S. HRG. 98-1106

GIFT TAX RELIEF LEGISLATION

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
ESTATE AND GIFT TAXATION

AND THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

APRIL 4, 1984

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CONTENTS

ADMINISTRATION WITNESS

PUBLIC WITNESSES

ADDITIONAL INFORMATION

COMMUNICATIONS

GIFT TAX RELIEF LEGISLATION

WEDNESDAY, APRIL 4, 1984

U.S. SENATE, SUBCOMMITTEE ON ESTATE AND GIFT TAXATION AND SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE,

Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Heinz, Dole, Symms, Chafee, Boren, Bentsen, Bradley, and Long.

[The press release announcing the hearing, background, and issues by the Joint Committee on Taxation and the statement of Senator Dole follow:]

[Press Release No. 84-130, Mar. 29, 1984]

FINANCE SUBCOMMITTEES ANNOUNCE JOINT HEARING ON GIFT TAX RELIEF LEGISLATION

Senator Steve Symms, Chairman of the Subcommittee on Estate and Gift Taxation, and Senator Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management, announced today that the Subcommittees will hold a joint hearing on proposed legislation to overrule the Supreme Court's decision in *Dickman* v. *Commissioner of Internal Revenue,* with respect to certain interest-free demand loans outstanding before February 22, 1984, the date of the Court's decision.

The joint hearing will begin at 10:00 a.m. on April 4, 1984, in Room SD-215 of the Dirksen Senate Office Building.

In the *Dickman* case, the Supreme Court held that the Federal gift tax applies to the value of forgone interest on an interest-free demand loan. The decision resolved a judicial conflict on the treatment of interest-free demand loans. The decision did not deal with interest-free term loans, which the Tax Court has held to be subject to gift tax.

Senators Symms and Packwood stated that the Subcommittees would welcome testimony on behalf of taxpayers and tax advisers affected by the *Dickman* decision. In addition, they stated that the Subcommittees would be interested in receiving testimony on the possible effect of proposed relief legislation on the general administration of the tax laws.

Senators Symms and Packwood stated that the Subcommittees would be particularly interested in testimony addressed to the following issues raised by the proposed legislation.

1. What actual amounts of gift tax liability would be forgiven if the scope of the *Dickman* case were to be retroactively limited?

2. What types of transactions would be provided relief by such legislation? Specifically, would the legislation largely apply to transactions entered into intentionally to avoid estate and gift taxes, or would it largely affect taxpayers who structured transactions as interest-free demand loans for nontax purposes?

3. What legal advice was typically given to taxpayers making interest-free demand loans? Specifically, were taxpayers advised of taxes? If so, were taxpayers advised not to file gift tax returns disclosing their transactions? Or were taxpayers advised to consider filing gift tax returns in order to take advantage of the 3-year statute of limitations, or the 6-year statute of limitations applicable where a return

significantly understates taxable gifts? What is likely to be the effect of the *Dickman* decision, in the absene of legislation, on attorneys or tax advisers who counseled clients to make interest-free loans?

4. What is the likely effect of retroactive legislative relief on the administration of the tax laws generally? Is such legislation likely to increase the tax compliance problems caused by aggressive tax shelters, and taxpayers playing the "audit lottery?"

5. What administrative problems are likely to be faced by taxpayers, estate administrators, and the IRS, if the *Dickman* decision is not limited?

BACKGROUND AND ISSUES

concerning

GIFT TAX LEGISLATION PROVIDING

RELIEF FROM THE *DICKMAN* DECISION

Scheduled for a Joint Hearing

Before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

and the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

of the

SENATE COMMITTEE ON FINANCE

on April 4 and 12, 1984

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

April 3, 1984

JCX-6-84

INTRODUCTION

The Subcommittees on Estate and Gift Taxation and Taxation and Debt Management of the Senate Committee on Finance have scheduled a joint public hearing on April 4, 1984, on legislative proposals to overrule, or limit the retroactive application of, the decision of the Supreme Court in Dickman v. Commissioner, 465 U.S. ___ (1984). In the Dickman case (decided on February 22, 1984), the Supreme Court held that the Federal gift tax applies to the value of the foregone interest on an interest-free or below-market interest rate demand loan.

This document, prepared in connection with the Committee hearing, contains three parts. The first part provides an overview of present law. The second part contains a brief discussion of the issues raised by the legislative proposals. The third part mentions several of such proposals.

I. BACKGROUND

Overview of the Federal gift tax

Under present law, a tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual. In general, this tax applies to all direct or indirect transfers of real property or tangible or intangible personal property. The amount of the gift is the value of the property transferred at the date of the transfer. If property is transferred for less than adequate and full consideration in money or money's worth, the amount of the gift is excess of the value of the property at the date of the transfer over the value of any consideration received at such date.

Under present law, the gift tax is a progressive tax that is applied to cumulative lifetime transfers.[1] The amount of gift tax payable for any period is computed by determining the amount of tax payable on the taxpayer's lifetime transfers, and then by subtracting the tax payable on the transfers made in prior taxable periods.[2]

The first $10,000 of gifts by a donor to any person during a calendar year are not treated as taxable gifts. For calendar years prior to 1982, the first $3,000 of gifts were not treated as taxable gifts. Under the split-gift rules, a donor and his or her spouse can elect to treat a gift by one spouse to any person other than the other spouse as made one-half by the donor and one-half by his or her spouse. Thus, by taking advantage of the split-gift rules, the annual exemption for a married donor can be as much as $20,000.

In addition, under present law, there is a cumulative lifetime gift tax credit. The amount of this credit for any calendar year is a statutory amount less amounts allowable as credits for all prior taxable periods. For 1984, the

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1 The gift tax is computed and payable on an annual basis for all gifts made during calendar years after 1981 and before 1971. For calendar years from 1971 through 1981, the gift tax was computed and payable on as quarterly basis.

2 Thus, if a taxpayer filed a gift tax return for gifts made in a prior period, but did not include all the gifts in that period on that return, the unreported gift could increase the amount of the tax owed on gifts made during a subsequent period even though a gift tax return had been filed for the prior period and the limitations period had run. See Daanen v. Commissioner, 30 T.C.M. (CCH) 286 (1971).

statutory amount is $96,300. This amount is to increase annually to a maximum of $192,800 for 1987 and subsequent calendar years. A unified credit of $192,800 is the equivalent of a gift and estate tax exemption of $600,000. By taking advantage of the split-gift rules, this exemption equivalent can be increased to $1,200,000.

Generally, a gift tax must be assessed within 3-years after the filing of a gift tax return. No proceeding in a court for the collection of a gift tax can be begun without a prior assessment after the expiration of the 3-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If a gift tax return is filed for a period, and all gifts made during such period are not reported on the return, the duration of the period during which a tax can be assessed, or a suit commenced without assessment, depends on the amount of the unreported gifts relative to the amount of the reported gifts. If the amount of the unreported gifts is in excess of 25 percent of the amount of the reported gifts, the tax may be assessed, or a suit commenced to collect the tax without assessment, within 6 years after the return was filed.

Demand or term loans to family members under present law

On February 22, 1984, the Supreme Court decided the case of Dickman v. Commissioner, 465 U.S. ___ (1984). In that case, the Supreme Court held that under present law an interest-free or below-market interest-rate demand loan by one family member to another family member (referred to herein as a below-market loan) resulted in a gift for Federal gift tax purposes.[3]

Prior to the Dickman decision, current law was reflected in Rev. Rul. 73-61, 1973-1 C.B. 408, issued by the Internal Revenue Service in 1973 holding that below-market loans resulted in gifts for Federal tax purposes, and several court decisions that reached inconsistent results.

Rev. Rul. 73-61, 1973-1 C.B. 408, involved a transaction

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3 In Dickman, the Supreme Court did not reach the question of the valuation of the gift. In dicta, however, the Court stated that "to support a gift tax. . . . the Commissioner need not establish that the funds lent did in fact produce a particular amount of revenue; it is sufficient for the Commissioner to establish that a certain yield could readily be secured and that the reasonable value of the use of the funds can be reliably ascertained."

in which a parent negotiated a loan with a bank requiring the payment of interest at an arms-length rate. Shortly thereafter, the parent made a loan to a corporation controlled by his son in exchange for interest-free demand and term notes. The Internal Revenue Service ruled that the right to use property, including money, "is itself an interest in property the transfer of which is a gift" for Federal gift tax purposes "unless full and adequate consideration in money or money's worth is received." Further, the Service ruled that, in the case of a term loan, the amount of the gift is the value of the right to the use of the money as of the date the money and the note are exchanged computed under accepted actuarial methods. In the case of a demand loan, because the borrower has the right to use the money only so long as the lender does not demand payment, the amount of the gift is the value of the use of the money for such portion of the year as the lender allows the borrower the use of the money.

In Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966), the taxpayers made large interest-free demand loans to their children during the years 1956 through 1962. The loans were bona fide and most were repaid. The Internal Revenue Service asserted that the taxpayers had made gifts to their children in an amount equal to the value of the use of the money loaned for the period during which each of the loans was outstanding. The District Court for the Northern District of Texas held that the loans did not result in gifts for Federal gift tax purposes.

In Crown v. Commissioner, 67 T.C. 1043 (1977), the Tax Court held that interest-free demand loans by a partnership to relatives of the partners (and trusts for the benefit of such relatives) did not result in gifts for Federal gift tax purposes. The United States Court of Appeals for the Seventh Circuit affirmed the decision of the Tax Court (585 F. 2d 234 (1978)). The Internal Revenue Service announced that it would not follow that Crown decision (1978-1 C.B. 2).

The case of Dickman v. Commissioner, T.C.M. 1980-575 (CCH) (1980), involved interest-free demand and term loans made to a relative and to a closely held corporation controlled by the relative during the years 1971-1976. Citing Crown, the Tax Court held that the interest-free loans did not result in a gift for Federal gift tax purposes. The United States Court of Appeals for the Eleventh Circuit reversed the Tax Court and held that the loans resulted in taxable gifts under present law in amounts equal to the value of the right to use the loan proceeds for the period during which the loans were outstanding. As discussed above, the Supreme Court resolved the conflict between the Seventh and Eleventh Circuits holding that interest-free loans result in a gift for Federal gift tax purposes under present law.

All the cases that have considered the treatment of below-market term loans have held that such loans result in gifts for Federal tax purposes. In each case, the amount of the gift, which is deemed to occur at the time the loan is made (i.e. on the exchange of the money and the note), is the excess of the amount of the loan over the present value of the principal and interest payments due under the loan. See Blackburn v. Commissioner, 20 T.C. 204 (1953); Mason v. United States, 365 F. Supp. 670, aff'd 513 F. 2d 25 (1975); Estate of Berkman, 38 T.C.M (CCH) 1083 (1979); Dickman v. United States, supra; and Rev. Rul. 73-61, supra.

Proposed legislation

The Committee has approved legislation that, in substance, would codify the holding of the Supreme Court in Dickman and provide for the income tax treatment of below-market loans. The proposed legislation would treat the parties to a below-market loan as if they had made a loan bearing a market rate of interest and the lender had made a gift of money which is used to pay the interest. Under this proposed legislation, the payment of interest is included in income by the lender and deductible by the borrower to the extent that an actual payment would be deductible.

The proposed legislation would be effective with respect to amounts outstanding on loans after the date of enactment except to amounts outstanding on term loans made before February 1, 1984.

II. ISSUES

The proposals which are the subject of the hearing would overrule, or otherwise limit the retroactive application of, the Supreme Court's decision in Dickman v. Commissioner, supra, with respect to below-market loans outstanding prior to February 22, 1984. These proposals raise a number of issues.

1. What is the likely effect of the Dickman decision on subsequent estate and gift tax liabilities?

It can be argued that pre-1984 loans should be exempted from the Dickman decision because it will be difficult to know what subsequent estate and gift tax liabilities are since the amount of an individual's estate and gift taxes are dependent on prior gifts. On the other hand, taxpayers who wish such assurance could file gift tax returns for prior years which would start the running of the statute of limitations.

2. What is the amount of the gift in the case of loans covered by the Dickman decision?

It can be argued that the Dickman decision creates significant administrative problems because the amount of the gift may be difficult to determine. Under the Dickman decision, the amount of the gift is the amount of the foregone interest which, in turn, depends upon the credit worthiness of the borrower and the general level of interest rates at the time the loans were outstanding. Since these two items often vary over time, separate determinations of the foregone interest would be required every time one of the two items vary. On the other hand, the determination of the value of a gift is a frequent problem encountered in the gift tax and there are other areas of the law which have the same valuation problems (e.g., sec. 482). Moreover, administrative problems with valuation could be solved by legislation providing an appropriate discount rate (such as is provided in the legislation approved by the Committee for pre-1984 loans).

3. Was it reasonable for taxpayers that have engaged in these transactions to expect that they would not be subject to tax?

It can be argued that taxpayers who made below-market loans were relying in good faith on the 1966 Johnson decision or the 1977 Crown decision and, accordingly, they should not be subject to the gift tax. On the other hand, it can be argued that a below-market loan involves, in substance, an assignment of income and, under general principles of tax law, such assignments are subject to gift tax. Moreover, the Internal Revenue Service's position has been clear at least since 1973 (Rev. Rul. 73-61, supra.), if not since 1966 (the Johnson case), and that the gift tax should apply with respect to amounts outstanding after taxpayers were on notice of the Service's position.

4. What is the likely effect of retroactive legislative relief on the administration of the tax laws generally?

It can be argued that if relief is provided in this case, relief should be provided in other cases in which the law is not clear. For example, relief should also be provided in other instances in which the Internal Revenue Service has lost one or more cases before the Supreme Court determined that the Service was correct. On the other hand, it can be argued that relief is justified in this case because prior to the Dickman decisions, the two litigated cases were decided favorably to the taxpayers.

III. POSSIBLE LEGISLATIVE PROPOSALS

There are a number of possible approaches that could be employed to overrule, or otherwise limit the application of, the Supreme Court's decision in Dickman v. Commissioner, supra.

These include:

1. A rule providing that there is no taxable gift for loans outstanding before the date of the Dickman decision (February 22, 1984).

2. A rule providing that there is no taxable gift for loans outstanding on the date the taxpayers were on notice of the Service's position (1966 or 1973).

3. A rule providing that there is no taxable gift on small loans (e.g., less than $100,000).

4. A rule providing an election for taxpayers to apply the new proposed statutory provisions to amounts outstanding prior to the enactment of the new rules.

5. A rule providing that there is no taxable gift if the loan is rewritten within a short period after the date of enactment to require the payment of interest at an adequate rate.

Statement of Senator Dole on Gift Tax Relief Legislation

INTRODUCTION

The issue of today's hearing is whether the Congress should provide some form of retroactive tax relief for individuals who used interest-free loans as a method of transferring wealth to members of their family. The courts have held since 1953 that low-interest loans for a fixed term can result in gift tax liability. However, the IRS lost the first two cases it brought involving interest-free loans payable on demand. In the third case, the IRS prevailed in 1982. And the Supreme Court decided this past February that the IRS was correct all along in taking the view that the Federal gift tax statute applies to gifts made through the device of an interest-free loan.

THE ROLE OF THE COURTS IN INTERPRETING TAX STATUTES

It is a common occurrence for the IRS, and other governmental agencies, to lose in one court and prevail in another court on the same issue. Indeed, much of the Supreme Court's caseload is devoted to conflicts between two or more Federal appellate courts. In our system, when the IRS and taxpayers disagree on the meaning of a statute, the decision is left to the courts. Because their role is to interpret existing statutes, and not to write new law, court decisions are generally applicable to all tax years not closed by the statute of limitations, or by agreement.

I look forward to hearing the views of taxpayers and tax advisors as to why a special exception from the general rule should, or should not, be enacted in this case by the United States Congress.

REVENUE CONCERNS

I am not primarily concerned, at this time, about the revenue loss associated with the proposed legislation. In part, this is because I am informed that there is currently no easy way to calculate the potential revenue loss. This is because the IRS has no records of individuals who make gifts, but fail to file gift tax returns.

We do know that one of the cases lost by the IRS involved loans in excess of $18 million. We also know that after that famous case was decided in 1978, the popularity of interest-free loans as a planning device really took off. I hope our witnesses from the legal and accounting professions will be able to provide the committee with some sense of the magnitude of the tax relief that is being proposed.

ADMINISTRATIVE ISSUES

My primary concern at this point is with the implications of the proposed relief legislation for our self-assessment tax system. The position of the IRS, that interest-free demand loans are subject to gift taxes, was known since 1966 and officially announced in 1973. The fact, that the IRS lost two cases on the issue, before it won its third case in the Supreme Court, does not seem to make a compelling case for relief.

More importantly, such legislation might set a troubling precedent. The Treasury would seemingly be placed on notice that, whenever it lost a tax case in tax court or district court, legislation should immediately be sent to the Congress to correct the decision, instead of proceeding further in the courts. While that might be a pleasant change for the courts, the burden it would place on Congress would be heavy. Moreover, the Congress would also be placed on notice that, unless it acted quickly on Treasury's proposals, substantial revenue losses could be anticipated.

Finally, taxpayers and their tax advisers would soon realize that the "audit lottery" could be played under a new set of rules. Not only could aggressive taxpayers feel confident that their chances of being audited were less than 2 percent, but taxpayers would be further emboldened by the thought that even if they were audited, they could litigate; even if they litigated and lost, they could appeal, and even if the Supreme Court upheld the IRS, the Congress could be counted on to forgive their tax liability.

In time, "Gresham's Law," that "Bad money drives out good money," would take on new twist: Bad tax advice would drive out good tax advice, since it really wouldn't make any difference whether you were right or wrong.

Perhaps these concerns are unwarranted. Perhaps they are legitimate but counterbalanced by other concerns. In any event, I look forward to hearing the comments and concerns of our distinguished witnesses.

Senator PACKWOOD. Are you ready, Buck?

Secretary CHAPOTON. Yes, sir.

Senator PACKWOOD. The committee will come to order. We have but one issue before us today and it's the issue of retroactivity of the *Dickman* case.

We have to testify before us today John Chapoton, the Assistant Secretary for Tax Policy of the Treasury, and numerous other lawyers and CPAs on behalf of different interests.

I would encourage the witnesses to put their entire statement in the record, and to limit their oral testimony to 5 minutes. I think the issue in this case is not complicated. The equities are debatable, but I don't think the issues per se are complicated issues to understand.

John, do you have any opening statement?

Senator HEINZ. Mr. Chairman, in lieu of an opening statement, I would just ask unanimous consent that a letter to you and Senator Symms from Irwin Griswald, the former dean of the Harvard Law School, and the former Solicitor General be placed in the record at this point.

The author, Dean Griswald, makes really two, I think, telling points. One is the fact that prior to the *Dickman* case and, in fact, prior to the 1966, 1977, 1978 decisions, there had never been a holding contrary to the fact that these were, in fact, not subject to tax. And, secondly, he goes into considerable detail on the difficulties that trying to apply the Supreme Court decision retroactively in terms of sorting out the variety of kinds of gifts, the difficulties of valuing the gifts, both the administrative and legal difficulties and the extent to which they would complicate the attempt to apply the Supreme Court decision retroactively in this case would make. And I just ask that it be a part of the record.

Senator PACKWOOD. Without objection.

Senator PACKWOOD. Senator Dole.

Senator DOLE. Thank you very much. I have a statement that I would like to put in the record where I have tried to review what the law has been and where we are today. I'm not so concerned about the revenue loss because I understand it may be pretty difficult to measure. But we do know that one of the cases lost by the IRS involved loans in excess of $18 million. We also know that after that famous case was decided in 1978, the popularity of interest free loans as a planning device really took off. So I'm hoping that some of our witnesses here can shed some light on that.

My primary concern at this point is that the implications of the proposed relief legislation as far as it might affect our self-assessment tax system. The position of the IRS that interest free demand loans are subject to gift taxes was known since 1966, and officially announced in 1973. The fact that the IRS lost two cases on the issue before it won its third case in the Supreme Court does not seem to make a compelling case for relief. More importantly, such legislation might set a troubling precedent. The Treasury would seem to be placed on notice that whenever it lost a tax case in tax court or district court, legislation should immediately be sent to Congress to correct the decision instead of proceeding further in the courts. That might be a pleasant change for the courts, but the burden that would place on Congress would be heavy. Moreover, the Congress would be placed on notice that unless it acted quickly on Treasury's proposals, substantial revenue losses would be anticipated. Finally, taxpayers and their tax advisors would soon realize that the audit lottery could be played under a new set of rules. Not only could aggressive taxpayers feel confident that their chance of being audited was less than 2 percent, the taxpayers would be further embordered by the thought that even if audited, they could litigate. Even if they litigated and lost, they could appeal. And even if the Supreme Court upheld the IRS, the Congress would quickly forgive their tax liability.

In the meantime, Gresham's law that "bad money drives out good money" would take on a new twist. Bad tax advice would drive out good tax advice, and it really wouldn't make any difference whether you are right or wrong.

Perhaps these concerns aren't warranted, but I hope to ask Mr. Chapoton if there is any real urgency to this issue. The last thing Congress wants to do is rush in here and bail out a lot of people who have a lot of money and then try to justify it to the rest of the American people. If there is some urgency, maybe we ought to act. But I don't think this ought to be a rush job. I don't see any urgency. I think we ought to have deliberate hearings and figure out what the facts are and then maybe take some appropriate action.

