July 2015

Nontaxable Transfers; Interest-Free Loans; Crown v. Commissioner

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by the defendant.[121] Where the former proceeding was a trial, this should not prove to be too difficult. However, where the former proceeding was a preliminary hearing and the witness was not actually cross-examined by the defendant, the testimony will not be admissible. Moreover, although the holding technically applies only to situations where there has been no cross-examination, in view of the court's comments on preliminary hearings,[122] the implication is strong that the court would still disapprove even if there has been actual cross-examination. It therefore appears that, at least in Ohio, it may be nearly impossible to use preliminary hearing testimony at a later trial because the state's highest court has decided that the mere opportunity to cross-examine will not be sufficient to guarantee a defendant his sixth amendment right to confront the witnesses against him.

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[121] 55 Ohio St. 2d at 194, 378 N.E.2d at 495.
[122] *Id.* at 196, 378 N.E.2d at 496.

FEDERAL GIFT TAXATION

Nontaxable Transfers • Interest-Free Loans

Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978).

INTEREST-FREE FAMILY LOANS remain outside the purview of the federal estate and gift tax statutes despite the recent efforts of the Internal Revenue Service to convince the judiciary that, in such loans, the fair market value of the foregone interest is a gift. This is an extrapolation of the Service's efforts to find income to the recipient in other interest-free money situations. In light of the Service's limited activity in dealing with tax consequences of the interest-free loans, the Seventh Circuit's decision in *Crown v. Commissioner*[1] will be an important reference for estate and tax planning. Doubtlessly, the Service will register its non-acquiescence[2] to *Crown* as it did with *Johnson v. United States.*[3] Consequently, the issue of interest-free family loans will be reviewed in the future by other circuits.

[1] 585 F.2d 234 (7th Cir. 1978).
[2] Rev. Rul. 73-61, 1973-1 CUM. BULL. 408. This ruling elaborates on §§ 2501, 2511, 2512(b) in the context of a loan between father and son. The Ruling explains the occurrence of a gift by evaluating the use of the money on the basis of each quarter such use was permitted.
[3] 254 F. Supp. 73 (N.D. Tex. 1966).

Lester Crown and his two brothers were partners in Areljay Company, which was unincorporated. Prior to and during 1967 Areljay loaned approximately $18,000,000, interest-free, to twenty-four trusts established for the benefit of the partners' children and other relatives.[4] The trusts used the loans to invest in another partnership, Henry Crown & Company, also unincorporated. The Commissioner calculated a deficiency against Lester Crown in 1973, determining that the forebearance of interest on the loans resulted in a taxable gift to the trusts.[5] In other words, the Commissioner claimed that Lester Crown gave a taxable gift to the trusts, this gift being equal to the amount of outstanding interest that was not collected on the loans to the trust. Crown contested the Commissioner's findings, using the Tax Court as his forum. The court held for Crown, stating that the making of a non-interest bearing loan under these circumstances is not a taxable event.[6] On appeal, the Seventh Circuit affirmed the Tax Court's decision, noting the possibility of a significant loophole in the gift tax laws, but refusing to close it by judicial construction.[7]

The Commissioner urged reversal based on three general arguments: first, that the transfer of money resulted in an economic benefit arising from an unequal exchange and/or transfer of property; second, that the benefit was measurable; and third, that the policy considerations arising from similar situations of a transfer of economic benefit merited reversal of the Tax Court's decision.[8] The Commissioner attempted to show a transfer of property under Code Section 2501[9] and the valuation under Section 2512(b).[10] But the court said specific statutory authority dealing with interest-free loans was lacking.[11]

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[4] 585 F.2d at 235. Approximately 13% of the trusts' indebtedness to Areljay consisted of notes payable on demand, with the remainder being loans on open account.

[5] The Commissioner applied an interest rate of 6% per annum to the daily balance of the loans outstanding during the year to arrive at a gift of $1,086,407.75. One-third of this amount was allocated personally to Lester Crown. *Id.* at 235. A more detailed breakdown of the Commissioner's computation may be found in Crown v. Commissioner, 67 T.C. 1860, 1862 (1977).

