time, and the loan is for a definite term, the Tax Court has ruled that a taxable gift exists. Estate of Berkman v. Commissioner, 38 TCM (CCH) 183 (1979).

The considerations and policy reasons for taxing or not taxing interest-free loans in the gift tax area may be different from those present in the income tax area. A discussion of such difference, if any, is beyond the scope of this article. See, e.g., Crown, supra and articles criticizing that decision. Note, however, that the reasoning applied by the Tax Court in Dean and Greenspun in order to find no taxable income to the recipient of the loan—no taxable income because of an assumed interest deduction—is not applicable in the gift tax area, since the individual on whom the tax would be imposed would never be entitled to an interest deduction.
rower's note must be valued, and the difference between the note's value and the loan amount is dividend income to the borrower. This occurs either in a single spike of income in the case of a term note, or in a continuous flow of dividend income in the case of a demand note.

The valuation approach might be criticized for its complexity and disregard for precedent. The complexity objection is unwarranted. While the graphs and equations of Part IV may appear formidable, the amount of dividend income can be measured using techniques found in existing regulations. Bargain loans can be valued pursuant to this article's suggestions by using techniques less burdensome than those used in valuing loans flowing in the other direction: from the shareholder to the corporation. The dividend income generated by a demand note requires a second calculation almost identical to that used in figuring declining balance depreciation. In short, the advocated valuation approach is well within the outer limits of complexity bounding existing law.

The stare decisis objection, the oft-repeated suggestion that change is now a job for Congress, ignores the Supreme Court's holding in LoBue: Appellate courts, especially the Supreme Court, are not powerless to correct long-standing errors of the Tax Court. Justice Black dismissed twenty years of established Tax Court law in holding that there was "no statutory basis" for the then well-established proprietary stock option doctrine. The similarities between IFLS's and LoBue are profound. Both involve patterns of tax avoidance based upon the refusal of the Tax Court to engage in a valuation of property transferred between related parties having an incentive to set an artificial transfer price as a

163. Treas. Reg. § 1.385-3(b)(1)(ii) (1980) contemplates that any loan from a shareholder to a corporation not bearing a "reasonable" interest rate must be valued "by using present value and standard bond tables." The difference between the note's issue price and its fair market value (the side payment in the case of IFLS's) is treated either as a contribution of capital (if the shareholder pays too much for the corporation's note) or as a dividend (if the shareholder pays too little). See Treas. Reg. § 1.385-3(a)(3). These regulations contemplate a measurement of the value of corporate debt obligations by using a discount rate which takes into account all factors bearing on value, including the debtor's ability to pay. Treas. Reg. § 1.385-3(b)(1). This article suggests using a simplified discount rate, a TBIR for term notes and a TNIR for demand notes, which is readily ascertainable from regularly published financial data. Cf. Treas. Reg. § 1.385-6(e)(2)(i)(A) (requiring the Secretary of the Treasury to determine the TBIR periodically for purposes of the "safe harbor" rule governing "reasonable" interest rates).

164. See supra note 147.


166. Id. at 247.
means of disguising a side payment. Both involve the Tax Court's refusal to adjust the artificial transfer price. Both involve a substantial threat to the tax base. And both may be easily cured by a Supreme Court decision broadly mandating a valuation approach with details to be worked out below.167

One final objection may be raised. The suggested approach is doubtless itself vulnerable to manipulation and circumvention. For example, term loans might be made to shareholders at a time when the corporation had no earnings and profits, thereby giving the shareholder an eventual interest deduction without any current adverse tax effect.168 Or a demand IFSL might be repaid at the end of each year, only to be re-borrowed at the beginning of the next.169 To this the author demurs. There are very few final solutions in tax law, but there may be structural improvements. The first of the suggested evasions is merely a new twist on an old technique of exploiting Code section 301(c)(2). The latter merely raises one of King Arthur's three fundamental problems:170 what to do when the subjects flee the jurisdiction on taxing day. Surely a system wrestling with this problem is preferable to the existing one where stripe-painting beats the tax.

167. The Court remanded LoBue to the Tax Court with directions for it to figure out both how much income was realized, and when it was realized. Id. at 250.

168. If the corporate lender has no earnings and profits, then the side payment would be treated first, as a non-taxable return of capital to the extent of the shareholder's basis in his stock invested, and then as long-term capital gain. See, I.R.C. §§ 301(c)(2) and (3). Cf. I.R.C. § 312(i). Thus, no current tax would be payable if the side payment portion of the IFSL was less than the shareholder's basis in his stock. The eventual "free" interest deduction upon repayment would be matched by an equal amount of interest income to the corporation.

169. The idea is to keep the IFSL off the corporation's balance sheet or schedule L of Form 1120. This would make auditing more difficult, but perfectly detectable by a look through the firm's bank statements. See Treas. Reg. § 1.385-6(g)(5)(vi)(1980).

170. See notes 2-4 and accompanying text, supra.