And I know the Treasury recommended some de minimis changes in the earlier bill, but those were rejected. And there are a lot of pressures on each of us. I've had calls from my State. And, again, maybe there is a reason to take action quickly. I don't think anybody is going to be disadvantaged if we fail to do this in the next couple of days. I will be happy to hear from Mr. Chapoton.

Senator PACKWOOD. Mr. Secretary, go right ahead.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary CHAPOTON. Thank you, Mr. Chairman. We are happy to have the opportunity to present the views. As I think you know, it's a matter of principle that the Treasury Department is strongly opposed to legislation overruling the holding in the *Dickman* case and making it nonretroactive. We do recognize that there are some practical problems for the taxpayers and their advisors that could be presented, and for the IRS as well, by carrying the *Dickman* case to its full extreme for the past. We think they can be handled administratively.

At the conclusion of my statement I set forth the approach the IRS intends to follow to relieve these concerns.

The present gift tax was enacted in 1932, Mr. Chairman, to close an obvious loophole in the estate tax system. The statute was broadly drafted and the committee reports accompanying the Revenue Act of 1932 emphasized the specific intent to reach all of the gratuitous transfers of any type of interest in property. The Treasury regulations since 1933 have reflected this broad scope of the gift tax.

The interest free demand loan is an attempt to avoid estate and gift taxes by freezing the transfer tax base at its current amount while delaying payment of tax until the taxpayer's death. The effect of the tax free transfer from one generation to the next—the significance of the tax avoidance potential through interest free loans—is illustrated by examples in my written statement. These examples clearly show why taxpayers and their advisors jump aboard this type of avoidance device in the hope that the IRS position would be rejected by the courts.

In addition to the transfer tax savings, significant income tax savings can result with the transferee when the borrower is in a lower income tax bracket than the lender.

Income and transfer tax savings can also be achieved if the transaction is at a below market interest rate rather than a no interest rate loan. The taxpayer first recognized this in 1953 in the *Blackburn* case, involving a sale of property in exchange for a low interest term note, holding that a taxable gift involved. A similar issue was again presented in 1979 in the *Berkman* case. The court again held that a taxable gift was involved. The borrower got a 20-year, 6-percent loan when the prevailing interest rates were much higher. The IRS took this same position in a 1979 Letter Ruling.

The first gift tax case involving interest free demand loans was the *Johnson* case in 1966 and the court held for the taxpayer. This case was promptly criticized by numerous commentators. For example in the one I mention in my written statement from the Stanford Law Review, the author says that the district court in *Johnson* simply overlooked the economic realities evident in these transactions.

The Service announced in 1973 they would not follow the *Johnson* decision, and would apply the gift tax to interest free demand loans in each calendar quarter during which the demand loan is outstanding.

The next development came in the Tax Court's decision in 1979 in the *Crown* case and the seventh circuit's affirmance in 1978. The decision declined to accept the IRS position. Again the court case was widely criticized by the commentators, and I cite a number of commenators in the testimony that did criticize that case.

And, of course, the last was the *Dickman* case that was decided in 1982 by the eleventh circuit and affirmed in 1984 by the Supreme Court. The facts in the *Dickman* case are important in that it includes 2 years prior to publication of the 1973 ruling by the Service. The Supreme Court specifically rejected the taxpayer's argument that the 1973 ruling presented a change in the position of the IRS or that the taxpayer was prejudiced in this regard, pointing to the broad sweep of the Treasury regulations under the gift tax.

With this background, let me turn to some of the specific questions that the witnesses were asked to address by the press release.

The first issue was the revenue impact of making the *Dickman* case nonretroactive. Most taxpayers who made interest free loans did not report them as taxable gifts, and for that reason it is difficult for the IRS to know the total amount of gift tax liability which would be forgiven if Congress acted in this regard. Some limited information is available. The IRS is currently contesting 33 cases involving interest free demand loans, involving an aggregate potential gift tax liability of approximately $5.5 million.

We think the volume of cases and the aggregate gift tax liability would be much larger in later years where the audit process has not yet been commenced. There is usually a considerable time lag in bringing gift tax cases to audit. Most of the cases relating to years after 1978, of course, when the *Crown* case was decided, have not yet been brought into the audit system.

In addition, interest rates increased significantly in the late 1970's, making the tax benefits substantially greater for interest free loans, and, of course, increasing the potential gift tax liability. We think a conservative estimate would mean that tens of millions of dollars are at stake.

We were also asked for a profile of the taxpayers who might be affected. Undoubtedly, there are many cases involving relatively small loans, including cases where taxes were an insignificant consideration. On the other hand, in light of the substantial attention which was given this issue following the *Crown* case, it is reasonable to assume that a substantial number of large loans were made during the period between the *Crown* and *Dickman* decision.

In the 33 cases currently being contested, at least four involve outstanding loan balances consistently in excess of $1 million. One of those involved loans to more than 20 recipients with an aggregate loan balance of up to $10 million. Another example is the *Crown* case itself, which involved loans of over $18 million. If you make the *Dickman* case nonretroactive, each of these loans would be made tax free, inconsistent with the Supreme Court holding.

Another question you asked us to address was the legal advice taxpayers may have received in making interest free demand loans. I cannot state with certainty the legal advice actually given, but I can address the legal advice we think that should have been given to the taxpayers. The IRS, on the position of the applicability of the gift tax, has not varied. The protaxpayer decisions in *Johnson* and *Crown* are contrary to the generally broad thrust of the gift tax and were widely criticized by commentators. We think taxpayers entering into substantial interest free demand loan transactions, especially after 1973, should have been advised by their tax advisors of the significant risk that the transaction would give rise to gift tax consequences.

Even prior to 1973, prudent tax advisors should have counseled their clients on the potential gift tax consequences. The Commissioner's victory in *Blackburn* and the Government's position in *Johnson* gave a clear indication of IRS' intention to apply the gift tax to loans not bearing a market interest rate.

More importantly, the Supreme Court itself directly addressed this issue in *Dickman*. And it clearly rejected the argument that it would be unfair to apply the gift tax to loans outstanding prior to 1973.

We see no equitable basis, Mr. Chairman, for granting nonretroactive relief to those taxpayers who entered into transactions with substantial tax-avoidance effect. This is especially true in those cases where the loans were so large that it is reasonable to assume the lender had professional tax advice. And to do so could encourage taxpayers to take aggressive positions in other areas, secure in the knowledge that if the Government's position is ultimately confirmed by the Supreme Court, Congress will be inclined to limit the Government's position to prospective application. The self-assessment tax system already favors overly aggressive reporting. And Congress ought not to exacerbate this problem by rewarding such conduct. This is particularly true when a significant legal issue is involved having substantial tax-avoidance potential. I would also echo the statement made by Senator Dole that bad advice drives out good advice. And we would be telling the taxpayers to take aggressive positions. We will be telling the tax counsel who is cautious in this regard that you need not be cautious—that even if you lose it in court, Congress is likely to protect you for past years.

Let me turn finally to administrative considerations. We recognize that many taxpayers undoubtedly made interest free loans of relatively small amounts with no thought of tax consequences at all. In most cases, no records would have been kept and literal application of the *Dickman* decision could be difficult. On the other hand, the gift tax law already contains mechanisms for removing most small transactions from the system. The annual exclusion is now $20,000 for a married couple gift, $6,000 before 1982. That would remove most interest free loans from the scope of the gift tax. If the statutory interest rate as provided in section 6621 is used as the basis for calculating the value of an interest free loan, a table on page 8 of my written testimony shows the amount that a loan could have been outstanding to each recipient for a full year without any gift tax consequences. Basically, the table shows that in most years a couple could have a demand loan outstanding of approximately $100,000 to each of several children or grandchildren with absolutely no gift tax consequences.

We recognize the taxpayers might have used up this annual exclusion by other gifts. For administrative convenience, the Service is willing to assume that the taxpayers had their entire annual exclusion available and to ignore annual variations in the maximum loan amount. For that reason, the Service will announce that it will disregard all interest free loans of up to $100,000 per recipient for any married couple, $50,000 for a single taxpayer, for the period prior to the Supreme Court's decision. Loans not greater than this amount would also be disregarded for purposes of computing the gift tax on future gifts and the estate tax on the taxpayer's estate.

We think the $100,000 exclusion is going to remove the vast majority of interest free loan transactions from the gift tax system, including all loans that were made for legitimate nontax reasons without the benefit of professional advice.

On the other hand, we think it's fair to assume that if you had a loan in excess of $100,000 per recipient, it was done with due concern for taxes. And, in fact, many of these cases will have been motivated by tax avoidance.

With respect to loans in excess of $100,000, the question remains as to what is the appropriate interest rate. We are suggesting, Mr. Chairman, that for these earlier years on the relatively low rate, the short-term T-bill rate—that might be used. And the IRS will so announce. We will also say that in the periods where the statutory 6621 rate might have been lower, the taxpayer for the prior years will have the option of using the lower rate.

So to summarize, Mr. Chairman, we think the administrative action that the Service is taking will be sufficient to respond to legitimate taxpayer concerns. This is clearly within the administrative discretion of the IRS. We do not think any further legislative action is necessary, and we strongly urge the committee not to simply give retroactive relief to all pre-*Dickman* interest free and low interest loans. Not only could that add a significant dollar cost on the Treasury, but most importantly the gift tax—some very large family loans made for the very purpose of transferring wealth in avoidance of the gift tax after careful advice of tax counsel.

In addition, we would be very concerned if this committee should state that a position taken by the Commissioner of the Internal Revenue is only valid starting from the date on which that position is confirmed by the Supreme Court.

Mr. Chairman, that concludes the summary of my statement. I will be happy to answer any questions.

[The prepared statement of Hon. John E. Chapoton follows:]

For Release Upon Delivery
Expected at 10 a.m. EST
April 4, 1984

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
AND THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittees:

I am glad to have this opportunity to testify regarding proposed legislation to grant retroactive relief to those taxpayers affected by the Supreme Court's decision in Dickman v. Commissioner. In the Dickman case, the Supreme Court upheld the Government's longstanding position that the forgone interest on a nonbusiness interest-free demand loan results in periodic gifts from the lender to the borrower for gift tax purposes.

As a matter of principle, the Treasury Department strongly opposes legislation that would make the holding in Dickman inapplicable to loans outstanding prior to February 22, 1984, the date of the Supreme Court's decision in that case. We recognize, however, that the Dickman decision, if carried to its logical conclusion, may present a number of practical problems for taxpayers and their advisers, as well as the IRS. We believe that these problems can be handled administratively and the approach that the IRS intends to follow is outlined in the last section of my statement.

Background

The present gift tax was enacted in 1932 to close an obvious loophole in the estate tax system. The statute is broadly drafted and the committee reports accompanying the Revenue Act of 1932 emphasized Congress' specific intent to reach all gratuitous transfers of any type of interest in property. The Treasury regulations since 1933 have always reflected this broad scope of the gift tax.

The interest-free demand loan is an attempt to avoid estate and gift taxes by freezing the transfer tax base at its current amount while delaying payment of tax until the taxpayer's death. To see how this works, an example may be helpful:

Suppose T has $300,000 and wishes to transfer as much as possible of this sum to her son S, after payment of Federal transfer taxes. Assume that T is in the 50 percent transfer tax bracket. T expects that the $300,000 will earn interest which will double its value by the time of her death. This would occur if (i) the funds can be invested at 10% before tax, (ii) T is in the 50% tax bracket, and (iii) the time period in question is approximately 14 years.

If T waits until her death to make the transfer to S, the $300,000 will grow to a pre-tax amount of $600,000, which is then subject to a 50 percent estate tax, leaving S with $300,000. If T makes an immediate gift to S during her lifetime, she may transfer $200,000 to S with enough left over to pay the gift tax liability of $100,000. The $200,000 amount which S receives will grow to $400,000 by the time of T's death.

Now suppose T makes an interest-free demand loan of $300,000 to S. If no gift tax liability is imposed at the time of the loan nor at any time while the loan is outstanding, the $300,000 of interest which the loan principal amount would earn (after income taxes) would go to S, free of any transfer tax consequences. If T then forgave the loan to S at her death, an estate tax liability of only $150,000 would be imposed, leaving S with $450,000 ($150,000 of after-death-tax loan principal plus $300,000 of accrued interest). If T forgave the loan to S immediately prior to her death, a gift tax of $100,000 would be imposed, leaving S with $500,000. Thus, compared to a direct transfer at death, the interest-free loan technique reduces the effective transfer tax rate from 50% of the total transfer to 16-2/3%. Compared with an outright gift, the effective tax rate is reduced 50% of the amount S receives to 20%.

Interest-free loans also can provide significant <u>income</u> tax savings if the borrower is in a lower income tax bracket than the lender. The benefit of this income tax savings can compound rapidly if the bracket spread is significant or if the loan is outstanding for a substantial time period. Using the above example, if S were in the 30 percent income tax bracket, the $300,000 loan amount would grow to $784,000 rather than $600,000, over the 14-year period. Of course, the additional $184,000 would accrue to S's benefit free of gift tax liability as well.

Similar income and transfer tax savings can be achieved with loans for a definite term and loans bearing a below-market interest rate (rather than no interest whatsoever). The Tax Court first recognized this fact in Blackburn, 20 T.C. 204 (1953), holding that a sale of property in exchange for a low-interest term note was a taxable gift measured by the difference between the value of the property sold and the value of the note. While the reasoning in this case is not directly applicable to a demand loan, Blackburn established the principle that a transaction involving a loan not bearing an arm's-length interest rate can give rise to gift tax consequences. A similar issue was presented in Estate of Berkman, 38 TCM 183 (1979), where the Tax Court found a taxable gift in a case involving a 20-year, 6% loan was made at a time when prevailing interest rates were substantially higher. The IRS took the same position as the Court in Berkman in the 1979 Letter Ruling 7905090.

The first gift tax case to face a situation involving interest-free demand loans was the 1966 District Court case of Johnson v. United States, 254 F. Supp. 73 (N.D. Texas 1966). While this case held that interest-free demand loans are beyond the reach of the gift tax, the decision was promptly criticized by numerous commentators. For example, the following language appeared in a 1967 article in the Stanford Law Review:

> [I]nterest-free loans cannot escape gift taxation if the gift tax is to continue to supplement effectively the federal estate and income taxes. The court in Johnson simply overlooked the economic realities evident in these transactions. Westover, Gift Taxation of Interest-Free Loans, 19 Stan. L. Rev. 870 (1967).

The Internal Revenue Service did not publish a nonacquiescence in Johnson since it was a district court decision. The Service did announce in 1973, however, that it would not follow the Johnson decision and that it would apply the gift tax to interest-free demand loans in each calendar quarter during which the demand loan was outstanding. Rev. Rul. 73-61, 1973-1 C.B. 408. The ruling indicated that the interest rate to be used in determining the value of the use of the loan principal during the calendar quarter would depend on the actual circumstances pertaining to the transaction.

The next development came in the Tax Court's 1977 decision and the Seventh Circuit's affirmance in Crown v. Commissioner, 67 T.C. 1060 (1977) (reviewed by the court), nonacq., 1978-2 C.B. 3, aff'd 585 F.2d 234 (7th Cir. 1978). While this decision declined to accept the Commissioner's position, the case again was widely criticized.*

The last case was Dickman v. Commissioner, decided in the Commissioner's favor by the Eleventh Circuit in 1982, 690 F.2d 812 (11th Cir. 1982), and affirmed by the Supreme Court on February 22, 1984, 52 U.S.L.W. 4222 (1984). The tax years in dispute in Dickman were 1971-1976, which includes two years prior to publication of the 1973 ruling. The Supreme Court specifically rejected the taxpayer's argument that the 1973 ruling represented a change in the position of the IRS on this issue that prejudiced the taxpayer, pointing to the broad sweep of the Treasury regulations under the gift tax, 52 U.S.L.W. at 4225, n.11.**

With this background in mind, I turn to the specific issues raised by the Subcommittees in the Press Release of March 29, 1984.

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* See, e.g., S. Surrey, W. Warren, P. McDaniel & H. Gutman, Federal Wealth Transfer Taxation: Cases and Materials 154-156 (2d ed. 1982); R. Stephens, G. Maxfield, S. Lind & D. Calfee, Federal Estate and Gift Taxation ¶10.01[2][f] (5th ed. 1983); H. Dubroff & D. Kahn, Federal Taxation of Estates, Gifts and Trusts ¶20-02, at 314 (3d ed. 1980); Joyce & Del Cotto, Interest-Free Loans; The Odyssey of a Misnomer, 35 Tax L. Rev. 459, 468-469, 489-490 (1980); Pulliman, Income and Gift Tax Implications of Nonbusiness Interest-Free Loans; Looking a Gift Horse in the Mouth, 58 Taxes 675 (1980).

** The numerous cases regarding the income tax consequences of interest free loans, beginning with the Tax Court's 1961 decision in Dean, 35 T.C. 1038, nonacq. 1973-2 C.B. 4 do not support the taxpayers' position in the gift tax area. The line of cases following Dean have found no taxable income to the borrower in the event of an interest-free loan in a business context. The tax consequences to the lender were not addressed even implicitly. Moreover, these cases are based on the rationale that if the receipt of an interest-free loan in a non-gift setting gives rise to taxable income, the borrower would be entitled to an offsetting deduction. Since in the gift tax context there would be no offsetting deduction, the Dean line of cases gives no support to the position that an interest-free demand loan is free from gift tax consequences.

1. Revenue Impact of Making Dickman's Holding Prospective Only

Because most taxpayers who made interest-free loans did not report them as taxable gifts, it is difficult for the Internal Revenue Service to know the total amount of gift tax liability which would be forgiven if Congress were to apply the gift tax only to interest-free loans outstanding after Dickman. Some limited information, however, is available. At the present time, the IRS is contesting 33 cases involving interest-free demand loans, involving an aggregate potential gift tax liability of approximately $5.5 million.

A number of factors indicate that the volume of cases and the aggregate gift tax liability for cases where the audit process has not yet begun is much larger. First, because of the considerable time lag in bringing gift tax cases to audit, most cases relating to years after 1978 have not yet been brought into the system. Second, interest rates increased substantially in the late 1970s. This made the tax benefits of interest-free loans substantially greater and also increased the potential gift tax liability for a fixed amount of loan principal. Hence, even a conservative projection from the existing caseload would indicate that tens of millions of dollars are at stake.

2. Profile of Taxpayers Affected by Dickman

As noted above, it is impossible for the IRS to know what taxpayers are affected by the Dickman decision since those taxpayers almost invariably did not report these transactions on gift tax returns. Undoubtedly, there were many cases involving relatively small loans, including cases where taxes were an insignificant consideration. On the other hand, in light of the substantial attention which was given to this issue following Crown, it is also reasonable to assume that a substantial number of large loans were made during the period between the Crown and Dickman decisions.

With respect to the 33 cases currently being contested, at least four involve outstanding loan balances consistently in excess of $1 million. One of these involved loans to more than 20 recipients with an aggregate loan balance of up to $10 million. Another example is the Crown case, which involved loans of over $18 million. Since the decision in Crown governs only the taxable year 1967, the Dickman decision would apply to other taxable years during which these substantial loans were outstanding.

3. Legal Advice to Taxpayers Making Interest-Free Demand Loans

Other witnesses will be testifying as to legal advice that was actually given to clients entering into interest-free demand loan transactions. For my part, I would like to address the issue of what legal advice should have been given by tax advisers to their clients.

As the background discussion above makes clear, the IRS position on the applicability of the gift tax to interest-free demand loans has never varied and has been clearly enunciated at least since 1973. The pro-taxpayer decisions in Johnson and Crown are contrary to the generally broad thrust of the gift tax and were widely criticized. Accordingly, taxpayers entering into substantial interest-free demand loan transactions, especially after publication of the 1973 ruling, should have been advised of the significant risk that the transaction would give rise to gift tax consequences.

Even prior to 1973, prudent tax advisors should have counseled their clients on the potential gift tax consequences of interest-free loans. The gift tax statute and the Treasury regulations have always had a broad scope, reaching indirect as well as direct transfers. Moreover, the Commissioner's victory in Blackburn and the Government's position in Johnson gave a specific indication of IRS's intention to apply the gift tax to loans not bearing a market interest rate.

Most importantly, the Supreme Court itself directly addressed this issue in Dickman. The Court clearly rejected the argument that it would be unfair to apply the gift tax to loans outstanding prior to 1973.

With regard to the question of whether taxpayers were advised to file gift tax returns in order to start the statute of limitations running, we can only guess that the practice varied widely. Undoubtedly, many taxpayers making large interest-free term loans were advised to file returns for the quarter during which the loan was made. For demand loans, however, a gift tax return would have to have been filed for every calendar quarter during which the loan was outstanding to fully protect the taxpayer. Practitioners may well have counseled against this practice since it could serve as a red flag to the Service, inviting audit.

4. Precedential Effect of Retroactive Relief

In light of the above, we see no equitable basis for granting retroactive relief to those taxpayers who entered into transactions with substantial tax-avoidance effect; this is especially true in those cases where the loans were so large that it is reasonable to assume that the lender had professional tax advice. To do so could only encourage taxpayers to take aggressive positions in other areas, secure in the knowledge that if the Government's position is ultimately confirmed by the Supreme Court, Congress will be inclined to limit the Government's position to prospective application. We are concerned that the self-assessment system already favors overly aggressive reporting. Congress ought not exacerbate the problem by rewarding such conduct through retroactive relief when the position of the Service is sustained. This is particularly important when a significant legal issue having substantial tax-avoidance potential is involved.