[6] 67 T.C. 1060, 1065 (1977).

[7] 585 F.2d at 241.

[8] *Id.* at 237-40.

[9] INT. REV. CODE of 1954, § 2501 imposes a tax "for each calendar quarter on the transfer of property by gift."

[10] INT. REV. CODE of 1954, § 2512(b) provides in full:

> Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar quarter.

[11] "No statutory language or statements in the legislative history have been cited dealing specifically with interest-free loans." 585 F.2d at 237.

Though the court found that Congress intended broad interpretation[12] of the gift tax statute, it concluded that the Commissioner had failed to show an unequal exchange.[13] The Commissioner tried to show that the trusts' promise to repay was not equal in money's worth to the loans and that the time value of money reinforces the idea that a promise to repay in the future does not equal the full value of the note at the time of the transfer.[14] However, in this case, the "pay on demand" notes did not allow a time of repayment to be ascertained, as noted by the majority.[15] Nor did the court accept the Commissioner's computation based on multiplying the outstanding balances of the loans by the market interest rate on similar notes.[16] This procedure would create a gift tax exceeding even the principal if the lender refrained from calling the loan for a sufficiently long period.[17] Thus, the court rejected the Commissioner's argument under Section 2512(b) for valuation of the transfer.

The majority countered the Commissioner's policy consideration with its own policy considerations for rejecting interest-free loans as a taxable event. The Commissioner had relied on the connection between the gift and

[12] The committee reports relating to the interpretation of gift tax statutes show the scope of the concepts:

> [T]he terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense; the term "property" reaching every species of right or interest protected by law and having an exchangeable value.
>
> The words "transfer . . . by gift" and "whether . . . direct or indirect" are designed to cover . . . all transactions . . . whereby property or a property right is donatively passed to another, regardless of the means or device employed.

H. R. REP. No. 708, 72d Cong., 1st Sess. 22, 27-28 (1932), *reprinted in* 1939-1 CUM. BULL. (Part 2) 476; S. REP. No. 665, 72d Cong., 1st Sess. 39 (1932), *reprinted in* 1939-1 CUM. BULL. (Part 2) 524.

[13] "The Commissioner presents no evidence in support of the latter proposition, *i.e.*, unequal exchange, but only the argument that the promise to repay the loan at some indefinite time in the future and that given this time-value of money this must be worth less than its face value." 585 F.2d at 238.

[14] *Id.*

[15] "The reason that the value at the time of the loan cannot be determined with greater certainty is that the transfer of the economic benefit is incomplete at that point, being yet totally dependent on the lender's continuing willingness to refrain from demanding payment." *Id.*

[16] The Commissioner would find a gift to have occurred during any quarter in which there were no-interest loans outstanding and would measure the amount of the gift by multiplying the outstanding balances by the market interest rate on similar notes. The imputation of interest in subsequent time periods is not a theoretically accurate measure of the difference in value at the time of the loan between the money loaned and the promise to repay.

Id. at 239.

[17] The majority used this example to show how the gift tax could exceed the actual principal:

> [I]f a lender makes a $1,000 no-interest loan and the "proper" interest rate is 10%, under the IRS formula he would be treated as having made a gift of $100 in each year the loan remains outstanding. If the loan remains outstanding for 20 years, he will be treated as having made gifts totaling $2,000, whereas he would only have been taxed on $1,000 if he had made a gift of the principal in the first place.

Id. at 239 n.14.

estate tax, saying that such interest-free loans circumvented the estate tax by reducing the value of the estate to an amount equal to the value of the forgone interest. The court refused to agree for two reasons. First, as long as the loans were payable on demand, the lender's estate could require the loans to be repaid. Second, while the lender could have been earning interest on the principal, our tax system does not require one to pay taxes on interest which could have been, but was not, earned.[18]

Furthermore, administrative problems would be created by the imputation of interest. Courts would have to determine the appropriate rate and taxpayers would not be able to know in advance whether a loan would result in a gift. The breadth of such imputation could reach such transactions as borrowing a small amount for a week.[19]