. To assure effective administration of the tax laws, the Commissioner must be allowed to enforce positions regarding the proper interpretation of the statute which have not been confirmed by the Supreme Court. As the Supreme Court itself stated in United States v. Estate of Donnelly, 397 U.S. 286, 294-295 (1970):

> Acts of Congress are generally to be applied uniformly throughout the country from the date of their effectiveness onward. Generally the United States, like other parties, is entitled to adhere to what it believes to be the correct interpretation of a statute, and to reap the benefit of that adherence if it proves to be correct, except where bound to the contrary by a final judgment in a particular case. Deviant rulings by circuit courts of appeal, . . ., cannot generally provide the "justifiable reliance" necessary to warrant withholding retroactive application of a decision construing a statute as Congress intended it.

5. Administrative Considerations

(a) Relatively Small Loans

We readily acknowledge that many taxpayers undoubtedly made interest-free loans of relatively small amounts to family members with little or no thought to the tax consequences of the loan. In most cases, no record will have been kept of the exact amounts and dates of the loans and repayments. Literal application of the Dickman decision to these cases could result in a burden on taxpayers and on the tax advisers charged with alerting clients to the tax consequences of these past transactions.

On the other hand, the gift tax law already contains mechanisms for removing most small transactions from the system. In particular, the annual exclusion of $20,000 for a married couple ($6,000 before 1982) will remove many interest-free loans from the scope of the gift tax. For example, if the statutory interest rate in section 6621 is used as the basis for calculating the value of an interest-free demand loan, the following table indicates the maximum demand loan a married couple could have outstanding to each recipient in any year without any gift tax consequences:

Year	Combined Annual Exclusion	Average Statutory Interest Rate	Maximum Loan
1974 and earlier years	$6,000	6.00%	$100,000
1975	6,000	7.50%	80,000
1976	6,000	7.17%	83,721
1977	6,000	7.00%	85,714
1978	6,000	6.03%	98,630
1979	6,000	6.00%	100,000
1980	6,000	11.50%	52,174
1981	6,000	12.00%	50,000
1982	20,000	19.33%	103,448
1983	20,000	14.44%*	138,476

* Effective annual rate reflecting daily compounding

Thus, in most years, a couple could have a demand loan outstanding of approximately $100,000 to each of several children (and grandchildren) with no gift tax consequences.

Of course, taxpayers making interest-free loans may have used up all or part of their annual exclusion on other gifts to the same recipients. However, for administrative convenience, the IRS is willing to assume that taxpayers had their entire annual exclusion available and to ignore annual variations in the maximum loan amount. Hence, the Service will disregard all interest-free loans of up to $100,000 per recipient for any married couple ($50,000 for a single taxpayer) for the period prior to the Supreme Court's decision in Dickman. Loans not greater than this amount also will be disregarded for purposes of computing the gift tax on future gifts and the estate tax on the taxpayer's estate.

We are of the view that this de minimis rule is sufficient to remove the vast majority of interest-free loan transactions from the gift tax system, including all of the small cases where loans were made for legitimate non-tax reasons and without the benefit of professional advice. On the other hand, we believe it is fair to assume that taxpayers making interest-free loans in excess of $100,000 per recipient did so with due concern to taxes. In fact, in many (perhaps most) of these cases, the loans were probably made with a tax-avoidance motive. For reasons we have already stated, these large cases should not be exempt from the gift tax.

(b) Large Loans

With respect to loans in excess of $100,000, the question remains as to what is the appropriate interest rate to use for computing amount of the gift arising from an interest-free loan. This is an issue that was not resolved in Dickman, although the Supreme Court did state:

> The right to use money is plainly a valuable right, readily measurable by reference to current interest rates . . .. 52 U.S.L.W. at 4224.

We agree that current market interest rates are an appropriate standard. Measures of current interest rates include the prime lending rate, money-market rates and T-bill rates. Within this realm of possibilities, the IRS has decided to apply a relatively low rate -- the short-term T-bill rate -- to loans outstanding prior to the Dickman decision. Moreover, in those periods where the statutory interest rate under section 6621 was lower than the T-bill rate, this rate may also be used. This will avoid prejudice to any taxpayer who was advised that his maximum gift tax liability would be based upon the statutory interest rate. The IRS will be issuing an announcement shortly of the applicable interest rates for all relevant periods.

To summarize, we believe the approach that the IRS is taking regarding interest-free loans is sufficient to respond to legitimate taxpayer concerns. This position is within the administrative discretion of the IRS. Accordingly, we do not believe that any legislative action is necessary.

Again, we strongly urge the Committee not simply to give retroactive relief to all pre-Dickman cases. Aside from the fact that such a course of action would have a direct cost of millions of dollars of gift tax liability, we would be very concerned if a public perception arises that a position taken by the Commissioner of Internal Revenue is only valid starting from the date on which it is confirmed by the Supreme Court.

This concludes my prepared remarks. I would be happy to answer your questions.

Senator PACKWOOD. Buck, I have 14 questions from Senator Symms. He has asked that I ask you two or three of them and then give you the rest to respond to, if possible, by Friday in writing.

Secretary CHAPOTON. By Friday?

Senator PACKWOOD. In writing. When did you get back from China, by the way?

Secretary CHAPOTON. A week ago Monday.

Senator PACKWOOD. First question from Senator Symms. If the IRS and the Treasury Department thought the law was clear that interest free loans were taxable gifts, why didn't the IRS appeal the *Johnson* decision to the court of appeals, or the *Crown* decision to the Supreme Court?

Secretary CHAPOTON. Mr. Chairman, I cannot answer that question directly. I will have to inquire. The IRS makes decisions all the time whether to appeal or not to appeal. I think in the *Crown* decision the point was there wasn't a conflict, and the thought was it couldn't be taken to the Supreme Court. In the *Johnson* case, I'm just not——

Senator PACKWOOD. Say that again.

Secretary CHAPOTON. In the *Crown* case—normally before the Court will take jurisdiction on cases, tax cases, there has to be a conflict between the circuits. I believe there was no conflict between the circuits.

Senator PACKWOOD. Second question from Senator Symms. Are you suggesting that a Revenue ruling, such as Revenue Ruling 73-61, has more precedential value for taxpayers to rely on than a decision by the Seventh Circuit Court of Appeals which affirmed the Tax Court decision? In other words, are you suggesting taxpayers cannot rely on Tax Court decisions and decisions of the circuit court of appeals if the IRS disagrees with their decisions?

Secretary CHAPTON. I'm absolutely saying they would do so with the full knowledge that if the IRS position is ultimately sustained, that they may have to pay more tax than the circuit court said they had to pay. That is the way our system works.

Senator PACKWOOD. This is not Senator Symms' question. Let me ask you this because he makes several references to the *Crown* case here. I understand this case went to the court of appeals and the court of appeals found for Mr. Crown.

Secretary CHAPOTON. Correct.

Senator PACKWOOD. And clearly it's not in his interest to appeal it. He won it.

Secretary CHAPOTON. Right.

Senator PACKWOOD. And the IRS chooses not to appeal it for whatever reasons. But even given that you mean to say even Mr. Crown cannot rely upon the law in his case as directed by the highest court that he can appeal to. He is doing that to assume that the courts will.

Secretary CHAPOTON. He can rely on that for that year clearly.

Senator PACKWOOD. I understand that. I saw your statement. You said for the year 1967.

Secretary CHAPOTON. Right.

Senator PACKWOOD. But he cannot presume that that case can apply to other years even though clearly the facts would apply. He is doing the same thing each year so the facts should apply each year. And he cannot get any further judicial review himself, and he can't count on the decision of the court.

Secretary CHAPOTON. Mr. Chairman, that is the nature of our judicial system. We either have to accept that judicial system or not. But he has to recognize as the court in *Crown*, the eleventh circuit, has to recognize. The were simply found to be wrong. And once the court is found to be wrong by the highest court of our land, unless we are willing to reverse that action by legislation, that is going to be the effect of the Supreme Court. Every Supreme Court decision has retroactive effect except in the limited circumstances where the court itself——

Senator PACKWOOD. On occasion when we have legislation that affects only one person or only affects a few of the very wealthy, we are inclined to use that as an excuse to treat it differently. I sometimes think that is unfair. Just because it affects one industry or a few wealthy people doesn't mean that equities ought to be out the window.

It just seems to inherently unfair that you do anything you can and you carry your case as far as you can go and you get a favorable decision, and you can't go any higher, and you are still stuck with used labor being subject to something that you thought had been finally litigated. It had been finally litigated as far as you were concerned. There was nothing more you could do. It just strikes me as unfair.

Secretary CHAPOTON. I think if you analyze it a bit further I think you will find that it is not unfair. If, indeed, as the Supreme Court found and as the IRS had maintained at that time, the effect in *Crown* was to transfer substantial amounts of wealth to a major relation with avoiding the gift tax—no doubt about it, that was the result.

Now why is it unfair for that decision to be reversed. Mr. Crown was certainly under tax advice. He knew the risks involved. He also knew the potential benefits. He had to decide that risk was worth taking.

Senator PACKWOOD. I understand the way the judicial process works. Even though the Supreme Court decides your case, if the Supreme Court 10 or 15 years later decides to reverse its opinion, you are still stuck. I'm just thinking of the poor devil that is the litigant, whether it is Mr. Crown or somebody else who has done everything they can in good conscience and is still stuck in what seems to me to be an unfair situation.

Secretary CHAPOTON. Well, I would suggest that Mr. Crown has still had a pretty good deal—and all similarly situated taxpayers. And I agree with you. I don't think we ought to single out and make this a pejorative situation where wealthy taxpayers are put in a worse class than others. I think you just have to deal with the question whether you avoided gift tax, whether there is a hole in the gift tax. And if there is a hole in the gift tax, and the court said that it doesn't exist, the taxpayers are wrong, I think the system has worked, indeed, as we designed the system to work.

And even to suggest that we would go back and say, well, there was a hole in the system, but for some reason taxpayers, in spite of all this information about the possibility of the position of the IRS and that it might be appealed to the Supreme Court, that they are protected. Indeed, simply by deferring payment of the gift tax, a very substantial benefit results. So I think the equities are just crystal clear to me on the other side.

Senator PACKWOOD. Well, let me give you the rest of these questions, if I might. And if you could respond to Senator Symms on them, he would appreciate it.

[The questions from Senators Packwood and Symms and Mr. Chapoton's answers follow:]

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

1984 APR 24 AM 9 22

APR 20 1984

Dear Mr. Chairman:

Enclosed is Treasury's response to the questions you submitted at the hearing on April 4, 1984 regarding interest-free demand loans, along with a copy of the questions themselves. I hope the responses will be helpful to you in your deliberations on this issue.

Sincerely,

John E. Chapoton
Assistant Secretary
(Tax Policy)

The Honorable
Bob Packwood
Chairman, Subcommittee on Taxation
and Debt Management
United States Senate
Washington, D.C. 20510

Enclosures

RESPONSE OF THE TREASURY DEPARTMENT
TO QUESTIONS POSED
BY SENATORS PACKWOOD AND SYMMS
REGARDING INTEREST-FREE LOANS

1. The Government decided not to appeal the Johnson case because the factual record in that case was poorly developed and it was felt that the case would make a poor litigating vehicle in the circuit court. The Government argues many cases and cannot possibly contest all adverse decisions.

   The Government had no right of appeal to the Supreme Court in the Crown case; it had only a right to petition for certiorari. The Government chose not to petition for certiorari since the Supreme Court ordinarily will not grant petitions for certiorari in the absence of a constitutional issue if there is no conflict between the circuits. In light of this standard, it was the Government's judgment that a petition in Crown would almost certainly be denied.

   It should also be noted that the failure to appeal Johnson and to petition for certiorari in Crown cannot be construed as an admission of the correctness of the taxpayers' position in those cases nor an indication that the IRS would not continue to pursue the position taken in those cases. As the Supreme Court stated in Helvering v. Hallock, 309 U.S. 106, 120-121 (1940): "[I]naction by the Treasury can hardly operate as a controlling administrative practice, through acquiescence, tantamount to an estoppel . . . ."

2. There were good reasons for the decision not to accept the court's invitation to publish regulations. First, the existing regulations already reflected the broad scope of the gift tax. It was clear that the IRS interpreted these regulations to cover interest-free demand loans. Hence, no further clarification was necessary on the question of whether interest-free demand loans were taxable. Second, it is generally the policy of the IRS not to issue regulations on an issue which is currently being litigated. Such a procedure could be viewed as an artificial attempt by the Government to bolster its litigating position.

3. As the IRS stated in Revenue Ruling 73-61, the proper interest rate to use in valuing the gift arising from an interest-free loan will vary depending on the facts and circumstances in each case. These facts could include the amount of the loans, the use to which the funds were put, the motivation for the loan transaction, whether or not the loan was secured, the credit worthiness of the borrower, and the interest rates prevailing while the loan was outstanding. As was stated at the hearing, the IRS will now use the lower of the short-term T-bill rate or the statutory deficiency

interest rate to resolve all outstanding cases. This should allow all taxpayers affected by the Dickman decision to calculate the amount of the taxable gift which arises from their interest-free loan transactions. The use of such a relatively low interest rate should induce many taxpayers not to contest the issue of valuation further with the Government.

4. Honest taxpayers who come forward to pay delinquent taxes are always worse off (at least financially) than dishonest taxpayers who do not come forward and do not get caught. The situation with the Dickman case is no different than any other on this point. On the other hand, dishonest taxpayers who do get caught may be liable for substantial penalties in addition to taxes and interest.

5. A revenue ruling adverse to the taxpayer simply puts taxpayers on notice as to how the IRS interprets the law on a given set of facts. Lower court decisions do have precedential value. They may give a taxpayer a reasonable basis for taking a position on a tax return with respect to a similar transaction and thereby insulate him from penalties, but they are no guarantee that that position ultimately will be sustained. Whenever there is a conflict between lower court decisions and IRS interpretations, a taxpayer who relies on such court decisions in reporting a transaction runs the risk that the lower court decision will be reversed by the Supreme Court.

6. The question is not whether the law was clear prior to Dickman. A decision of a court that rejects the position of the Government always leaves the state of the law somewhat unclear, except for a Supreme Court decision or an adverse decision of the Tax Court in which the Commissioner acquiesces. It was clear at all times, however, that the gift tax statute and regulations were broad enough to reach interest-free demand loan transactions and that the gift tax would have to be applied to such transactions in order to prevent erosion of the transfer tax base.

7. Just as it is impossible to publish a regulation on every controversial issue, it is also impractical and unwise for the IRS to seek legislative resolution of every dispute with taxpayers. Also, in the years 1966-1976, this issue probably was not significant enough to seek legislation since there were relatively few interest-free demand loan transactions prior to the Crown decision. In 1978 and 1981, the issue was being contested in the courts and a judicial resolution seemed preferable to legislation.

8. Congress should not require a taxpayer to earn income on all investments. On the other hand, when one taxpayer loans another a substantial sum of money without charging interest, it is not unreasonable to recharacterize the transaction as

an interest-bearing loan coupled with a transfer from the lender to the borrower (as a gift, payment for services, or whatever is appropriate). The imputed interest on the loan aspect of the transaction must be subject to income tax if the tax avoidance potential of interest-free loans is to be eliminated.

9. The Committee reports accompanying the Revenue Act of 1932 emphasize Congress' specific intent to reach all gratuitous transfers of any type of interest in property:

> The terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense; the term "property" reaching every species of interest 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 and comprehend all transactions (subject to certain express conditions and limitations) whereby and to the extent . . . that property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment.

H.R. Rep. No. 708, 72d Cong., 1st Sess. 27-28 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 39 (1932). Although no specific reference was made to interest-free loans, the quoted language clearly indicates that Congress intended the gift tax to be broad enough to cover such transactions.

10. Given the consistently low interest rates prevailing until fairly recent times, it is likely that few taxpayers engaged in interest-free demand loans to avoid taxes prior to the 1960s. If any such cases were presented to the IRS, they were resolved without litigation. Thus, Johnson cannot be construed as a change in the IRS position; it was simply the first case the Government had to litigate. See also the response to Question 1(b) on the meaning that can properly be assigned to inaction by the Treasury or IRS on an issue.

11. (a) Certain interest-free loans resemble other tax shelter transactions in that their sole or primary purpose is the avoidance of taxes. Interest-free loans serve to reduce estate taxes by excluding the income earned on the loaned funds from the lender's estate and may reduce income taxes by shifting taxable interest income from a higher-bracket to a lower-bracket taxpayer.

(b) As indicated above, the IRS position on the application of the gift tax to low-interest and interest-free term loans had been clear at least since the 1953 Tax Court decision in Blackburn. Since interest-free demand loans were rare prior to the 1960s, the IRS had no specific public position regarding interest-free demand loans until the decision in Johnson was announced. Since that time, the consistent position of the IRS has been that interest-free demand loans give rise to taxable gifts. Thus, in cases where taxpayers considered taxes in planning interest-free loans, they were confronted with consistent practice against the position they planned to take on the gift tax issue.

(c) Taxpayers entering into shelters may or may not have case authority directly on point to support their position. See, however, the response to Question 5 as to the right of taxpayers to rely on court decisions.

12. The IRS has proposed a generous *de minimis* rule to remove common family transactions from the scope of *Dickman*: for a married couple, all pre-*Dickman* interest-free loans of $100,000 or less per recipient ($50,000 for single taxpayers) will be disregarded for all gift and estate tax purposes. The IRS is willing to forgo the tax on certain tax-motivated transactions below this amount in order to assure that common family transactions will not be subject to the *Dickman* rule.

Additional Questions

1. Based on the facts as described in your question, I would not describe the position the Government has taken as "ridiculous." If the sum deposited was large enough, it is not unreasonable to suspect that part of the motivation of the daughter for depositing the funds in a non-interest bearing account (rather than an interest-bearing account at the same bank) was to benefit her mother as owner of the bank. On the other hand, it is also possible that this was a purely commercial transaction and that the choice of a non-interest bearing account was made without regard to any benefit it would confer on the owner of the bank. Whether the transaction is a gratuitous one or a commercial transaction excepted from the gift tax will be determined if the case goes to trial.

2. The gift tax consequences of the situation you describe are not governed by *Dickman*. *Dickman* dealt with gratuitous, intra-family demand loans. The lender received nothing of value from the borrower to offset the value of the gift. In the case of funds deposited with a retirement home, the retiree receives services from the facility which are probably based on the value of the right to use the funds while the retiree is at the facility. Hence, there would be no gift.

With respect to income taxes, the Senate Finance interest-free loan provision applies to low-interest loans exceeding $10,000 made to an independent contractor by a person for whom the contractor performs services. Thus, to the extent that funds advanced to life care facilities by residents are in connection with performance of services, the advances would be subject to the bill.

It is appropriate for these advances to be subject to the new rules contained in the bill. Use of interest-free and low-interest loans to pay for services or other benefits received by a resident of a life care facility enables the resident to pay the costs of residing in the life care facility out of pre-tax dollars. This is because, in most cases of this sort, the facility is a tax-exempt institution that can invest the funds and receive a tax-free return. If the fee to the facility were paid by the resident out of the earnings on the advanced funds, the fee would come from after-tax dollars since the resident would have been taxable on those earnings and would not have been allowed a deduction for the fee. Thus, in the absence of corrective legislation, an interest-free or low-interest loan would allow the equivalent of an improper deduction for the fee because the resident would not be taxed on the earnings from the advanced funds.

Questions

1. If the I.R.S. and the Treasury Department thought the law was clear that interest free loans were taxable gifts why didn't the I.R.S. appeal the Johnson decision to the Court of Appeals or the Crown decision to the Supreme Court?

2. After the Seventh Circuit Court of Appeals in the Crown case invited the I.R.S. to issue regulations, why didn't the I.R.S. issue Regulationsto clarify the tax treatment and the valuation of interest-free demand loans?

3. Why did the I.R.S. take inconsistent positions in court cases in valuing interest-free loans? For example in the Johnson case, the I.R.S. applied the table in the regulations for valuing future interests at 3-1/2 percent and then in the LaRosa case it is arguing that the rate should be twice the average prime rate for the last five years, which could be more than 30 percent.

4. Does retroactive application of Dickman to intra-family loans encourage taxpayers to violate the law and reward taxpayers who do violate the law by taxing only those taxpayers who come forward and report such transfers?

5. Are you suggesting that a revenue ruling such as Rev. Rul. 73-61 has more precedential value for taxpayers to rely on than a decision by the Seventh Circuit Court of Appeals which affirmed a Tax Court Decision? In other words, are you suggesting taxpayers cannot rely on tax court decisions and decisions of the Circuit Courts of Appeals if the I.R.S. disagrees with their decisions?

6. If the I.R.S. felt that the law was clear, prior to the Dickman decision, that interest-free demand loans were taxable gifts, why did the Tax Court en banc find differently?

7. Since the courts ruled against the I.R.S.'s position on interest-free loans, why didn't the I.R.S. ask Congress to provide legislation when Congress amended the gift tax laws in 1966, 1969, 1974, 1976, 1978 and 1981 that such loans were taxable?