The court observed that only one case, *Johnson v. United States,*[20] had dealt with the interest-free family loan. There no appeal was taken, despite a holding for the taxpayer that no gift was made by the forebearance of interest.[21] Although non-acquiescence to that decision was published in Revenue Ruling 73-61,[22] the court noted inactivity on the Commissioner's part to pursue the interest-free loan's taxability under the gift statute.[23]

A brief but strong dissent relied on the broad interpretation of Sections 2501, 2511[24] and 2512(b), as evidenced by legislative history.[25] The dissent criticized the majority for recognizing a benefit in substance, but dismissed the form as inapplicable to the gift tax guidelines established by Congressional intent.[26]

Despite the lack of case law on point,[27] there are cases which have dealt with the taxability of interest-free loans.[28] Two factual points distinguish those cases from *Crown:* (1) the loans had been between corporations or

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[18] *Id.* at 236.

[19] *Id.* at 241.

[20] *Id.* at 240. *See* Note, 19 STAN. L. REV. 870 (1967).

[21] 585 F. 2d at 240.

[22] Rev. Rul. 73-61, 1973-1 CUM. BULL. 408.

[23] 585 F.2d at 241.

[24] INT. REV. CODE of 1954, § 2511 expands § 2501 to apply "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible . . . ."

[25] *See* note 12 and accompanying text *supra.*

[26] 585 F.2d at 242 (Van Pelt, C.J., dissenting).

[27] "The question of whether the loan of property or cash constitutes a taxable gift by the lender if no charge of an inadequate charge is made for the loan is unsettled." C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 26.15 (3d ed. 1974).

[28] Kerry Investment Co. v. Commissioner, 500 F.2d 108 (9th Cir. 1974); Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862 (3d Cir. 1974); B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972); J. Simpson Dean v. Commissioner, 35 T.C. 1083 (1961).

businesses, and (2) the Commissioner had employed Section 482[29] as his basis for deficiency. The court's consistent rejection of IRS attempts to impute the taxable income was noted by citation to *J. Simpson Dean v. Commissioner.*[30] The imputing of interest was rejected in *Dean* since there was neither a case holding nor an administrative ruling or regulation which recognized the income to the taxpayer.[31] However, an equally persuasive counter-argument exists in *Latham Park Manor, Inc. v. Commissioner,*[32] in which the lender had interest income for interest-free loans made to the parent corporation determined under Section 482, as amplified by Regulation 1.482-1.[33] The Ninth Circuit in *Kerry Investment Co. v. Commissioner*[34] held that an allocation of income could be made even if the interest-free loan did not result in the production of gross income to the borrower.[35] The taxpayer in *Kerry* had made interest-free loans to a subsidiary corporation wholly owned by the taxpayer. The court remarked that "any scheme which permits related entities to regulate their tax obligations by transfer and retransfer of monies between themselves should be carefully scrutinized."[36] The *Crown* dissent agreed with this idea, particularly in light of the large amount of the transfer involved.[37]

Joseph Lupowitz Sons, Inc. v. Commissioner[38] differs from *Kerry* and *Latham Park,* and from *B. Forman Co. v. Commissioner*[39] in that the *Lupowitz* court found there to be contributions to capital instead of loans.[40] In *Forman,* however, the court found that the Commissioner was entitled to allocate interest where the lender-taxpayer had waived a right to interest on notes paying 5% per annum.[41] *Gertrude H. Blackburn v. Commissioner,*[42]

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[29] INT. REV. CODE of 1954, § 482 reads in pertinent part:
> In any case of two or more organizations, trades or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income [or] deductions . . . between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income . . . .

[30] 585 F.2d at 240.

[31] 35 T.C. at 1089.

[32] 69 T.C. 199 (1977).

[33] Treas. Reg. § 1.482-1 (1968). Regulation 1.482-1(a) provides definitions of terms used in Section 482, and Regulation 1.482-1(b) establishes the standard to be applied as "that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

[34] 580 F.2d at 110.

[35] *Id.*

[36] *Id.* at 109.

[37] 585 F.2d at 241-42 (Van Pelt, C.J., dissenting).

[38] 497 F.2d at 862.

[39] 453 F.2d 1144 (2d Cir. 1972).

[40] *See* 497 F.2d at 865-66 for an explanation of the court's reasoning in determining whether the transfer should be considered debt or equity.

[41] 453 F.2d at 1156.

[42] 20 T.C. 204 (1953).

cited by the Commissioner in *Crown,* dealt not with an interest-free loan, but with a transaction for less than adequate consideration between relatives that resulted in a gift.[43] The mother transferred real property to her children for a note worth less than the fair market value of the transferred property, the note bearing interest at a rate of 2¼% per annum. The opinion of the Commissioner was sustained in finding a gift equal to the difference in the interest charged and the market rate of 4%.

These cases show that the Service recognizes the transfer of an economic benefit in the interest-free family loan, but that such a transaction does not come within the purview of Code Section 482 by virtue of the types of parties involved, *i.e.,* relatives instead of businesses. The creation of income theory under Section 482 is akin to the gift tax question, but there is a problem as to whether interest should be imputed on such a loan and treated as a property interest subject to gift tax.[44]

Yet the remedy under the gift statutes was rejected in *Johnson,* the only case found on point, where taxpayers had made interest-free loans to their children. The *Johnson* court rejected the deficiency summarily by saying that Section 2501 did not cover this transaction and that the loans did not reduce the estate of the taxpayers nor defeat the purposes of the gift statute.[45] The court found no legal requirement for interest and commented that "the time has not come when a parent must suddenly deal at arm's length with his children."[46] *Crown* dealt with interpretation of statutes and policy considerations in more detail than did *Johnson.*[47] Neither *Johnson* nor *Crown,* in either the Tax Court or the Seventh Circuit opinion,[48] dealt with the use of interest as a property right spoken of in Section 2511.[49]

In criticizing the nontaxability of interest-free family loans, a number of commentators note the similarity of such loans to a revocable or short-term trust, but also point out the dissimilarity between the tax treatment of the trust and that of the interest-free family loan.[50] The trust requires the donor to pay gift tax on the corpus and the donee to pay income tax

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[43] *Id.* at 204-06.

[44] Hooton, *Gift Tax Analysis of Non-Interest Bearing Loans,* 54 TAXES 635, 639 (1976).

[45] 254 F. Supp. at 77.

[46] *Id.*

[47] *Compare* 585 F.2d at 237-41 *with* 254 F. Supp. at 77.

[48] *See generally* 585 F.2d at 234-41; 254 F. Supp. at 73-77; 67 T.C. at 1060-70.

[49] *See* note 24 and accompanying text *supra.*

[50] Carey, *Interest-Free Loans and the Gift Tax,* 38 OHIO ST. L.J. 903, 909 (1977); Hooton, *supra* note 44, at 639-40; O'Hare, *Taxation of Interest-Free Loans,* 27 VAND. L. REV. 1085, 1091 (1974); Note, 42 ALBANY L. REV. 471, 477 (1978); Note, 19 WM. & MARY L. REV. 361, 371 (1977).

on the income generated by the corpus. But the net result of *Crown* is an avoidance of both the income and gift tax.[51]

Consequently, the *Crown* decision, as commentators and tax planners have noted, allows the interest-free family loan to provide an effective estate and tax planning device.[52] Even after the *Johnson* decision, one tax planning article specifically outlined an interest-free loan plan to escape taxation.[53] The attributes of the suggested plan are: (a) the lender should retain no control implicitly or explicitly over the funds to avoid an inference of assignment; (b) the transaction should be evidenced in writing with adequate repayment provisions which are enforced; and (c) there should be a specific provision in the agreement for no interest. Interest-free loans allow an individual in a higher bracket to avoid taxes through "income splitting,"[54] completely contravening the purpose of the gift statutes.[55]

In discussing administrative considerations in *Crown*, the majority did not discuss Section 2503(b)[56] which provides a $3,000 threshold for gift taxation. This weakens the policy consideration argument regarding administrative problems since a significant amount of money could be loaned without interest before a taxpayer would reach the $3,000 limit.[57] Another weak point in the decision is the failure of the opinion to decide specifically whether forebearance of interest is a property right covered by Section 2511. Instead, the decision focuses upon valuation difficulties which would probably pose no problem since the market value of interest is fairly ascertainable.