8. Should Congress require taxpayers to earn income on all investments - that is, if a parent lends money to a child, is the I.R.S. requiring him to pay tax on income whether or not the child earns income on the proceeds of the loan?

9. Is there any legislative history in the gift tax statutes that says that loans between family members are taxable?

10. Why did the I.R.S. wait more than 30 years after the enactment of the gift tax laws to claim that interest free demand loans could give rise to taxable gifts.

11. Would you agree that interest-free family loans are completely different from typical tax shelter transactions? Do taxpayers who invest in tax shelters generally rely on decades of consistent practice. For example, do positions taken in tax shelters generally rely on Tax Court, District Court and Circuit Court of Appeals cases that are directly on point?

12. If we overrule Dickman only with regard to certain transactions, how can we be assured that we are not taxing common family transactions such as loans to make a down payment on a house? Is the I.R.S. willing to tax common family transactions to tax tax-motivated transactions?

ADDITIONAL QUESTIONS

1. Mr. Chapoton, I have been made aware of a case in a rural area of the United States wherein an individual owned the only bank in the county in which they resided.

   That individual happened to have a daughter who had a variety of accounts at the bank which her mother owned. Since her checking account balance is a fairly large amount and the account is not an interest bearing account, the IRS has ruled that the amount the daughter has deposited in her checking account at her mother's bank -- the only bank in the county -- is an interest free loan.

   I would like you to comment on this situation. Don't you think it is somewhat ridiculous?

2. Mr. Chapoton, there is another question that I have because I think the matter needs to be clarified before the Senate passes its tax bill.

   Yesterday, I was contacted by an individual who works for a "Life Care Community." Sometimes, these establishments are know as continuing care retirement communities or similar names.

   Generally, these facilities provide their residents with total care during the remaining life of the individuals who decide to reside at one of these facilities.

   When an individual decides to enter one of these facilities, they generally pay an initial fee which is refunded to their estate, upon their death. Since there is no interest paid on the initial fee, will it be considered an interest free loan to the facility under the provisions in the Senate bill or the Supreme Court decision?

   If so, wouldn't you agree that this matter needs to be reviewed?

Senator PACKWOOD. Do you mind if we go to Bob Dole next? He has got to leave.

Senator DOLE. I asked a question in my statement there. Is there any urgency? It seems to me that just the perception of trying to rush this through because we have all heard from some rich person in our State is not the way to proceed. There may be a lot of equities that ought to be considered. This case was only decided in February. We have been busy in this committee every day since that time. Is there some urgency about this?

Secretary CHAPOTON. Mr. Chairman, I see no urgency whatsoever. As I have stated in my written statement, the IRS is going to have an administrative announcement which we think will take care of the administrative difficulties of applying this in the past. That takes care of that problem.

If there are additional tax liabilities assessed that you ultimately decide shouldn't be paid, that can be handled by legislation later as well as today. I see no urgency whatsoever.

I would also say, Senator Dole, that I would like to echo your statement. I mentioned the concern about bad advice crowding out good advice. I think we have really got to be concerned in this tax system about setting a situation where the taxpayer is asked a question when they come in for counsel—what are the changes of being caught? That's number one. Or if caught, what are the chances that this won't be applied retroactively?

Clearly, there were cautious tax advisors saying that there are problems here; that you had better be careful. Are we now to say that those cautious tax advisors—and I would point to a case—that some tax advisors said unless you are willing to pay the gift tax, don't do this transaction. Now I think we should reward those advisors as well. They have followed the system. They have given prudent advice. We cannot reward aggressive positions in the self-assessment system.

Senator DOLE. We have a number of outstanding witnesses. And I think with one exception they are probably all here to say that—I assume they represent the ones who may be involved. I have no quarrel with that, but it seems to me we shouldn't make a determination based on everybody who comes in here with a client saying don't do it to us. We ought to give Treasury some time and the Joint Committee some time and let the process work. It may very well be that they are right in this case. And there is some precedent for overruling the Court. In fact, there is even some pending in a bill now.

But I would just urge that we not try to move too quickly.

Secretary CHAPOTON. We certainly agree with that.

Senator DOLE. And I do know that there are some de minimis provisions that you will probably implement administratively.

Secretary CHAPOTON. Yes, sir. These are specified in the statement.

Senator DOLE. Right. And it would seem to me that at least since 1973 when there has been a ruling out there that at least there should have been some notice.

Senator Danforth is not here this morning, who is a recipient of interest free loans, feels very strongly the other way—that there should be retroactivity. That he understood this might be a consequence.

And somebody called to my attention an article in the Practical Accountant dated September of 1978. I don't understand it fully; maybe you do. It says how to use interest free loans in family tax planning. "The interest free loan provides an excellent tax planning tool, especially if the IRS position does not prevail. But even if the IRS is successful in its position and the *Johnson* and *Crown* cases are overturned, the interest free loan can still be used and could be more beneficial than a revocable or short-term trust in reducing a family's tax burden." That's even if they lose.

Secretary CHAPOTON. That's correct. At the very least, you probably obtained an income tax benefit. You have also reduced the estate by the size of the gift tax itself. And, of course, you have had a long deferral on payment of the gift tax.

Senator DOLE. Well, I would like to include this article and two other relevant articles in the record. And, hopefully, we can work with Treasury. And there are some very real concerns. I don't want to indicate that there aren't some equities on the other side. I don't know what the disposition of the committee would be, but I haven't seen much action on the House side.

[The articles from Senator Dole follow:]

How to Use Interest-Free Loans in

Family Tax Planning

by Michael A. Taicher

For a number of years, the IRS has taken the position that an interest-free loan is a property right subject to gift tax. But recently the Tax Court, in *Crown*, 67 TC 1060 (1977), rejected this view and held that no gift tax was due on massive loans (some $16 million) made by a partnership to relatives of the partners.

In view of the importance of this decision, a fresh look at the interest-free loan is in order, since it offers an approach to spreading income among family members which, in many ways, is superior to the short-term trust.

This article will examine the situation as it is today and discuss some techniques for using interest-free loans in family tax planning. The article following this one will cover interest-free loans in a business environment.

THE BASIC TECHNIQUE

For generations, tax planners have been attempting, by various devices, to shift income from high-bracket taxpayers to low-bracket dependents or to split income among family members. The use of the interest-free loan appears to accomplish this goal, while allowing the parties maximum flexibility.

EXAMPLE: A wealthy father makes a $50,000 loan to his 18-year-old son. The loan is evidenced by a demand note with a fixed repayment schedule, specifically stating that the loan is interest-free. The funds are invested by the son in a 6% savings account, yielding an annual income of $3,000. The father's tax bracket is 60%, the son's 19%. If the father had invested the $50,000 in the same savings account, he would pay a tax of $1,800 on the interest, ending up with net after-tax income of $1,200. The son, however, will pay a tax of only $570, and will be left with a net after-tax income of $2,430. Thus, the father has been able to shift $2,430 of cash to the son, resulting in a tax saving of $1,230 to the family unit.

With the proceeds from the savings account, the son could, for example, help pay his college expenses. The father is in essence letting the government "subsidize" a portion of the son's college education, instead of funding it with after-tax dollars.

THE THREE REQUIREMENTS

For an interest-free loan to achieve the desired tax objective, three requirements must be met:

1/ The lender must not retain control over the funds.

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2/ The transaction must constitute a true loan, and

3/ The note evidencing the loan must specifically provide that no interest is due.

Let's examine each of these criteria.

No Control By Lender

The first requirement is that the lender retain neither explicit nor implicit control over the investment or disposition of the loaned funds. If any semblance of control is retained, the IRS is likely to apply the "assignment of income" doctrine to the transaction, arguing that it is the *lender* that is "earning" the income, since he is the person who controls the disposition of the property.[1] Alternatively, the IRS might claim that the loan was a capital contribution to a family partnership. Under this theory, possibly all of the partnership's profits could be reallocated to the lender, since he furnished and controlled the investment capital of the venture and should therefore be entitled to a return on his investment.[2]

If the lender is in the position of a creditor, with no control over the assets, these arguments by the IRS should fail.

Transaction Must Constitute a True Loan

It is essential that the transaction qualify as a true loan, creating genuine indebtedness, instead of being characterized as a gift. Otherwise, the transfer will be subject to gift tax (although the goal of transferring the income would be achieved).

In *Grossman*, 9 BTA 643 (1927), the court held that where money is transferred by a parent to his child, the transfer is presumed to be a gift, unless it is shown otherwise. To defeat this presumption, the transaction should be structured so as to leave no room for dispute. In *Estate of J. F. Ames*, 5 TCM 76 (1946), the court stated that where the circumstances clearly indicate that genuine indebtedness, rather than a gift, is contemplated by the parties, the close family relationship becomes unimportant.

Some characteristics evidencing a valid loan are:

1/ The loan is evidenced in writing.

2/ Adequate provision is made for repayment.

3/ Repayment is strictly enforced.

Note Should Specify No Interest

The third requirement is that the note evidencing the loan specifically provide that there is no intention to charge interest and that there is no obligation on the part of the borrower to pay it. In many states, this is an essential ingredient, since state statutes often create a legal obligation to pay interest on debts where the agreement is silent as to interest. The Service has announced that it recognizes that these state laws can create an obligation to pay interest.[3] Where such obligation to pay interest exists, each year's foregone interest will be considered a gift from the father to the son in that year.

Assuming that the interest-free loan has been properly structured, let's now see what the courts and the IRS think about interest-free loans.

THE CASE LAW

Until the recent *Crown* decision, the only major case in the interest-free loan area was *Johnson*, 66-1 USTC ¶12,386, 17 AFTR 2d 1403 (DC Tex., 1966). There, the taxpayer and his wife had made interest-free loans to their two adult children during the period 1956-1962. The average unpaid balance was as high as $500,000. By 1962, all but $30,000 had been repaid. The IRS did not dispute that the children were taxable on the income or contest the validity of the loans. It claimed, however, that a gift of the value of the use of money loaned had been made to the children (based on the prevailing interest rate of 4% on the average unpaid balance for each year).

The court found that no taxable gift had been made since there was no requirement, under contract or state law (Texas), for the children to pay interest on the loans or for the parents to charge it. The court further indicated that if, under the circumstances, there was to be a taxable gift, Congress would have so provided.

In *Rev. Rul.* 73-61, the Service announced that it would not follow the *Johnson* decision (although it has not appealed it). The ruling stated that the *right to use* property—in this case, money—is itself an interest in property. The transfer of this property interest is a *gift* of the economic benefit—interest in the case of

"Section 482 is a weapon that the IRS might unleash against interest-free loans."

money—unless full and adequate consideration in money or money's worth is received.

The Service's position is buttressed by the Tax Court decision in *Blackburn*, 20 TC 204 (1953), and the Seventh Circuit decision in *Mason*, 75-1 USTC ¶9318, 35 AFTR 2d 75-1028 (CA-7, 1975). *Blackburn* held that a taxable gift was made when the taxpayer sold a building to her children and received a note with interest payable at less than the local rate of interest on such transactions, the amount of the gift being the difference between the interest charged and the local rate. *Mason* recognized the economic benefit derived by a charity as a result of the failure by the taxpayer to charge a fair rate of interest on payments due from the charity over a number of years, and allowed the foregone interest as a charitable "gift."

THE DECISION IN CROWN

In *Crown*, 67 TC 1060 (1977), the second major case in the area of interest-free loans, the Tax Court rejected *Rev. Rul.* 73-61 and decided to follow the *Johnson* rationale. It held that a one-third partner was not subject to gift tax on his proportionate share of the interest that could have been earned on his partnership's interest-free loans of $1.5 million to trusts for the benefit of relatives of the partners. Furthermore, the majority stated that *Rev. Rul.* 73-61 was not persuasive and that the law was as enunciated in *Johnson*.

Despite this reaffirmation by the Tax Court, the IRS has nonacquiesced and has appealed the *Crown* decision to the Seventh Circuit. Moreover, there was a strong dissent, which focused primarily on the merits of *Rev. Rul.* 73-61, with respect to the gift aspects of any transfer of property and with the *Blackburn* method of valuation. It appears that *Crown* will merely add weight to taxpayer's arguments, but it will not be determinative.

THE USE OF SECTION 482

While there seems to be no case or ruling applying Section 482 to interest-free loans, this section is a possible weapon which the IRS might decide to unleash. Therefore, some brief consideration of this possibility seems appropriate.

Section 482, as you know, provides generally that the Commissioner may reallocate gross income, deductions, credits or allowances between or among "two or more organizations, trades or businesses (whether or not incorporated . . . and whether or not affiliated) owned or controlled directly or indirectly by the same interests," if he determines that such reallocation is necessary in order to prevent evasion of taxes or to clearly reflect income. While Section 482 seems geared to businesses rather than individuals, let's see what would happen if the IRS applied Section 482 to the example at the beginning of this article.

Under Section 482, the IRS might try to reallocate gross income to the father in an amount equal to the interest which would have been earned on an interest-bearing loan at the applicable rate (assume 6%). The father's income would thus be increased by $3,000 while the son's income would be decreased by $3,000, thereby nullifying the transfer of the income to the son. In addition, a $3,000 gift would be deemed to have been made by the father to the son, since the son ended up with the $3,000 that belonged to the father.

At least two arguments could be advanced against this approach:

1/ If the funds are used solely for investment in non-income-producing assets, and not in the conduct of an active trade or business, the son would not be engaged in a trade or business with respect to the loan and therefore would *not* come within the meaning of "organizations, trades, or businesses" as such terms are used in Section 482.

2/ Even if the son did invest the loan proceeds in income-producing assets (i.e., a trade or business), the business should *not* be considered as "controlled by the same interests" (i.e., the father) for purposes of Section 482 unless it can be shown that the father asserts dominion over the business activity.

The use of Section 482 in this area is discussed in greater detail in the following article dealing with loans between business entities.

TAX PLANNING

The interest-free loan provides an excellent tax-planning tool, especially if the IRS' position does not prevail. But *even if* the IRS is successful in its position, and the *Johnson* and *Crown* cases are overturned, the interest-free loan can still be used—and can be more beneficial than a revocable or short-term trust in reducing a family's tax burden.

For example, a revocable trust is set up by a grantor to transfer cash to an intended beneficiary while the grantor retains the power to obtain the trust corpus. In such case, the current income is taxable to the grantor[4] and a gift of the income is deemed made to the beneficiary.[5] The interest-free loan concept affords the lender the same flexibility as a trust in retaining the power to reacquire the corpus, since the loan will take the form of a *demand* note. However, the interest-free loan has a significant advantage over the revocable trust in that the borrower, not the lender, is taxed on the income. And even if *Johnson* and *Crown* are incorrect, the lender will still have no *income* tax to pay on the income generated—and his gift tax problem will be no worse than that incurred in the revocable trust situation, i.e., an annual gift of the income.

If a short-term ("Clifford") trust is set up, the grantor is not entitled to reacquire the corpus for a period of less than ten years and one day.[6] Unlike the revocable trust, the grantor is not subject to income tax during the term of the trust, but he is subject to a gift tax on the term interest given. For example, if the grantor transferred $50,000 to a trust for a ten-year-and-one-day period with a right of reversion, the regulations[7] provide that a gift of $22,080 (about 44% of the corpus) has been made.[8] In contrast, an interest-free loan permits access to the corpus at any time (since it is a demand loan). Moreover, there is no current gift, as there is in a short-term trust. Again, even if *Johnson* and *Crown* are incorrect, there is only an *annual* gift of the foregone interest (usually a much smaller amount than the gift of a lump sum, as in a short-term trust). Moreover, if this amount is less than the $3,000 a year exclusion,[9] there would be no current gift tax at all.

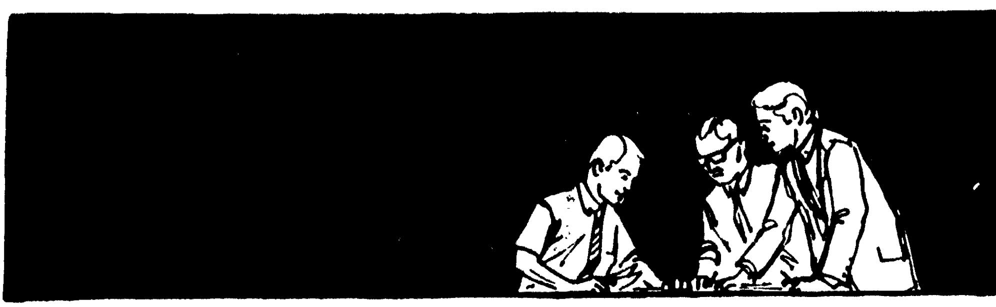
Be careful, however, not to substitute an interest-free loan for a trust in situations where the beneficiary is a minor. The minor's lack of capacity to enter into contracts could create a problem in establishing bona fide indebtedness. In addition, lenders are usually unwilling to divest control of substantial sums of money to a minor with little money management expertise.

It has been suggested that these two drawbacks can be eliminated by making the loan to the minor through a custodian (e.g., the minor's other parent). Should this technique prove effective, it adds yet another dimension to the tax planning possibilities.

Situations which immediately come to mind in which interest-free loans will be useful are funding college tuition, helping out a parent, helping a young professional get started, and helping newlyweds purchase their first house. The use of this technique is limited only by the sums to be lent and the resourcefulness of the tax planner. ■

1. Two landmark Supreme Court cases, *Helvering v. Horst*, 40-2 USTC ¶9787, 24 AFTR 1058 (1940), and *Corliss v. Bowers*, 2 USTC ¶525, 8 AFTR 10910 (1930), stand for the proposition that the person to be taxed, i.e., the earner of the income generated, is the person who has command over the property or who controls its disposition.
2. See Section 704(e) and *Culbertson*, 49-1 USTC ¶9323, 8 37 AFTR 1391 (CA-5, 1949).
3. IT 1720, II-2 CB 54 (1923).
4. Section 671.
5. Section 2511.
6. Section 673(a).
7. Reg. 25.2512-9, Table B.
8. Undoubtedly, the tax on this gift will reduce the unified credit and create a greater net tax in the grantor's estate.
9. The exclusion is $6,000 if the spouses split the gift.

How to Use Interest-Free Loans in Business Tax Planning



by Richard Callahan

The prior article examined the use of interest-free loans in family tax planning. Now let us look at interest-free loans in a business setting, showing how they can be used to benefit key employees and shareholders and to transfer funds among related corporations.

LOANS TO EMPLOYEES AND SHAREHOLDERS

Interest-free loans can provide a valuable fringe benefit for key employees and a tax opportunity for shareholders.

As a fringe benefit, interest-free loans give a company the opportunity both to reward and to retain key employees at a cost which is less expensive to the company over a period of time than increased compensation.

EXAMPLE: An employee in the 50% tax bracket desires to accumulate an additional $10,000 within the next ten years. His employer is also in the 50% tax bracket. Both the employee and the employer can generate a 10% annual return on investment (5% after taxes). Let's compare the cost to the employer of providing the employee with this $10,000 accumulation by (1) paying him additional compensation and (2) giving him an interest-free loan.

Additional compensation: The employer would have to increase the employee's salary by $1,514 a year for the ten-year period, which would leave the employee with $757 a year after taxes.[1] This after-tax income at a 5% after-tax yield would provide the desired $10,000 accumulation at the end of ten years. The total cost to the employer would be $12,425.[2]

Interest-free loan: The employer would have to lend the employee $15,900 (evidenced by a ten-year non-interest-bearing note). In ten years, these funds at a 5% after-tax yield would have grown to $25,900[3] (after taxes). After repaying the $15,900 loan to the employer, the employee is left with his $10,000 accumulation. The cost to the employer is only $10,000 (i.e., the income foregone on the $15,900 loan).

Thus, the interest-free loan can provide the employer with the desired $10,000 accumulation at $2,425 less cost to the employer (i.e., the $12,425 cost under the additional compensation method less the $10,000 cost under the interest-free loan method) than if this were done through additional compensation. The reason for this cost difference is that an interest-free loan will not cost the employer more than the additional wealth sought by the employee while the tax to the employee from the additional compensation would add to the employer's cost.

An interest-free loan can provide the employee with the immediate use of funds, giving him an opportunity to participate in an investment which he might not otherwise be able to afford. The proceeds of many employee interest-free loans have been invested in tax shelters and other long-term investments which provide a cash flow that enables the employee to repay the loan. Interest-free loans have also been advanced to an employee to organize a new business. The intent here is for the lender to buy the business when growth and profits reach a predetermined level. Any gains realized by the employee would generally be taxed at capital gains rates and could possibly be deferred through a tax-free reorganization.[4]

The Income Tax Questions

In analyzing the tax consequences of an interest-free loan to an employee or shareholder, the following questions are relevant:

1/ Must the borrower recognize taxable income for the economic benefit derived from the interest-free use of the borrowed money?

2/ If so, would the borrower be entitled to an offsetting deduction for interest expense if interest income is imputed to him by the IRS?

3/ Must the lender recognize interest income?

4/ Is an employer-lender allowed a compensation deduction regardless of whether or not the employee recognizes taxable income?

5/ What is the standard for measuring any inputed income and expense on an interest-free loan?

Section 61 is the Code provision commonly relied on in support of the position that the borrower should recognize taxable income for the economic benefit derived from the free use of borrowed money. Section 61 defines gross income as "all income from whatever source derived." However, in *Dean*, 35 TC 1083 (1961), *nonacq.*, the only reported case to date on interest-free loans advanced by a corporation to either an employee or a shareholder, the Tax Court held that the shareholders did not realize a taxable gain attributable to the free use of the borrowed money.

In *Dean*, two shareholders had interest-free loans outstanding in excess of $2 million from a corporation which they controlled. The Tax Court held that prior court decisions which imputed income for the economic benefit derived from the rent-free use of corporate property did not apply to interest-free loans. The court reasoned that if funds had been borrowed to pay for the use of property, the interest would have been fully deductible even if the property was for personal use. However, the cost of renting property for personal use would not have been deductible. In brief, the Tax Court implied that there is no taxable gain attributable to the free use of borrowed money because of the offsetting interest expense deduction.

The IRS, on the other hand, asserts that the borrower of an interest-free loan realizes an economic benefit which is taxable—but is *not* entitled to an offsetting interest expense deduction, perhaps because Section 163(a) requires that interest expense be "*paid* or *accrued* within the taxable year of indebtedness." [*Emphasis added.*]

Dean has been criticized by some commentators because it implies that the borrower would be allowed an offsetting interest deduction even if the funds were invested in tax-exempt bonds.

The *Dean* decision fails to raise the question of the proper tax treatment of the lender. If an analogy can be made to prior court decisions regarding the rent-free use of a corporation's property, then the lender of interest-free funds should not be subject to imputed interest income. If, however, an employer-lender does have interest income imputed by the IRS, it should also be entitled to an offsetting compensation deduction.

As to whether an employer-lender would be allowed a compensation deduction *regardless* of the tax treatment afforded the employee, the *Mason* case, 75-1 USTC ¶9318, 35 AFTR 2d 175-1028, would support the deduction. There, the court allowed the lender a deduction for the economic benefit received by a charity from borrowing money at less than the current market rate.

As a tax planning alternative to interest-free loans to employees, the employer could consider charging an adequate rate of interest on the loan and correspondingly increasing the employee's salary to a level commensurate with the interest charge. If an unreasonable compensation problem does not exist, the net effect would be the same both to the employee and to the employer (provided, of course, that the funds are not invested in tax-exempt municipals).

Finally, a few words should be added regarding the standard for measuring the economic benefit received from an interest-free loan. The position taken by the IRS in *Dean* forewarns taxpayers of possible tax problems if a corporation loans money to an employee or shareholder at a "safe haven" interest rate (i.e., between 6 and 8%).[5] The IRS may contend that the borrower realizes a taxable gain on the difference between the cost of obtaining a similar loan in the marketplace and the "safe haven" rate assessed by the company.

Dangers in Loans to Shareholders

There are certain potential dangers with loans to shareholders that do not exist in the case of loans to non-shareholder employees. One such danger is that the IRS could conceivably impute interest income to the corporation, deny the corporation an offsetting compensation deduction (since the borrower is a shareholder, not an employee), and treat the economic benefit realized by the shareholder as a dividend. (It would be as though the shareholder-borrower paid the interest to the corporation, which in turn paid this amount back to the shareholder as a dividend.) And there is no certainty that issuing a written note with a definite repayment schedule would serve to blunt such an attack by the IRS.

INTERCORPORATE LOANS

Let us consider interest-free loans between related companies (brother-sister, parent-subsidiary, or combination of either). Such loans can be advantageous to both companies since:

1/ There is no interest charge to add to any cash flow problems of the borrowing company,

2/ There is no interest income realized by the lending company,

3/ There is no possible waste of an interest expense deduction by a company operating at a loss,

4/ There is no net tax increase for the group in the event the borrowing company is in a lower tax bracket than the lending company, and

5/ The lending company can receive repayment on the loan without any income tax consequences.

A controversy has existed for a number of years about the authority of the IRS under Section 482[6] to "create interest income" as the result of an interest-free loan between commonly controlled businesses. Although Section 482 specifically allows the IRS to allocate gross income *when it already exists,* the controversy arises over whether the statute authorizes the IRS to allocate *non-existing income.*

The IRS Position

The position of the IRS is set forth in the regulations under Section 482. Reg. 1.482-2(a)(1) states that "where one member of a group of controlled entities makes a loan directly or indirectly to another member of such group and charges no interest . . . the district director may make appropriate allocations to reflect an arm's-length rate for the use of such loan or advance." Reg. 1.482-1(d)(4) goes on to say that the district director may make an appropriate allocation to reflect an arm's-length rate even if "the ultimate income anticipated from a

"The Tax Court now agrees that Section 482 can be used to 'create' income."

series of transactions may not be realized or is realized during a later period."[7]

The IRS made an interesting concession in *Pitchford's Inc.*, which involved several interest-free loans between related corporations. Prior to the trial, the IRS conceded that if the borrower's financial condition was "so weak" that there was no reasonable expectation that the interest would be collected, then an allocation of interest income would be improper. However, the IRS argued that the borrower's financial condition was *not* so poor as to preclude interest payments. The Tax Court held that the borrowing company's financial condition was, in fact, weak enough to preclude the payment of interest—but the court did not express an opinion on the IRS concession.

The Courts' View

For many years, the Tax Court took the position that the IRS could allocate income and expense only when an *actual shifting* of income had occurred between the controlled companies. It felt that there was no income to be allocated under Section 482 if the borrowing company did not generate any gross income from the funds. The position of the Tax Court was commonly referred to as the "tracing" approach (because the taxpayer had to be able to trace the proceeds of a loan to prove that they did not produce any gross income).

However, the Tax Court was overruled on this issue by the Second, Fifth, Eighth, and Ninth Circuits.[8] Because of these reversals, the Tax Court recently changed its position (*Latham Park Manor, Inc.*, 69 TC No. 15) and now agrees with the four circuit courts. The IRS has included the "creation of income" issue on its list of prime issues.

When the IRS imputes interest income to the lending company, a correlative interest expense adjustment is made against the income of the borrower. Frequently, however, the borrowing company operates at a loss or is in a lower tax bracket than the lending company, so that a Section 482 adjustment can result in a net increase in the group's tax liability.[9]

The IRS will generally consider other arrangements between the companies (e.g., where the lending company shortly before, during, or after the tax year receives another form of reimbursement from the borrowing company, such as management fees or royalties). If the offsetting adjustment does not affect the character of the income or otherwise distort the taxable income of the group, a Section 482 allocation will not be necessary.

EXAMPLE: P renders services to S in connection with the construction of S's factory. Although an arm's-length charge for such services, determined under Reg. 1.482-2(b), would be $100,000, P bills S $125,000 for the services. During the same taxable year, P makes a substantial interest-free loan to S to help S finance the construction; the arm's-length interest on this loan would be $25,000.

No allocation would be made with respect to the overcharge for services or the undercharge on the loan since they were approximately equal and the taxable incomes of P and S were not distorted.[10]

If however, P were a personal holding company and the interest income, if reported, would have been personal holding company income, an allocation would then be made to reflect the correct amounts of interest income and service income.[11]

In order to establish that a set-off to the adjustments proposed by the District Director is appropriate, the taxpayer must notify the District Director within 30 days after the date of the examination report.[12]

The IRS views the offset adjustment rules as being limited to transactions between the two companies involved and not among all the members of a controlled group. In *Liberty Loan Corp.*, 74-1 USTC ¶9474, 32 AFTR 2d 73-5028 (CA-8, 1974), a consumer finance company borrowed money on behalf of its 400 finance companies at a 5½% interest rate and then reloaned the money to its subsidiaries. Because 50 of these subsidiaries were insolvent or financially troubled, Liberty charged them little or no interest. However, it charged the profitable subsidiaries 5¾% interest. The total finance charges to all the subsidiaries as a group covered Liberty's $5^1/_2\%$ interest expense on the borrowed money. All of the subsidiaries reloaned the borrowed money to consumers at higher interest rates. The IRS sought to allocate interest income to Liberty on the advances to the financially troubled subsidiaries. The Eighth Circuit held for the IRS. It took the position that Section 482 does not support a netting of the *total* interest expense of the subsidiaries to determine whether an arm's-length rate was charged, but rather each loan must be viewed as a single transaction to determine whether a proper arm's-length rate was assessed by the lending company to the particular borrowing company. Consequently, Liberty was required to realize a profit for borrowing money on behalf of its subsidiaries. (Although the subsidiaries receiving the advances at little or no interest were entitled to a deduction for the imputed interest expense, this deduction was of little value to these insolvent and financially troubled companies.)

The circumstances in *Pitchford's Inc.* differ from those in *Liberty Loan Corp.* in that the financial condition of Liberty's subsidiaries appears to have been stronger than that of Pitchford's related company.[13]

Constructive Dividend Danger

There is also the danger that the IRS will treat interest-free loans between brother-sister corporations as a constructive dividend to the common parent.

EXAMPLE: Brother Corp., which owns a shopping center, lends $100,000 without interest to Sister Corp., a home developer, to help finance a residential housing development adjacent to the shopping center. Jones is the common stockholder of both corporations. The IRS might make one of the following adjustments:

1/ Impute interest income and expense between both companies.

2/ Impute a constructive dividend from Brother Corp. to Jones of $100,000 (the entire principal, not just the interest) and treat Jones as having made a capital contribution to Sister Corp.

A constructive dividend attack by the IRS should not be successful if:

1/ The advances were *not solely* for the personal benefit of Jones, or

2/ There exists a corporate business purpose for Brother Corp. to advance the funds.[14]

Under the facts given, Brother Corp. should be able to demonstrate a business purpose for making the loan since the company should benefit directly from having a residential housing development adjacent to its shopping center.

Avoiding a 482 Attack

To avoid the risk of a Section 482 allocation or a constructive dividend, advances between related corporations might be made in the form of contributions to capital rather than as interest-free loans. Alternatively, the *value* of the interest-free use of the loan might be treated as a contribution to capital. If the loaned funds are invested in the borrower's business, there should be no reallocation of income by the IRS. Only if the capital contribution has no business purpose or is invested by the borrower as a conduit for the lender or as part of a plan to avoid taxes, should reallocation under Section 482 be appropriate.

Cash payments could be made back to the lender tax-free if paid before the borrower generates any earnings and profits. If, however, the distribution constituted a dividend, it would qualify for the 85% or 100% dividend exclusion.

In determining whether money has been advanced as a loan or a capital contribution, the courts will look beyond the literal terms in which the parties have cast the transaction. Although there are no controlling criteria, the courts generally consider the following factors as indicative of a capital contribution.[15]

1/ The inability of the borrower to repay the advances for a number of years.

2/ The impossibility of the borrower to raise funds other than from the lender.

3/ The lack of an enforceable obligation to pay on demand or at a specified date the money advanced or a fixed rate of interest.

4/ The thinness of the borrower's capital structure.

The time spent exploring a feasible alternative to an interest-free loan between related corporations is well worth the effort since the IRS has an excellent track record in ligating this Section 482 issue. Another factor to consider is that some state franchise taxes have special provisions aimed at intercompany loans.

The tax consequences of interest-free loans are, in many situations, still not clearly resolved. Interest-free loans should continue to play an important role in a company's compensation plan for non-shareholder key employees. However, such loans between a shareholder and his closely held corporation will probably be a source of unintended dividend income equivalent to the value of the money loaned. The IRS will probably continue to reallocate interest income and expense among related corporations under Section 482 when an arm's-length interest rate is not charged. ■

1. For readers who are interested in seeing how this is arrived at mathematically, the formula is:

$$FV = PMT \times \frac{(1+i)^n - 1}{i}(1+i);$$

$$\$10{,}000 = \$757 \times \frac{(1+5\%)^{10} - 1}{5\%}(1+5\%),$$

where *FV* = future value of an annuity due and *PMT* = deposit at the beginning of each year. However, for convenience, it is simpler to use a financial table showing the accumulated value of $1 a year if invested at a specified percentage for a specified number of years. One such table, in the "Accounting Desk Book" by William J. Casey, indicates that $1 will grow to $13.207 in ten years if invested at 5% (the after-tax effective rate). Dividing $10,000 by $13.207 gives us $757 as the annual investment needed.

2. The net ten-year after-tax compensation cost of $7,570 plus the $4,855 of income foregone from a $1,514 ten-year annual investment of 5% after taxes. To obtain the $4,855 of income foregone, use the same table as in note 1. Since $1 a year for ten years grew to $13.207, the income earned over the period was $3.207 ($13.207 less the $10.00 of principal). Multiplying $3.207 by $1,514 gives us total foregone income of $4,855.

3. Again, for the mathematically inclined, the formula is $FV = PV \times (1+i)^n$; $\$25{,}900 = \$15{,}900 \times (1 + 5\%)^{10}$, where *FV* = future value of initial investment at the end of n periods and *PV* = present value of investment at time. Using a table that shows how much must be invested today to total $1 in ten years at 5% after taxes, we find a factor of .6139. In other words, to accumulate $1 in ten years we must invest $.6139 today, earning $.3861 over the ten-year period. To earn $10,000, we would have to invest 25,900 times as much (10,000 ÷ .3861) or $15,900 (25,900 × .6139).

4. Caution is advised when the only security for the loan is either a nonrecourse note in the tax shelter investment or in the new business investment. In such case, the IRS might argue that the loan is actually an investment by the employer, not the employee, and that repayment of the loan is compensation taxable to the employee. Prop. Reg. 1.83-3(a)(1).

5. Reg. 1.482-2(a)(2)(iv).

6. The IRS has the authority under Section 482 to allocate gross income, deductions, etc., between or among two or more organizations, trades or businesses in order to prevent the evasion of taxes or to clearly reflect income.

7. The arm's length rate is the rate which would have been charged in independent transactions between unrelated parties under similar circumstances. However, if the creditor is not in the business of making similar loans, the arm's-length rate is deemed to be the actual rate charged if at least 6% and not more than 8% simple interest. If the market rate is less than 6% the lender may charge less than 6% but not less than the market rate. If the market rate is greater than 8%, the lender may charge more than 8% but not more than the market rate. If no interest was charged or if an adjustment is required for an inadequate or excessive interest charge, the rate of interest will be 7% per annum. Reg. 1.482-2(a)(2)(iv).

8. *B. Forman Co., Inc.*, 72-1 USTC ¶9182, 29 AFTR 2d 72-403 (CA-2, 1972), *cert. denied*, 407 US 935 (1972); *Fitzgerald Motor Co., Inc.*, 75-1 USTC ¶9275, 35 AFTR 2d 75-832 (CA-5, 1975); *Kohler Corp.*, 73-2 USTC ¶9687, 32 AFTR 2d 73-5860 (CA-8, 1973); *Kerry Investment Co.*, 74-2 USTC ¶9522, 34 AFTR 2d 74-5239 (CA-9, 1974).

9. Reg. 1.1502-13(c)(2) states that Section 482 applies during all consolidated return years. Since the transaction has an immediate effect on both members, the adjustment washes out on a consolidated basis. The adjustment can be significant in certain instances, e.g., for a separate calculation of earnings and profits.

10. Reg. 1.482-1(d)(3), Example 2.

11. Reg. 1.482-1(d)(3), Example 3.

12. Reg. 1.482-1(d)(3).

13. *Pitchford's Inc.* TCM 1975-75.

14. *Joseph Lupowitz Sons, Inc.*, 74-1 USTC ¶9485, 34 AFTR 2d 74-5054 (CA-3, 1974).

15. *Fin Hay Realty Co.*, 68-2 USTC ¶9438, 22 AFTR 2d 68-5004 (CA-3, 1968).

ARE YOU FULLY UTILIZING YOUR OFFICE SPACE?

In these days of high office rents, you should try to utilize your office space to the maximum extent possible. For example, you should consider stacking additional file cabinets on top of the file cabinets presently in use (or perhaps use wall-hung cabinets). Similarly, you should have your bookshelves run up to the ceiling wherever possible. A roller-type step stool can be used to reach the higher cabinets and shelves. (By utilizing the full height of a 10′ × 15′ file room, you can store more than one million additional documents.)

Some accountants have found that the use of letter-size file cabinets, instead of legal-size files, saves much needed "floor" space. Letter-size cabinets will accommodate most correspondence (8-1/2″ × 11″). Moreover, most types of accounting workpapers can be obtained in this smaller size. Certainly, for annual tax clients, there is no need to use large-size workpapers, which require legal-size filing cabinets.

TAXATION OF

Estates, trusts & gifts

EDITED BY JOHN B HUFFAKER LL B

What planning opportunities does CA-7's no-gift-tax holding in Crown open up?

by **MARK B. EDWARDS**

The Seventh Circuit's decision in Crown *creates opportunities for the use of interest-free loans in tax planning. Mr. Edwards analyzes this important decision and explains what tax-planning strategies may now be available.*

In holding that an interest-free loan which is payable on demand does not result in the making of a taxable gift by the lender,[1] the Seventh Circuit in *Crown*, 9/19/78, *aff'g* 67 TC 1060 (1977), *nonacq.*, has opened up the door to planning possibilities. However, the IRS nonacquiescence to the Tax Court opinion indicates continued nonacceptance by the IRS. Thus, *Crown* is probably just the first battle in a long war between tax planners and the IRS, a war to be ultimately ended by the Congress or the Supreme Court.

Factual background

The taxpayer in *Crown* was one of three brothers who were the members of a partnership. In 1967, the partnership made loans of approximately $18 million to 24 trusts which had previously been established for the benefit of the children and other close relatives of the brothers. All of the loans were evidenced by demand notes ($2,073,000) or by open accounts ($15,956,000). (No distinction was made by either court between these two forms of debt.) Neither the open accounts nor the demand notes made any provision for the payment of interest, except that the notes did call for the payment of 6% interest after demand. No demand for payment was made during 1967, and no interest was paid.

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In a notice of deficiency dated November 30, 1973, the Commissioner determined that a valuable property right (the right to use money without the payment of interest) had been transferred to the trusts, and asserted that a gift tax was due upon this transfer. The value of the gift was calculated at $1,086,408 by applying an interest rate of 6% to the daily balance of loans outstanding during the year. One-third of this amount was then imputed to the taxpayer as a one-third owner of the lending partnership, and a proposed gift tax deficiency of $46,085 was computed.

Tax Court opinion

In the Tax Court, the Commissioner argued that the right to use money is in itself "property" and that the transfer of such property without full and adequate consideration is a gift within the meaning of Sections 2501 and 2511. In support of this position, he pointed to *Rev. Rul.* 73-61, 1973-1 CB 408, issued one year before the deficiency notice in *Crown*. The Ruling provides that, in the case of a loan for a fixed term of years, the value of the right to use the money loaned is to be determined actuarially and is deemed to be a gift as of the date the loan is made. In the case of demand loans, the Ruling notes that the value of the right to use the money cannot be determined at the date of the loan. Instead, a gift will be deemed to have been made at the end of each calendar quarter during which the borrower is granted the use of the money, to be valued presumably by the market value of such use during the past quarter.

A majority of the participating Tax Court judges disagreed with the Commissioner[2] but did not respond directly to his allegation that the right to use money subject to a demand loan is a property right whose transfer is subject to the gift tax. Instead, the judges relied upon four factors for their decision:

1. There was no favorable precedent for the Commissioner's action. In fact, the courts had uniformly rejected every attempt by the IRS to subject the making of interest-free loans to income or gift taxes. Of great weight was *Johnson*, 254 F. Supp. 73 (DC Tex., 1966), where, on facts essentially the same as those before the court, the district court had held that no gift had been made. No appeal was taken by the Commissioner from this decision.

2. The court was reluctant to expand the scope of the gift tax without clear Congressional mandate. The opinion points to the analogous situation under Section 482 where the courts refused to permit the creation of income in the interest-free loan area until such action was specifically sanctioned by Regulation.[3]

3. There was concern that the principles voiced by the Commissioner could be extended to "a multitude of situations involving gratuitous use or sharing of real or personal property among relatives," creating a situation which would be "administratively unmanageable."

4. The judges felt it was inequitable for the Commissioner to assert *now* that such interest-free loans were gifts when the statutory authorities offered in support of the position had been in existence since the creation of the gift tax laws.

There was a vigorous dissent by four judges who felt that these loans violated both the intent and the letter of the gift tax law. The primary focus here was upon the concept of the unequal exchange under Section 2512(b), with the dissenters saying that "the transfer of the privilege of using such funds is the making of a gift if adequate consideration is not paid for such transfer."

Seventh Circuit's opinion

On appeal, the Service leaned heavily upon the reasoning of the four dissenting judges in the Tax Court. In addition to arguing that the right to use money for an indefinite period is a gift of a "property right", the Service characterized the transaction as an "unequal exchange" within the meaning of Section 2512(b). In this view, the lender would be exchanging money for a promise to repay a like amount of money upon demand. As a third line of attack, the Commissioner asserted that, if a gift was not made at the time of the making of the loan, a gift was made continuously as the lender refused to demand repayment.

The Seventh Circuit upheld the Tax Court by a two-to-one margin. The court first responded to the Commissioner's concept of the unequal exchange. Noting that this theory presumed the value of the promise to repay upon demand to be less than the amount of loaned money, the court commented, "The Commissioner has not produced any evidence showing that demand notes systematically trade at a significant discount from face value in the market place." They went on to observe that the proposed method of calculating the amount of the gift was "not entirely consistent" with this theory. The Commissioner had proposed to find that a gift had occurred at the end of each calendar quarter for which there were interest-free loans outstanding, measured by multiplying the outstanding balances by the then-current interest rate for similar notes. But the court concluded: "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."