As the *Crown* majority stated, the only recorded case on point is *Johnson v. United States*.[58] But the *Crown* court bolstered its argument by finding analogous cases under the income tax statutes. The *Crown* court followed the reasoning of *Johnson* by implying that interest-free family loans

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[51] *See* Frazier, *Interest-Free Loans between Family Members*, 48 J. OF TAX. 28 (1978).

[52] Aslanides & McGowan, *Interest-Free Loans Get Green Light as Compensation and Estate Planning Devices*, 7 TAXATION 132, 136-37 (1978); Burke, *Interest-Free Family Loans—Available as a Tax Planning Tool?*, 48 TAXES 137 (1970); Cooper, *New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 186 (1977); Hyde, *Income and Gift Tax Implications of Interest-Free Loans between Relatives*, 1 B.Y.U.L. REV. 155, 176 (1978); Rumpler, *A Tax Loophole For Everyone*, 1 OHIO C.P.A. 15 (1979); Tidwell, *Lester Crown Points the Way to Estate Tax Reduction Under the* 1976 *Tax Reform Act*, 55 TAXES 651 (1977); Note, 19 B.C.L. REV. 359, 360 (1977).

[53] Burke, *supra* note 52, at 138-39.

[54] Hyde, *supra* note 52, at 176; Note, *supra* note 52, at 360.

[55] *See* Lowndes, *supra* note 27, at § 22.2 for a discussion of the general purpose of the gift tax as a supplement to estate and income taxes.

[56] INT. REV. CODE of 1954, § 2503(b) excludes the first $3,000 for gift tax purposes per taxpayer per year.

[57] If the market value of interest were 10%, a taxpayer could loan $30,000 before reaching the $3,000 floor under Section 2503(b). A married couple, for instance, could loan $60,000 if the interest rate were 10%.

[58] 585 F.2d at 236.

should be dealt with specifically by statute or regulation because of the familial status of the parties and because foregone interest is not statutorily held to constitute a gift. Additionally, *Crown* looked to decisions in the Second, Third and Ninth Circuits which considered the question of taxability of interest-free loans based on the income tax. As the court observed, these circuits were loathe to impute interest until Treasury Regulation 1.482-2 was promulgated.[59] If the *Crown* majority was correct in its observation of these courts' decisions, it would follow that at least these three circuits would wait for comparable regulatory guidelines in the area of gift taxes. The reluctance of the district court in *Johnson* and of the aforementioned circuits to impute interest without specific guidelines indicates that cases comparable to *Crown* should be favorable to the taxpayer in these courts.

Since *Crown* did not mention any other circuits' decisions, it is not safe to assume that the unmentioned circuits would find for the taxpayer. Even if other circuits decide against the taxpayer, there could be a further split in the way they allow the Commissioner to compute interest. In that case, a statute, regulation or Supreme Court decision would be necessary for clarification. Of these options, a statute or regulation would provide the least ambiguity since a Supreme Court decision would offer a sound solution only for cases on point with the decided cases.

Two statutory or regulatory possibilities exist to make such situations taxable. Section 482 could be expanded to include individuals who are related to place interest-free family loans within the sphere of the income tax. Otherwise, the statute or regulation must provide gift taxation of the foregone interest. Specifically, such a provision might value such loans at a flat rate to save judicial speculation[60] and to afford a specific, uniform tax. At the same time it would allow intrafamily loans at an interest rate lower than what might be expected in an arm's length transaction. The gift tax could be satisfied and so could policy considerations concerning intrafamily dealings without the burden of an arm's length evaluation.

Until such a statute or regulation is enacted in either the income or gift tax provisions, the *Crown* decision will permit the interest-free family loans to avoid both the gift and income taxes and to provide an estate planning device.

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[59] *Id.* at 240.

[60] *See* Carey, *supra* note 50, at 918.