Next, the judges dealt with the concept of the use of money as a property right in itself. "The question is whether such an 'at will' interest can properly be characterized as 'property' under the gift tax laws; *i.e.*, whether it is 'protected by law' and has an 'exchangeable value.' " The court conceded that certain "at will" interests are protected at law, (*e.g.*, interests such as tenancies at will in real property and contracts terminable at will) but stated that they had been furnished "no authority suggesting that the recipient of a loan payable on demand has a legally protectible interest vis-a-vis the lender." In addition, the court notes that there was "no evidence showing that the borrower's 'at will' interest has an exchangeable value."

Finally, the court disposed of the Commissioner's argument that the gift occurs continuously as the lender refused to demand repayment by stating that such argument "implies a broader concept of what constitutes a property right under the gift tax laws than has heretofore been recognized." The court also utilized the Commissioner's Rulings against him by noting in a footnote that "the IRS has consistently maintained that a donation of the use of property that is not a 'legally enforceable conveyance' does not constitute a gift of 'property' within the meaning of the charitable contribution provisions of the Internal Revenue Code."

Having thus spoken directly to each argument of the Commissioner, the Seventh Circuit went on to emphasize the same broad considerations which were decisive in the Tax Court opinion:

1. "The Commissioner cites little precedent in support of his interpretation. . . . The only case directly on point here, [*Johnson*], is squarely contrary to the Commissioner's position."

2. "Courts have generally been inhospitable to the Commissioner's attempts to make the granting of interest-free or low interest loans a taxable event, absent an express statute or Regulation. The courts refused to give into the Commissioner's efforts to inpute interest on interest-free or low-interest loans between related business entities until the IRS promulgated Regulation 1.482-2 under newly granted authority."

3. "Another problem with adopting the judicial construction urged by the Commissioner is the extremely broad potential reach of the principles that would be at least implicitly recognized."

4. "Lastly, our hesitancy to adopt the result advocated by the Commissioner by judicial construction is reinforced by equitable considerations. . . . [T]he Commissioner has only recently begun

INCOME TAX TREATMENT OF INTEREST-FREE LOANS

On an issue not before the court, the Internal Revenue Service contended, in arguing the *Crown* case, that the loans gave rise to constructive income to the lending partnership taxable under the income tax. The Service has tried on several occasions to assert that the recipient of an interest-free loan is in receipt of income. The following cases indicate that the effort has been in vain.

1. *Dean*, 35 TC 1083 (1961). Taxpayers were the recipients of interest-free loans from a closely-held corporation which they controlled. The Tax Court held that there was no income by virtue of the loan, intimating that this result was grounded in the presence of an offsetting interest deduction.

2. *Saunders*, 294 F.Supp 1276 (DC Hawaii, 1968), *rev'd on other grounds*, 450 F.2d 1047 (CA-9, 1971). Taxpayer was involved in attracting financial backers to purchase a tract of land. At closing, he purchased an interest in the land by giving non-interest bearing promissory notes to the new owner's group. The district court held he had received no income for services rendered because an individual is under no obligation to charge for services rendered.

3. *Joseph Lupowitz Sons, Inc.*, 497 F.2d 862 (CA-3, 1974). Funds were transferred from one closely-held corporation to another controlled by the same individuals. The IRS asserted that a constructive dividend had been realized, but the court, relying on *Dean*, rejected the argument because the corporations treated the transfers as loans and none of the funds were used for the personal benefit of the individual taxpayers.

An analogous situation existed in the area of allocation of income among related business entities. Before the promulgation of Reg. 1.482-1 (d), pursuant to the statutory authority granted by Congress, the courts did not permit income to be created by imputing interest on interest-free loans. See, *e.g.*, *Tennessee-Arkansas Gravel Co.*, 112 F.2d 508 (CA-6, 1940); *Smith-Bridgman*, 16 TC 287 (1951). After the issuance of Regulations specifically providing for such creation (Regulations issued under authority granted by the statute itself), however, the courts have consented. See *B. Forman Co.*, 453 F.2d 1144 (CA-2, 1972); *Latham Park Manor, Inc.* 69 TC 199 (1977). For an in depth analysis of *Latham Park*, see King and Dinur, *Tax Court gives in on creation of income under 482*, 48 JTAX 66 (February 1978). ☆

to assert that the making of non-interest bearing loans is a taxable event, even though the statutory authorities offered in support of that position have been in existence since the creation of the gift tax laws. When the Commissioner's position on the same issue involved in the case at bar was squarely rejected by the court in [*Johnson*], no appeal was taken. Moreover, the Commissioner's non-acquiescence in that decision was not made public until seven years later, ..."

The dissenting judge was offended by the amount of dollars escaping the transfer tax, stating that the decision " 'just ain t right.' " He asserted that Sections 2501, 2511 and 2512 are broad enough to cover the transaction.

Planning possibilities

Although the future of interest-free loans is not clear, some planning points can be established. If the loan is made for a definite term, the value of the promise to repay will be less than the money transferred and a gift will have occurred. This result was strongly intimated by the Seventh Circuit. Moreover, there should be no agreement or plan that payment will not be demanded for a predetermined time.

The loan should also be represented by a note, executed by the borrower with full legal formalities so as to create true debt. While the courts in *Crown* did not distinguish between demand notes and open accounts, it has been held that a transfer of money in a close family relationship is presumed to be a gift unless otherwise shown.[4] Thus, the transaction should clearly be structured as a loan, and there should be no pre-agreed plan to forgive the notes.[5]

The note should specify that the loan is without interest. Many states have statutes which create a legal obligation to pay interest on a debt if the agreement between lender and borrower is silent on the subject, and the IRS has indicated that it will recognize these laws for income tax purposes.[6] Thus, each year's foregone interest would be taxable to the lender for income tax purposes, then taxable (to the extent it exceeds the annual exclusion) under the gift tax as a gift to the lender.

Now consider the application of such interest-free loans in specific situations. Suppose, for example, that father (F), who is in a high income tax bracket, wishes to provide additional income for his son (S). This can be accomplished by use of a Clifford or short-term trust in which property is placed for a period of at least ten years, with the income during that time to be paid to S. If the requirements of the Section 673 are met, the income will be taxed to S, and F's goal will be accomplished. Note, however, the disadvantages of this arrangement to F. Upon the creation and funding of the trust, a gift tax must be paid on the value of the income interest transferred to S (Reg. 25.2511-1(h), example 7). In addition, F has been required to relinquish rights to the principal for the ten-year period.

If the *Crown* doctrine is followed, however, the same income tax result can be achieved without the gift tax cost and without restriction in F's principal. F would establish an irrevocable trust with a minimum corpus for the benefit of S. He would then make an interest-free loan to the trust. The income earned by the trust by investment of the money would be paid, and taxed, to S. At the same time, since the loan would be repayable to F by the trust upon demand, F would not be denied access to his principal in event of emergency need.

Even if *Crown* were not followed or were to be reversed by Congressional action or by Regulation, the interest-free loan would have some advantages. Under the valuation method proposed by the Commissioner in *Rev. Rul.* 73-61, a gift would be deemed to have been made each calendar quarter in an amount equal to the outstanding balance of the loan multiplied by the then-market rate of interest. These small gifts would be reportable annually, but a gift tax would be due only to the extent the total exceeded the $3,000 annual exclusion. Moreover, the gift tax paid in the aggregate would almost certainly be less than the tax due upon the one-time gift of the income interest in the case of the short-term trust, at least for many years.

Other possibilities for the use of an interest-free loan are supplementing the income of a parent, funding cost of a college education, assisting newly married children to purchase a home, or permitting a young professional to establish a practice. In fact, in virtually any situation where property might be transferred by outright gift, an interest-free loan should be explored as an alternative. In many cases it may be preferable because of the lack of gift tax consequences and because of the flexibility introduced by permitting the creditor/donor to recover the principal in event of a change in circumstances as to himself or as to the debtor/donee.

Conclusion

The issue presented in *Crown* is by no means settled. There were vigorous dissents in both the Tax Court and the Seventh Circuit and the majority in both courts seemed to invite action by Congress or the Treasury. Said the Seventh Circuit: "We express no view here as to whether a prospective regulation making such loans taxable would be valid or whether, on the other hand, the problem would best be left to Congress." In the meantime, however, the tax practitioner is left with delightful speculation on what can be accomplished by use of the interest-free loan. ★

[1] For a discussion of the income tax aspects of such loans see the box on page 169.

[2] Eight judges comprised the majority, four dissented and three did not participate. For a more detailed discussion of the Tax Court opinion, see Frazier, *Interest-free loans, between family members: What practitioners can expect after* Crown, 48 JTAX 28 (January, 1978).

[3] See the cases cited in the box on page 169.

[4] *Estate of Ames*, TCM 2/7/46; *Grossman*, 9 BTA 643 (1927).

[5] See *Rev. Rul.* 77-299, 1977-2 CB 343, which stated that such a plan resulted in a gift at the time the "notes" were issued.

[6] See IT 1720, II-2 CB 54 (1928).

Prop. Regs. ease estate deduction for heirs' legal fees

THE SERVICE has issued a proposed amendment to Reg. 20.2053-3(c)(3) which eases the restriction on the estate tax deductibility of attorneys' fees incurred by beneficiaries in connection with litigation regarding their interests. As it now reads, the Regulation denies the deductibility of all legal fees for beneficiaries on the ground that they are personal expenses and not estate expenses. As amended, Reg. 20.2053-3(c)(3) would allow a deduction if the litigation is essential to the proper settlement of the estate under Reg. 20.2053-3(a). Expenses are deemed essential if they are actually and necessarily incurred in the collection of assets, payment of debts or distribution of property.

The proposed amendment reflects the difficulty in this area of specifically defining what interests are served in certain estate litigations. For example, the courts have allowed deductions for fees incurred by beneficiaries in defense of a decedent's will (*Estate of Morris, Jr.*, TCM 1966-191), and in arriving at the proper construction of a will (*Estate of Bluestein*, 15 TC 770 (1951)). In *Pitner*, 388 F.2d 651 (CA-5, 1967), *rev'g and* *rem'g* 248 F.Supp. 695 (DC Tex., 1965), fees incurred by beneficiaries in a successful state court action to enforce a contract in the estate's favor were also allowed. The court distinguished between disputes among beneficiaries themselves and disputes with outsiders who have no legitimate interests in the estate. All of these matters are essential to the settlement of an estate.

The IRS states that its proposed amendment is designed to "test" the deductibility under the general principles of Reg. 20.2053-3(a) rather than impose a flat disallowance on beneficiaries' attorneys' fees. Of course, even under the proposed amendment if a beneficiary's expense is approved by a probate court as an expense payable or reimbursable by the estate, it will not be deductible unless it is "essential to the proper settlement of the estate." ✩

All shares in estate affect blockage factor

In valuing closely-held stock for estate tax purposes, Reg. 20.2031-2(f) provides that consideration be given to the degree of control over the corporation which is represented by the block of stock to be valued. In *Rev. Rul.* 79-7, IRB 1979-1 17, the Service has amplified this rule by indicating that stock, includable in the gross estate under Section 2035 (gifts within three years of death), should be combined with shares actually held in determining the blockage factor.

In *Rev. Rul.* 79-7, the decedent had originally owned 60% (600 shares) of a closely-held corporation. Two years before his death, he transferred 300 shares to his son. The IRS determined that the transfer was made in contemplation of death, so it was includable in the decedent's gross estate under the pre-1976 version of Section 2035. (The Ruling specifically indicates that it applies equally to gifts made within three years of death under Section 2035 as amended by the Tax Reform Act of 1976.)

In valuing both blocks of stock, the two blocks are combined. Thus, the son's shares are treated as though the transfer had never taken place. The value per share of stock is significantly increased because the decedent is found to own a controlling interest in the business.

Although the Ruling does not indicate whether this logic would apply to related situations, it seems that stock included in the gross estate for any reason should be considered in measuring blockage. Thus, transferred stock which is returned to the gross estate under Sections 2036, 2037, or 2038 should be equally susceptible to this treatment. ✩

Post-death gains on installment sale not IRD

In a case of first impression, the Court of Claims held in *Sun First National Bank of Orlando*, Ct. Cls., 11/15/78, that post-death gains on payments of installment obligations based on a sale made by a trust prior to the grantor's death are not income in respect of a decedent (IRD). At stake was a Section 691(c) deduction by the trust for estate taxes paid by the grantor's estate.

An *inter vivos* trust was established by the decedent in 1941 with an income interest retained for her life. The assets were shares of stock which later appreciated enormously and were sold by the trust in 1965 for installment obligations running until 1980.

To avoid immediate inclusion of the gain in its income, the trust elected the installment method under Section 453. Although taxed as capital gain, the payments were deemed trust income and not corpus under applicable state law and were distributed annually to the decedent until her death in 1968. Thereafter, they were distributed to the grantor's daughter as remainderman under the trust. Upon the decedent's death, under Section 2036, the entire value of the trust corpus was included in her estate because of her retained life interest.

In a reversal of the usual positions, the trust argued that the payments made on the installment obligations after the decedent's death constituted IRD, and the Service disagreed.

Under Reg. 1.691(a)-1(b), IRD is defined as income to which a decedent was entitled at death but which was not included in the final income tax return. A common example is the final paycheck of an employee received after death. Under Section 691(a), IRD is taxed not to the decedent but to the recipient, who is then entitled to a deduction under Section 691(c) with respect to any estate taxes paid by virtue of the inclusion of the IRD in the decedent's estate.

In *Sun First National Bank*, the trust was not concerned with being taxed as "recipient" of the payments because the daughter, as the income beneficiary, would include the post-death payments in her income in any event. The trust, however, sought the IRD determination in order to obtain the Section 691(c) deduction.

The Court of Claims held that the payments on the notes were not IRD. The court conceded that the decedent would have received the income had she lived, but stated that this does not make it IRD unless she had also earned or accrued it during her life. The pre-death sale which generated the income was made by the trust and not the decedent. Thus, the decedent's entitlement to the income arose solely by virtue of her income interest in the trust which required that she be alive. Therefore, by definition, of course, entitlement to post-death payments could not arise prior to death.

The court cited the purpose of the IRD provisions which is to shift income away from the decedent and tax it to the actual recipient. Thus, an unfair inclusion into the decedent's final tax return of a lump-sum of income which may have otherwise been spread over a number of years is avoided. Here, this unfairness was not involved since the trust and not the decedent was to be taxed on the income.

A second argument of the taxpayer was that the inclusion of the trust corpus in the decedent's estate caused the decedent to be the "constructive" owner of the corpus. Under this theory, the decedent is deemed the seller of the stock and the trust is deemed to have acquired the installment obligations by reason of her death. The notes would constitute IRD under Section 691(a)(4).

The court disagreed. It explained that the inclusion of trust assets under Section 2036 is designed solely to prevent the avoidance of estate taxes through lifetime transfers which are in reality testamentary dispositions. It does not, however, make the decedent the constructive owner of the assets and ignore the separate reality of the trust. For all tax purposes, the trust is considered a separate entity.

Nor did the decedent's capacity as income beneficiary under the trust cause her to be deemed the constructive recipient of the installment payments. Trust income is distinct from the income of the beneficiary upon its distribution.

The court dismissed two additional

arguments of the taxpayer, holding that the grantor trust provisions of Sections 671-677 apply to deem a grantor the owner of trust corpus solely for the purpose of shifting trust income to him. Section 671 specifically limits the effect of these provisions to Sections 671-678.

Lastly, the court ruled that the trust was not entitled to a step up in basis. (The carryover basis provisions of TRA '76 are not effective until after 1979.) Under Section 1014(a), property acquired from a decedent which is later included in the decedent's estate receives a step up in basis except when, as here, it has been sold by the acquirer prior to the decedent's death.

Furthermore, the court refused to consider each installment note as a separate transaction so that the later ones could be deemed not yet sold at the date of death. It held that this was not in keeping with the limited purpose of Section 453 which is to spread the tax burden of a single transaction to coincide with the receipt of gain over time, but not to alter the nature of the transaction.

One judge dissented from the IRD holding, agreeing with the trustee that the decedent should be deemed the constructive owner of the trust corpus in keeping with the constructive ownership effect of Sections 677 and 2036. He maintained that the actual sequence of events did not significantly differ from what would have been the case had the decedent made the sale and then transferred the notes to the trust. In effect, the dissenting judge would not limit Section 691(a)(4) to installment notes actually received from decedent. ☆

New estate & gift decisions this month

ESTATE TAX

Death benefit was transfer made in contemplation of death. (TCM)

Decedent entered into an employment contract with his professional corporation that had a death benefit. Less than three years later, he and his wife died in a plane crash. The IRS determined that the death benefit was a transfer in contemplation of death (under pre-TRA 1976 law.)

Held: For the Commissioner. The death benefit was a valid contractual obligation of the corporation, so it constitutes a "transfer." *Estate of Kopperman*, TCM 1978-475.

"Maintenance and medical care" is an ascertainable standard under Section 2041. (Rev. Rul.)

Decedent was the income beneficiary of a trust which empowered the trustee to apply the principal for decedent's maintenance and medical care. Under local law, that power was limited by an ascertainable standard. It is not a general power of appointment under Section 2041, and the trust principal is not included in decedent's estate. *Rev. Rul.* 78-398, IRB 1978-45.

Proceeds from converted community property not excluded from gross estate for marital deduction computation. (Rev. Rul.)

Section 2056(c)(2)(C) provides that, if the decedent and decedent's spouse convert community property to separate property interests, the interest held by the decedent will be excluded from the gross estate for purposes of computing the maximum 50% marital deduction. This exclusion does not extend to proceeds earned on the separate share of the decedent. *Rev. Rul.* 78-391, IRB 1978-44.

Insurance proceeds paid to decedent's children are not deductible under Section 2053. (Rev. Rul.)

Decedent made a property settlement with his former spouse, incorporated into a divorce decree, requiring him to maintain insurance on his life with his children as beneficiaries. The policy was includable on his estate under Section 2042. The proceeds of the policy paid to decedent's children are not deductible claims against the estate under Section 2053. *Rev. Rul.* 78-379, IRB 1978-42.

Estate expenses of South Carolina decedent not charged against marital bequest. (Rev. Rul.)

A South Carolina decedent whose will had no provision for apportionment of taxes and other expenses will not have those expenses charged against the marital deduction bequest to his spouse. South Carolina law compels that conclusion. *Rev. Rul.* 78-419, IRB 1978-48.

IRS to amend Proposed Regs. on special-use valuation elections. (Ann.)

The Service will amend the Proposed Regulations under Section 2032A concerning the special-use valuation election. The original proposed rules stated that if executors did not conform elections made before September 15, 1978 to the Proposed Regulations by January 15, 1979, the elections are automatically revoked. The amendment will eliminate this automatic revocation rule. It also will permit estates who made the elections before final Regulations are issued to revoke them within six months after the adoption of the final Regulations. *Ann.* 78-171, IRB 1978-48.

Residence given to child included in parent's estate. (Rev. Rul.)

Decedent transferred his residence to his child but continued to live in the house with the child. The Service ruled that the house was included in his estate under Section 2036 because of an implied understanding that he would remain in the house. *Rev. Rul.* 78-409, IRB 1978-47.

Charitable deduction can be reduced only by amount of actual death taxes paid. (DC)

The Commissioner determined that a charitable deduction should be reduced by the maximum amount of possible state inheritance taxes that could have been incurred upon the exercise of a power of appointment.

Held: For taxpayer. Since the spouse died before the estate tax return was due without exercising the power of appointment, no state death taxes were incurred. The Commissioner cannot, therefore, reduce the charitable deduction by a hypothetical tax, when none, in fact, was paid. *Farmers Trust Co.*, DC Pa., 9/26/78.

Inconsistent will provision voided and marital deduction allowed. (DC)

The Commissioner denied a marital deduction because of inconsistent will provisions as to property passing to a spouse.

Held: For taxpayer. The marital deduction was allowed for property passing to the spouse and inconsistent will provisions passing property to spouse and son were voided. *Petteway*, DC N.C., 10/10/78.

Adjudication of incompetency negates general power of appointment. (DC)

The decedent possessed a life interest in property which was not limited by an ascertainable standard. Shortly before her death, she was judged incompetent. The Commissioner sought to include the value of the property in her gross estate.

Held: For taxpayer. Section 2041 would ordinarily include the value of the property in her estate under the rationale that she possessed a general power to appoint the property at her death. The fact that she was declared legally incompetent prior to her death effectively negates this power. *Williams*, DC Tex., 9/28/78.

IRS publication explains computation of three deductions and net gifts. (Ann.)

The Service has issued new *Publication 904, Computing the Interrelated Charitable, Marital and Orphans' Deductions and Net Gifts*, which replaces the Supplemental Instructions for Form 706. The publication explains how to compute the three deductions listed above if they must be reduced for death taxes paid from the deductible property. It also explains computation of the gift tax when the donee pays the tax. *Ann.* 78-152, IRB 1978-42.

Passage of title is not distribution fixing alternate valuation date. (Rev. Rul.)

Under the law of State X, title to real property passes immediately to a decedent's heirs or devisees. The executor may take possession of the realty, but only if authorized by the probate court. The executor's potential right of possession lasts until the final decree distributing the estate. The passing of title immediately after death is not a distribution fixing the alternate valuation date. The date will be six months after the decedent's death if the final decree is after that date. *Rev. Rul.* 78-378, IRB 1978-42.

Rare coins are valued at market value, not face, for estate taxes. (Rev. Rul.)

The Commissioner has ruled that the value of United States silver coins in an estate is their fair market value whether or not the decedent was a dealer. *Rev. Rul.* 78-360, IRB 1978-40.

GIFT TAX

Part of survivor annuity under qualified plan is a taxable gift if employee could withdraw employer contributions before retirement. (Rev. Rul.)

Taxpayer participated in a qualified profit-sharing plan that entitled him to withdraw up to one-half of the employer contributions from the plan after 15 years of service. When he retired, he received a joint and survivor annuity for him and his wife. The gift tax exclusion in Section 2517 for annuity payments under qualified plans does not apply when taxpayer constructively received part of his account before retirement. Since he constructively received half of his account after 15 years of service, one-half of the value of the annuity rights of the wife is a taxable gift. *Rev. Rul.* 78-399, IRB 1978-45.

Proposed merger of company taken into account in gift tax valuation. (Rev. Rul.)

For purposes of gift tax under Section 2512, the valuation of stock of a closely-held corporation should take into account the company's proposed merger with a publicly-held corporation. *Rev. Rul.* 78-367, IRB 1978-41.

Secretary CHAPOTON. No; we have not seen that on the House side either.

Senator DOLE. Thank you.

Senator PACKWOOD. John.

Senator HEINZ. Thank you, Mr. Chairman. To return to the line of questioning that Bob Packwood had, it would seem to me, Buck, that your position, as you state it, would be unassailable and we wouldn't be having this hearing or having this debate if the IRS had litigated the *Crown* decision in 1978 or had litigated any of the other decisions which stopped short of going to the Supreme Court. If it had been the *Crown* case rather than the *Dickman* case, which came along later, that had gone to the Supreme Court, I don't think anybody would be questioning the issue of tax policy here.

And my question to you is: Why didn't the IRS appeal the *Crown* case? And, second, after the Seventh Circuit Court of Appeals in the *Crown* case invited, as I understand it, the Internal Revenue Service to issue regulations, why didn't the IRS issue regulations to clarify the tax treatment and the valuation of interest free demand loans?

You had two bites at the apple, as I understand it, and you didn't take either.

Secretary CHAPOTON. Well, they had a ruling out that they thought specified the issue, specified the amount, the fact that the gift tax would apply and the amount of the gift tax involved.

Senator HEINZ. A, why didn't the IRS appeal?

Secretary CHAPOTON. Senator Heinz, I can give you a letter on that, if you want, or a letter from the Commissioner or a letter from the Justice Department. It's my understanding the decision was made on the basis that there was not a conflict among the circuits, and that the Supreme Court would simply not accept an appeal on a tax case where there was not a conflict between circuits.

Senator HEINZ. So where there is no conflict, the IRS has a policy——

Secretary CHAPOTON. No; the court has a policy.

Senator HEINZ. You would actually be precluded from taking that case to the Supreme Court.

Secretary CHAPOTON. I'm not an expert in this area. I'm not sure whether the Supreme Court would, in every case, deny—and we are not just talking about tax cases. We are talking about other controversies as well.

Senator HEINZ. I understand. Now when the Supreme Court refuses to hear a case, that has the effect of affirming the lower court decision?

Secretary CHAPOTON. No; not if they were refused because they don't consider the case. They can say that there is not a conflict and they just refuse to hear the case. So they would not have passed on the merits.

Senator HEINZ. You are saying that this case would not have been accepted.

Secretary CHAPOTON. Would not. It would not have been accepted by the Supreme Court.

Senator HEINZ. And at no time has the IRS ever appealed a case to the Supreme Court where there has not been a conflict among the lower courts.

Secretary CHAPOTON. I can't say that, but I can give you more information on their policy.

Senator HEINZ. All right. Then come back to my second point, Buck. Apparently the court of appeals in the *Crown* case invited the IRS to issue regulations. And why didn't the IRS at that point take up the invitation of the court?

Secretary CHAPOTON. I think the game, then, Senator Heinz, was in the judicial process, and they continued through the judicial process.

Senator HEINZ. I'm not sure that answers my question. This, apparently, was a part of their decision, and the end of the judicial process, as I understand the facts. And at the end of the judicial process where the court found in favor of *Crown,* they said to the IRS, look, why don't you guys issue some regulations to clarify the tax treatment and evaluation of interest free demand loans? As I understand it, the IRS didn't do that.

Secretary CHAPOTON. The IRS did not do that. It proceeded in court, the other cases in the courts. It proceeded with this position. It set up for liabilities, gift tax liabilities, on the basis of the 1973 ruling. And I wasn't there then, but I assume that the decision was that there wasn't any necessity for a regulation.

Senator HEINZ. Just one clarification. What has more authority—what sends a stronger signal to taxpayers and tax advisors? That is, a Revenue ruling or a Revenue regulation?

Secretary CHAPOTON. I would say a regulation clearly has more authority and a Supreme Court case has even much more authority than that. [Laughter.]

Senator HEINZ. Let me just say, Mr. Chairman, I understand the hierarchy of value. I do understand our judicial process, too, Buck.

But, Mr. Chairman, it seems to me odd that the Internal Revenue Service, feeling as strongly as it does, and apparently did then, didn't take what I would understand to be the next most authoritative step, one invited by the circuit court, which was to issue something stronger than ruling—regulations. That's for the committee to decide.

Secretary CHAPOTON. I would say, Senator Heinz, we are doing such a good job in getting our regulations out anyway, maybe a regulation was put in the process and we are only 5 or 6 years behind.

Senator HEINZ. You are gaining on it slowly.

Secretary CHAPOTON. No; you are gaining on us through this bill. [Laughter.]

Senator HEINZ. A second question I have relates to something that Senator Dole and you both mentioned about the bad tax advice crowding out good advice. And certainly we don't want that to happen. And you said, as I recollect, in your statement that prudent tax advisors should have counseled people not to make these loans.

Secretary CHAPOTON. No; not to not make them. There are still advantages in making them. But of the gift tax.

Senator HEINZ. Well, of the consequences involved. Now presumably what they should have said is, look, the Internal Revenue Service has issued a ruling, and the ruling means that if that ruling ever prevailed at some future point in time what you have done is going to be taxable and that is going to be expensive, and, therefore, you have got to weigh that risk. Taxes are expenses, I hope you understand. We have been confronted, as I recollect, with at least one or a set of Revenue rulings by you that there are a lot of fringe benefits that are taxable. Nonstatutory fringe benefits that are taxable. Isn't that right?

Secretary CHAPOTON. No. We have not issued any since I have been here.

Senator HEINZ. You do take the position——

Senator PACKWOOD. So does the IRS.

Secretary CHAPOTON. No, Senator Packwood. Since I have been here, there has been a moratorium on issuing rulings defining new——

Senator PACKWOOD. But I don't think that's the question he is asking. The position of the Treasury Department and the position of the IRS is that those fringe benefits should be taxable.

Secretary CHAPOTON. The position is where it is administratively—well, we are getting into another issue. But, basically, there ought to be a statutory basis for excluding economic consideration passing to employees. That is correct. I don't mean to avoid your question. That would say a lot of fringe benefits that may have been customarily not taxable, without changing the law probably would be taxable.

Senator HEINZ. Is it not true that you have proposed rulings?

Secretary CHAPOTON. We proposed a set? Senator, since I have been here, we have not proposed rulings or regulations.

Senator HEINZ. I'm not talking about you. How long have you been here now?

Secretary CHAPOTON. Since early 1981.

Senator HEINZ. I'm just trying to get Buck to state the facts. Buck, when I say "you," I mean the Internal Revenue Service. [Laughter.]

Now is it not true that the Internal Revenue Service has been trying to issue a ruling taxing fringe benefits of nonstatutory kind?

Secretary CHAPOTON. Why don't we short circuit this by saying the answer is probably yes. That the IRS, after a change in the law, would say that fringe benefits that are not taxable under the moratorium which now exists are taxable.

Senator HEINZ. Now is it not true that were we to relieve the moratorium that the ruling—that you would go ahead with the proposed ruling? And if you did go ahead with the proposed ruling, the logic would be that you have got a ruling, presumably if we didn't act it would be litigated, eventually somehow or another it might be 5, 10, or 15 years later the Supreme Court would decide the case, and under the precedent that you are arguing for today, fringe benefits would be taxable way back?

Secretary CHAPOTON. Senator, I am sure there are other analogies that make the point. I don't think that's a good one. Let me just make it clear, that absent the moratorium we are not issuing any fringe benefit regulations. We think Congress ought to deal with that problem.

If in an area, though, that we issued regulations——

Senator HEINZ. You are talking "we," the Reagan administration?

Secretary CHAPOTON. We, the Reagan administration, and the IRS under the Reagan administration. I am saying what the IRS could do under our guidance. And that is not issue any regulations taxing fringe benefits.

Senator HEINZ. I understand your position, but let's assume that something slipped up. And the regulations, which the IRS has been proposing for years, were issued. Now you may say you don't want to issue them, but the IRS has taken the position that you want to issue them. And you can reverse that. But so far as I understand it, the proposed rulings have not been withdrawn, have they?

Secretary CHAPOTON. They have not been issued.

Senator HEINZ. I understand that. But have they not been proposed? They do exist, don't they?

Secretary CHAPOTON. There was a discussion of draft regulation. There is no set of regulations, no set of rules proposed out there that would tax fringe benefits.

Senator HEINZ. I understand the administration position is you don't want to propose the rules.

Secretary CHAPOTON. No IRS set of rules. I'm not trying to be difficult. I think your point is valid. I'm just not sure the fringe benefit area is a good place to do it. I think there are other areas where we would issue a set of regulations. Normally, we always consider the IRS. Whether it is a confused state of law, make it retroactive or nonretroactive. That is a discretion of the IRS. And if that goes to litigation, then when the litigation is resolved, that law is going to be applied retroactively.

Senator HEINZ. Let me just ask you one last question. With respect to your de minimis rules, I gather you are saying that—and this ignores the question of why $100,000 is a valid threshold—how you intellectually under any circumstances justify a situation where your threshold could result in a substantial liability to a lot of people who simply aren't in the league of Lester Crown at $18 or how ever many million dollars that was. I am told that farm sales under the 7-percent safe harbor rates, even if there is no income to the seller, would be subject to *Dickman*. I'm told that the use of family property, such as land for grazing or growing crops, or if aggregated, not only those two things, but such things as use of the family home, an automobile, would be subject to *Dickman*. In the case of a child over majority or parent or other family members living at at separate apartment or in a separate home without payment of room and board would be subject to *Dickman*.

I am told that loans for a disaster emergency would be subject to *Dickman*. I am told that a loan to a child or spouse of a child following business reverses would be subject to *Dickman*, if any of those were over $100,000. Now that seems to me to be a pretty long list. Would you contend that those would not be subject to *Dickman?*

Secretary CHAPOTON. No; those would be, if they are over $100,000. There is a logical, intellectual basis for the $100,000. It is basically geared to the exclusion for these years, and it tries to be just a level amount to eliminate confusion.

But to answer your specific question—if those loans are over $100,000—those transactions over $100,000 would be subject to gift tax.

Senator HEINZ. Let me give you one other unusual example, probably, but we don't know what else is going to crop up here. I've been told that there is a taxpayer who loaned $250,000, clearly over $100,000, to a church interest free. The loan was for the church's building fund. And if you assume in this case that the loan was in 1976 and wasn't paid back until 1981, wouldn't that result in approximately $75,000 of gift tax liability in interest? And, further, isn't it true that that taxpayer would not be entitled to any charitable deduction?

Secretary CHAPOTON. There would be no gift tax. It would be a charitable exclusion from the gift tax. He would have the effect of a charitable deduction by excluding the income from his tax so the effect would be exactly the same as if he had realized the money, made the gift and taken the charitable deduction for the interest income.

Senator HEINZ. That's comforting.

Secretary CHAPOTON. I think he's in exactly the same position as if he had invested the money himself and given the money over to the church.

Senator HEINZ. Thank you, Mr. Chairman.

Senator PACKWOOD. Lloyd.

Senator BENTSEN. Thank you, Mr. Chairman.

Mr. Secretary, I, as a matter of principle, generally don't support things that have retroactivity. There are times that I do, but that's the exception rather than the rule for me. I think you run into a lot of problems that you might not otherwise have.

I would like to understand what you anticipate doing, if you can talk in further detail, when you talk about a policy statement on administration of this. I heard the $100,000 threshold. How far back in years would you anticipate going? You are really running into some nightmares, it seems to me, on the administrative side.

Secretary CHAPOTON. Well, I think that's primarily a theoretical problem, frankly, Senator. But we have not proposed any limitations on the number of years, if it were a large gift. And we are talking now over $100,000. Excuse me, an interest free loan over $100,000. There is no time limit in the IRS administrative action.

Senator BENTSEN. You mean they could go back as many years as they would so desire?

Secretary CHAPOTON. Could go back, which is highly unlikely that that is going to happen, but theoretically you could go back as far as the gift tax has been in existence. Yes, sir.

Senator BENTSEN. Would that mean that you would be doing some audits that you might not do otherwise?

Secretary CHAPOTON. I think not. Unless a case came up in an estate tax audit, which often the gift tax question arises.

Senator BENTSEN. I understand.

Secretary CHAPOTON. And, indeed, you see quite often on an estate tax audit the gift tax question from many prior years arise,

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and gift taxes are assessed as a part of the estate tax process. That could arise here.

Senator BENTSEN. Thank you very much.

Senator PACKWOOD. Buck, I have no further questions. Welcome back.

Secretary CHAPOTON. Thank you.

Senator PACKWOOD. Next is a panel of Vester T. Hughes, David R. Brink, and Howard M. McCue.

Why don't you gentlemen go ahead in the order that you appear on the witness list. Mr. Hughes, can you go first?

STATEMENT OF VESTER T. HUGHES, JR., HUGHES & HILL, DALLAS, TX

Mr. HUGHES. Mr. Chairman, my name is Vester Hughes. I have practiced law with emphasis on income, estate, and gift tax in Dallas, TX since July 1, 1956, just under 29 years. I am very aware of the problem of interest free loans since I participated in the preparation of the taxpayer's brief in the *Dickman* case.

We have just seen an example of why there should be retroactive nonapplication of the *Dickman* case. We had one of the foremost tax authorities in this country who preceded me here. He apparently forgot about the 1969 split-interest provisions, which means that if there is an interest-free loan to a charity, you do not qualify for the split-interest provision, allowing a charitable gift tax deduction. And in the case which Senator Heinz mentioned there would be a tax gift of some $75,000 on that interest free loan to a church from 1976 to 1981. It was a $250,000 loan that I'm aware of in the State of Louisiana.

Yes, there was some planning that went on. But the scope of the *Dickman* case is so broad that what comes within its gambit is absolutely amazing. It covers not only estate planning situations, but common everyday transactions as well.

You have the traditional family situation, where a child is loaned money to go into business, or a child is loaned money to buy property, or a child is loaned money because there have been business reverses. For example, I know of a situation in the State of Texas where, in a comparatively wealthy family, the son-in-law thought that he wanted to be worthy of the family into which he married so he went into a business deal. It was an improvident deal and he lost $2 or $3 million. His own estate could not handle it. His father-in-law loaned him $500,000 interest free so he would not have to go into bankruptcy. This is not the area which I submit that Congress intended to give rise to a gift tax when it enacted the 1932 gift tax provisions.

Sure, the Supreme Court has the last word. It has to. But this body has overruled the Supreme Court on many occasions.

Some significant ones are the *Hendler* case, when there was a question of whether or not "boot" was going to be taxable. The Government won the case over in the Supreme Court. But it's one of those cases where you win a battle and lose a war. It was suddenly realized that basis would be stepped up in all sorts of transactions that had been thought to be tax free.

So Treasury came up to the Hill; got a retroactive amendment which they should have. The same thing happened in *Spiegel.* The same thing happened in *Diedrich* which is now pending in the House bill on net gifts.

Prospective only, I submit, will not have the effect that has been suggested on the enforcement of the tax laws. Failure, failure to make it prospective only, I do believe, will have that adverse effect on the tax laws. The reason I say that is because you have here a situation that is so offensive to common thought. Let me say I'm not defending my own professional position. I never recommended interest free loans as a tax planning device. You say, OK, if you didn't, why are you here talking? I feel very strongly that the proper administration of the tax law is more important than justifying my prior positions.

Nonetheless, it seems to me that we should take into account that for 34 years—until 1966—no one suggested on any broad base that interest free loans, demand loans, would give rise to taxes, and that is was another 16 years—in 1982—before the taxpayer lost.

And it's not fair to try to draw a line that says you go back. If you look at what is suggested in terms of the administration of the law, what we have here is really legislation from down the street; not up here on this part of the Hill where it is supposed to occur.

This body is capable of drawing those lines. This body does it very well. And it should, in my judgment, as a policy matter do that, and do that prospectively. But to try to draw those lines and look back, when people didn't have anything other than that 50-year history of nontaxability to go on, to me is unfair, particularly when there is a very wide net in which people indiscriminately are caught. You can't sign a gift tax return unless you can report all prior gifts. So it's not something there is a statute of limitation on. The same is true on the estate tax return.

Thank you.

Senator PACKWOOD. Thank you, sir.

[The prepared statement of Mr. Hughes follows:]

STATEMENT OF VESTER T. HUGHES, JR.
JOINT HEARING BEFORE SENATE COMMITTEE ON FINANCE'S
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
AND
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
APRIL 4, 1984

My name is Vester T. Hughes, Jr. I have practiced law with particular emphasis on Federal income, estate and gift taxation in Dallas, Texas, for just under 29 years. I appreciate this opportunity to appear before the subcommittees today.

I strongly urge that the U.S. Supreme Court's decision in Dickman v. United States not be allowed to apply retroactively from its announcement on February 22, 1984. The Dickman decision is so broad that it applies the gift tax to a multitude of common transactions that neither the 1932 Congress that initially enacted it, today's Congress, nor any intervening Congress would have thought possible. The Dickman decision is contrary to decades of prior practice, and attempts to apply it to past decades (potentially all the way back to 1932) would lead to such insurmountable administrative burdens that it should not be allowed to stand insofar as the past is concerned.

The Dickman decision would treat a wide variety of common transactions consummated in the past as taxable gifts. Most people would never have considered such common transactions to give rise to a taxable gift. For example, a parent's interest free loan to a child to enable that child to make a down payment on a new house would be treated as taxable gift. A parent's interest free loan for educational or medical expenses of his child would result in a taxable gift. Interest free loans for a wedding or to start a new business venture would be treated as a taxable gift. Attempting to help family members through a crisis by loaning them money interest free after a fire, flood or business bankruptcy also would give rise to a taxable gift.

The history of the administration of the gift tax argues against retroactively taxing these common transactions under Dickman. Notwithstanding the common transactions in which interest free loans have been used, it was not until 1966, 34 years after the gift tax was enacted, that the Internal Revenue Service ("IRS") first raised the issue of whether an interest free demand loan would give rise to a taxable gift. (See Johnson v. United States, 254 F.Supp. 73 (N.D. Tex. 1966).) The IRS lost that case and did not appeal it. The IRS then waited 7 more years before it issued a revenue ruling disagreeing with the Johnson decision and asserting that interest free demand loans constitute taxable gifts. (See Rev. Rul. 73-61, 1973-1 C.B. 408.) Four years later the IRS tried to apply its ruling in the Crown case but lost in both the Tax Court and Court of Appeals for the Seventh Circuit. (Crown v. Comm'r, 67 T.C. 1060 (1977), aff'd, 585 F.2d 234 (7th Cir. 1978).) It was not until 1982 -- 50 years after the gift tax was enacted and 9 years after it published its ruling -- that in the Dickman case the IRS for the first time was able to persuade a court to agree with it. See Dickman v. United States, 690 F.2d 812 (11th Cir. 1982).

This history demonstrates two things. First, the IRS did not attempt to treat interest free loans as gifts for many, many years. Second, taxpayers were relying on consistent historical practice in not treating interest free demand loans as giving rise to taxable gifts. This is extremely important to the Committee's concern over the likely impact of retroactive legislative relief on the administration of the tax laws. Legislatively overruling Dickman for retroactive periods will not in my judgment create tax compliance problems or give taxpayers incentive to take aggressive tax positions. The interest free loan issue is unique. As the history outlined above demonstrates, taxpayers have been relying on 34 years of IRS inaction, 16 years of consistent court decisions, and their own common sense that helping a family member should not cause a tax. This is completely different from taking aggressive positions with regard to tax shelters and other schemes where taxpayers take novel positions in hopes that they will win the "audit lottery" or perhaps prevail in court.

Administrative enforcement problems also support limiting Dickman. The great number of situations that have occurred in the past and to which Dickman is applicable will prohibit effective or consistent enforcement. Any attempted application of the decision will of necessity be uneven and sporadic.

The severity of the problem is compounded by the fact that the many common situations that can cause taxable gifts under Dickman will do so even if they occurred, for example, in the 1940s, 1950s or 1960s. This is so because where no gift tax return is filed, no statute of limitations applies to the IRS's ability to audit and assert a gift tax deficiency. And people engaging in such common transactions ordinarily would not have filed a return. (While it is true that no gift tax would be due unless the gift exceeds the annual exclusion amount ($3,000 from 1943 through 1981), such amounts frequently are given as annual cash gifts, without need of filing a gift tax return.) Taxpayers are not going to be inclined to file amended gift tax returns for an unlimited number of prior years. If they did, the administrative burden of handling the returns for such earlier periods would be great. For gifts made after 1970 and before 1982, gift tax returns were filed on a quarterly basis. So 4 amended returns would have to be filed for each of those years in which an interest free loan had been outstanding.

Even if taxpayers were inclined to file amended gift tax returns with regard to interest free loans, they would have no basis on which to know how to value such transactions for gift tax purposes. The Dickman decision merely asserts that interest free loans result in taxable gifts. It does not address the value question. The gift tax law requires that the fair market value of the use of the money loaned is the measure of the gift. Taxpayers and the IRS alike will be forced to try to determine what appropriate interest rate or other measure of value was applicable for periods well in the past to which the gift tax is being retroactively applied. This may need to be done on a daily basis. In every interest free loan case decided to date, the IRS has asserted a different theory for determining the appropriate imputed interest rate. Disputes will be inevitable.

Thus. taxpayers who try to comply with the decision will be drawn into valuation arguments with the IRS while those who simply ignore it or are not aware of its existence may escape such burden. This unequal application of the law will, in my judgment, do far more damage to the integrity of our tax system than a legislative solution that overrules Dickman for periods. prior to its announcement on February 22, 1984.

In addition, the problem is not confined to past years. To file a current or future gift or estate tax return correctly, a taxpayer must know, report, and use in the computation the amount of all prior taxable gifts. Thus, if Dickman is allowed to apply retroactively, not only will people owe past due taxes on common transactions that occurred years ago, they will file incorrect future gift and estate tax returns to the extent they are not aware of Dickman or cannot or have not complied with it for past years. Congress should not allow a group of taxpayers to become lawbreakers because in the past they engaged in common familial transactions. Application of Dickman should be legislatively curtailed for past periods.

Next, I would like to present three examples of situations where Dickman would apply to create a taxable gift, but in which I believe there is virtually unanimous agreement that such a result is inappropriate. The first situation involves sales of property between related parties to which the imputed interest rules of Code Section 483 apply. Notwithstanding that Section 483 provides safe harbor interest rates to be applied to such transactions for income tax purposes, under Dickman, to the extent such interest rates are below market interest rates (which they generally have been over the years), a taxable gift would result. Thus taxpayers are in the position of having entered into a transaction pursuant to a safe harbor provision of the income tax portion of the Internal Revenue Code only to find themselves, some years later, subject to a gift tax under Dickman. This is particularly true of a qualified sale of land between family members which Congress has said would have no income tax recharacterization if made at 7% -- certainly neither Congress nor the public would have thought that a transaction so qualifying would give rise to a taxable gift.

The second situation involves making an interest free loan to a charity. Direct gifts to a charity are not subject to gift tax due to the charitable deduction for gift tax purposes under Code Section 2522(a). However interest free loans to a charity constitute split interest gifts under Code Section 2522(c)(2) which are not eligible for the charitable deduction from the gift tax. Thus persons who made such loans in the past would, under Dickman, unwittingly have made taxable gifts.

The third situation involves interest free loans to a family member for medical or educational purposes. Since 1982, direct gifts by payment to the school or hospital are exempt from gift tax pursuant to Code Section 2503(e). However, under Dickman, interest free loans for such purposes would be subject to gift tax. Thus Dickman represents the untenable result of allowing families that can afford to make direct gifts for such purposes to escape the gift tax while subjecting to the gift tax families who are not wealthy enough to afford direct gifts but are able to make loans for such purposes.

Previous Congresses cannot have intended for the gift tax to reach these transactions. Yet the Supreme Court has chosen in Dickman to interpret the gift tax in such a broad manner that these past transactions would result in "surprise" taxable gifts. Such anomalous results should not be allowed to occur. Only congressional action can prevent such results.

These three examples, together with the many examples of common familial interest free loan transactions given earlier in my testimony, make it clear that Congress must do something with regard to the enormous breadth of the Dickman decision. The legislative relief I favor is an outright prohibition against the application of Dickman for periods prior to its announcement on February 22, 1984.

I know that it has been suggested that Dickman be overruled for past periods only with regard to loans that are less than a certain dollar limit, or with regard to certain transactions. I understand that your subcommittees are concerned with reports that taxpayers entered into interest free loan transactions for tax avoidance purposes. I do not condone such practices and have never counseled a client to engage in such a transaction. But I believe that the large number of non-tax motivated family loan situations require legislative relief from retroactive taxation. Trying to draw a line to distinguish one kind of transaction from the other with dollar limits or other exceptions is imperfect at best. Further, when done retroactively, it is offensive to a person sensitive to the fair functioning of the tax system. Hence, I oppose any type of such retroactive line drawing. Carving out exceptions and _de minimis_ rules is proper for prospective legislation like that pending before the House and the Senate with regard to low interest loans made in the future. But making exceptions, providing _de minimis_ rules and setting statutory imputed interest rates for retroactive periods is wholly inappropriate. In taking such an approach, Congress would be telling taxpayers that, even though the transactions in question have already occurred -- and in some cases decades past -- a new set of rules determining how those transactions are going to be taxed is being legislated. It simply is not fair to determine after the fact which transactions would be taxable and which are not. That being the case, and faced with the present situation with regard to the unacceptable breadth of _Dickman_, the best course of action is to provide legislative relief that applies to all taxpayers -- prohibit the application of _Dickman_ for periods prior to February 22, 1984.

Yes, under my approach _Dickman_ would not be applicable to past tax avoidance motivated interest free loan transactions. But many of these transactions can be taxed by the IRS without _Dickman_. In some cases the alleged loan is not a bona fide indebtedness -- it is a sham. The IRS has long been able to attack such transactions under the step transaction or economic substance arguments.

It still would be able to do so under my proposal and tax the worst of the tax avoidance schemes. But at the same time, it would not be able to tax common, non-tax motivated familial transactions -- transactions it would be able to tax if Congress either does nothing or draws an arbitrary, retroactive line to determine which past transactions are "good" and which "bad."

Finally, a word about Congressional precedent for overruling Supreme Court decisions. It is sufficient to say that when circumstances in the past have required such action, it has been taken. Two notable examples are the addition to the Code in 1939 of the predecessor provisions of Section 357 to overrule United States v. Hendler, 303 U.S. 564 (1938), and the amendment in 1949 of Section 811(c) of the Internal Revenue Code of 1939 to overrule Estate of Spiegel v. Comm'r of Internal Revenue, 335 U.S. 701 (1949). A more recent example is found in the pending House Ways and Means Committee tax bill, H.R. 4170. Section 802 of the bill (discussed at pages 1707-08 of H. Rep. No. 98-432 (March 5, 1982)) overrules, for retroactive periods only, the Supreme Court's decision in Diedrich v. Comm'r, 457 U.S. 191 (1982), that payment of gift tax by a donee results in income to the donor.

I believe that the circumstances surrounding the interest free loan issue require similar action. Indeed, the need for relief on this issue is even more compelling -- the historical basis for overruling Dickman is far stronger than in the past cases in which the Supreme Court has been overruled by Congress.

In conclusion, Dickman should not be allowed to apply retroactively. The benefits of overruling Dickman for past periods far outweigh the disadvantages.

Thank you for asking me to testify.

Senator PACKWOOD. Mr. Brink.

STATEMENT OF DAVID R. BRINK, DORSEY & WHITNEY, WASHINGTON, DC

Mr. BRINK. Mr. Chairman, thank you. My name is David R. Brink. I'm a partner in a law firm of more than 200 lawyers, with main offices in Minneapolis. And I specialized among other things, in trusts and estates and taxation.

Our firm, in general, represents both rich clients, I'm glad to say, and middle-class clients. We do not have a specific client we are representing in this matter. But I would like to urge four reasons the law should be amended to bar retrospective application.

First, unless amended, the Treasury proposal, both that contained in section 162 of the proposed Tax Reform Act and under the *Dickman* case, seems to me to favor the rich. Rich families don't often make interest free loans, although when they do it obviously becomes big news as in the *Crown* case. They normally have the money to fund their business ventures or to pay adequate interest. And they usually can find quickly the money to pay off demand loans within 60 days, and thus use an exemption that will be built into section 162 of the Tax Reform Act.

Rich parents or grandparents usually prefer outright gifts to younger generations rather than loans because they do not want the income or principal to return to their estates. But when occasionally they do make intrafamily loans, the rich are likely to have made and reported other outright or trust gifts. Thus, they are protected as to old loans under the 6-year statute of limitations that applies when a gift tax return has been filed.

In contrast, the typical interest free loan that we see is from a father, perhaps, to enable a son to start a business or farming career. And these loans are generally made in less-than-rich families, and there are a great many of those that don't hit the headlines.

Those people didn't always get or seek good advice or keep good records of those old loans. But now their funds are tied up in the enterprises they purchased with the loans, and so they can't pay off the loan in 60 days or at any time soon. And they have not made other reportable gifts over the years and so may be liable for tax, interest, and even penalties, going back as far as—as we heard from Secretary Chapoton—1932, because time never runs on unfiled gift tax returns.

So without amendment, it seems to me that the total Treasury proposal tends to discriminate in favor of the rich.

Second, without amendment, the proposal imposes unfair hardships and inequities. The February decision of the Supreme Court in *Dickman* finally enunciated for the first time a general principle that the use of demand loan money is a gift, but didn't tell us how to compute it. And that principle was never asserted by the IRS, at least in court, until 1966. And after that, the IRS never finally won a case involving interest free loans, at least, until *Dickman*. And, therefore, taxpayers who may in some cases have been unsophisticated, but got, I think, decent advice, decided that the courts were right and not the Service, and made such transactions over many years, probably 50 or more at this point.

Now section 162 of the proposed Tax Reform Act does deal with the same field. And it offers some new taxpayer relief, and some defenses in *Dickman*-type situations. And it does provide an explicit measure of the amount of the gift. But those reasonable taxpayer protections will exist only prospectively from the date of enactment of the Tax Reform Act. They are not available as exemptions, defenses or measurements on old gifts covered by the *Dickman* case. So I say that we are in a posture where the new law will be less hard on loans than the old law that they propose to apply under *Dickman*.

Third—and I think this is significant—I seem to have used my time. If I might just make one concluding remark, I would like to point out that section 802 of the proposed Tax Reform Act does bar retrospective application in a very similar situation; namely, the case of net gift where a new court decision would otherwise be applied to old transactions. And we have precisely this kind of a measure in section 802.

Thank you very much, Mr. Chairman, for indulging me in 1 more minute.

Senator PACKWOOD. Thank you, Mr. Brink.

[The prepared statement of Mr. Brink follows:]

STATEMENT OF

DAVID R. BRINK

submitted to the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

and the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

of the

FINANCE COMMITTEE

of the

UNITED STATES SENATE

on the Subject of

GIFT TAX RELIEF LEGISLATION

(to Section 162, S2062, Proposed Tax Reform Act of 1984)

INTEREST FREE AND BELOW-MARKET LOANS

April 4, 1984

Mr. Chairman and Members of the Subcommittees:

My name is David R. Brink. I am a senior partner of Dorsey & Whitney, a law firm of more than 200 lawyers in nine offices, including its home office in Minneapolis, Minnesota. I now head the Washington, D.C. office where I specialize in, among other things, tax and estate planning matters. I have chaired our firm's department dealing with Trusts, Estates and Estate Planning and have been active in the American College of Probate Counsel, the American College of Tax Counsel and the Sections of the American Bar Association dealing with these topics. In the past, I have testified before subcommittees of the Finance Committee in support of the tax proposals of the American Bar Association of which I was President in 1981-82.

Today, I do not appear in any such representative capacity, but rather in a sense _pro bono_. I testify at the invitation of a group of lawyers nationwide who seek to limit the inequities and hardships that would be caused by enactment of Section 162 of the proposed Tax Reform Act of 1984 in its present form. They and I believe that Section 162 should be amended so that gift taxes and possible income taxes will not be asserted against lenders in interest-free or low-interest intrafamily demand loan transactions entered into before the date of enactment of the Tax Reform Act. (At a minimum, relief should be granted as to gift tax on loans made before February 22, 1984, the date of the Supreme Court decision in Dickman v. Commissioner.)

The fact that I appear pro bono is itself significant. Naturally, I would like to be paid to represent one or more wealthy lenders who would be damaged by retroactive application of Section 162 and the Dickman case. (I am happy to say that our firm has some wealthy clients.) After some search, we have concluded for the present that none of them appears to have made such interest-free loans. Rich parents or grandparents often make outright gifts, rather than loans, not wanting either the interest orthe principal back in their estates. If they want to shift the income but receive the principal back, they create short-term or "Clifford" trusts. When they do make loans to, for example, a child, the child usually can pay interest. Even in cases where below-market loans are made, the borrower in a rich family normally is in a good position to pay off the loans within 60 days and thus permit the lender to avail himself of the clause now in Section 162 that protects against the prospective application of the gift and income tax to such loans.

This left me with more typical potential less-than-rich clients consisting primarily of farmers and small businessmen. I believe that clients of this type in a number of cases may have made interest-free demand loans, primarily to enable children to get themselves started in similar careers. Let us look at a typical situation.

Assume that many years ago Father, a farmer, lent Son, a would-be farmer, at no interest, most of his available funds to buy a farm and farm equipment. The funds supplied no longer exist in liquid form and cannot be gotten out in 60 days to repay the loan, even assuming the assets purchased with the loan have not declined in value. Son does not now have the money to pay the loan and Father is liable both for possible future income taxes on interest that no one ever receives and for gift taxes, both future and past, on imputed interest since the beginning of the loan. Those tax obligations and interest on tax could well exceed the whole amount originally lent. At the time of the transaction both Father and Son received legal advice, sound at the time, that the arrangement had no tax consequences. Now their only hope is to sustain the burden of proving that the arrangement was not entered into with intent to avoid taxes or that the loan never realized any income to Son. Even successful assertion of those defenses will protect the taxpayer only as to the future and not as to old gift taxes claimed under the Dickman case. Time never runs on unfiled gift tax returns.

The same situation assumed as to a farmer could apply at least as often to a small businessman. If the farmer or small businessman represents the typical case, why do I not find clients in that group? The primary answer is that we do not know who they are and they or their accountants do not know who they are. That is because the loan transactions are often so old, and the computational difficulties of ascertaining whether loans were ever below-market or were within available gift tax exemptions or exclusions are so great, that no one really knows at this point whether he owes old returns and taxes. If Section 162 is passed without relief, such clients may surface. Certainly they will surface if the IRS asserts liability against them for gift taxes, interest and possible penalties on transactions now many years old. That process would involve a great burden, both for the IRS and for taxpayers. Then my firm and lawyers and accountants throughout the country would have plenty of work for specific clients.

But application to these old loans would involve both great hardship and many inequities. These would be less for the very rich, who are likely to be able to produce the liquid funds to pay off the loans within 60 days, than for the less-than--rich, who are strapped for cash to pay the loans quickly or to fight, or pay, liabilities that never existed under the law until 1984.

For while gift tax liability can go back to 1932 under the Dickman case, no case had finally been decided in favor of the IRS until 1984, when that case was decided. And Section 162 creates for the first time a wholly prospective measure of the amount of such gifts. It establishes taxpayer defenses---but they are prospective only. It also creates an entirely new income tax on hypothetical interest imputed to the lender.

The IRS never even asserted a gift tax on below-market loans until 1966, and never, as noted, finally prevailed until Dickman. It is therefore not surprising that loans by farmers or small businessmen entered into in the '30s or later were not reported as gifts or even that no adequate records were retained.

The possibility of retrospective application of the tax laws to such old loans even more clearly demands relief than in the case of "net gifts", where taxability of old transactions was not established until the decision of Diedrich v. U.S. in 1981. Net gifts are gifts in which the donor of property requires payment of the gift tax by the donee. They involve liability by donors for capital gains tax on the excess of gift taxes over the donor's cost basis. They are single transactions that, by hypothesis, required the filing, at the time, of a gift tax return. On the other hand, low interest loans, if they constitute reportable gifts at all--which is difficult to ascertain, are continuous gifts from year to year during the entire life of the loans. (As noted, low interest loans were not finally recognized as reportable gifts until Dickman.) Yet the proposed Tax Reform Act of 1984 properly recognizes the hardship and inequity of retrospective application of the newly settled tax law now applicable to net gifts in Section 802 of the Act. How much clearer it is that the new, or newly settled, law on below-market loans should not be applied to transactions pre-dating enactment!

To my knowledge, the IRS has not proposed computational rules or taxpayer defenses for past gifts possibly resulting from below-market loans that predate enactment. Likewise, as this is prepared, the Treasury had not yet issued an estimate of any revenue loss resulting from adoption of any gift tax relief amendment. When such figures are issued, I suggest that they will be highly speculative, since they will depend for past years largely on voluntary taxpayer compliance in reporting old gifts that taxpayers honestly will not be able to ascertain whether they made.

As to prospective application, wealthy families generally will be able to pay off the loans within 60 days. Farmers, small businessmen and other middle-class taxpayers usually will have their assets tied up in the family farm or business and therefore will not possess the liquidity to avail themselves of that relief.

In any event, the relief provided in Section 162 as presently drafted will not assist taxpayers, rich or poor, for open gift tax years going back to 1932. The rich often have made other clearly reportable gifts that occasioned the filing of a gift tax return in earlier years, thus making available to them the six-year statute of limitations applicable when a return has been filed. Those less rich normally have not had any other reason to file gift tax returns and therefore have no statute of limitations to protect them. Thus, without a gift tax relief amendment barring retrospective application, present Section 162 tends to discriminate in favor of the very rich and against the less-than-rich. Only a complete bar to tax enforcement in pre-existing transactions is fair to all taxpayers.

The revenue cost of such a measure is likely to be small and certainly is highly speculative. Enforcement would be selective or haphazard. It would depend largely on voluntary taxpayer compliance. And taxpayers have few guidelines under Dickman to enable them to decide whether they made gifts above applicable exclusions and exemptions over the years. Against the possible speculative revenue generated by not granting this reasonable relief must be balanced the extreme administrative and computational difficulties for the IRS, and for taxpayers, of enforcing the present proposal.

* * *

I thank you for the opportunity to supply this statement. I strongly urge you to amend Section 162 by limiting to prospective transactions any enforcement of the gift and income taxes against below-market intrafamily demand loans.

Senator PACKWOOD. Mr. McCue, Mr. Oppenheimer.

STATEMENT OF HOWARD M. McCUE III, VICE CHAIRMAN AND CHAIRMAN-ELECT, FEDERAL TAX COMMITTEE, CHICAGO BAR ASSOCIATION, CHICAGO, IL

Mr. McCUE. Mr. Chairman, my name is Howard McCue. I am a member of the firm of Mayer, Brown & Platt. I am accompanied by my partner, Mr. Oppenheimer.

As indicated in your witness list and my statement, I am an officer of the tax committee of the Chicago Bar and a professor in a tax program, but I do not appear on behalf of either of those institutions.

I am, however, a practitioner who has worked almost exclusively in estate and gift matters. I practice in that area that falls within the jurisdiction of the seventh circuit, and I believe I can tell you what responsible tax advisers have advised their clients in that area.

We were aware of the IRS position that was taken in *Johnson* and we were aware of Revenue Ruling 73-71, but following the *Crown* decision it was clear that the law in the seventh circuit was that interest free loans did not lead to gifts subject to tax, with three warnings:

First, the *Crown* result could be overturned by the Supreme Court; second, that result could be overturned if the seventh circuit reconsidered its own conclusion; and third, that result could be overturned by Congress. And any one of those three results could conceivably occur retroactively.

I submit to you that clients were advised of these facts and also were advised that the district court in *Johnson,* the Tax Court in *Crown,* the circuit court in *Crown* had all suggested this was an appropriate area for legislation. The Tax Court thought that the issue was sufficiently clear, when it resolved the *Dickman* case, that it resolved the *Dickman* case in favor of the taxpayer with a memorandum decision. Taxpayers reasonably concluded that the law was clear, and they made loans thinking that what they had done was not subject to gift tax.

Now, I would like to address the issue of compliance. It has been suggested that retroactive application of the *Dickman* decision will foster compliance with the law. I tend to represent individuals and not tax shelter promoters, but I submit that that is incorrect. Many people advised of the *Dickman* result will simply conclude that prior years are past, and they will do nothing. Others conscientiously advised by honest tax advisors will file gift tax returns for prior years.

The first group, however, having ignored the law once will feel more comfortable, I suggest, ignoring it later. And the people who file gift tax returns, being told that the law has been changed, will feel that they have been mousetrapped, not by their tax advisors but by their Government, which decided the issue one way at one stage and then resolved the issue another way another time.

I would like to touch briefly on the administrative problems. This morning we heard that Treasury is going to suggest a de minimis rule. That will, of course, reduce some of the administrative problems. The estate administrator, however, still must determine all the taxable gifts made by the decedent at any time, as well as all the taxable gifts made by the decedent's spouse. I am still trying to figure how that problem is going to be worked out, when one must ask a surviving husband to list all of his gifts and all the loans he has ever made.

I am not sure how the de minimis rule works in loans of property. If a taxpayer has let his children use the summer house for the weekend, and if the summer house is worth more than $100,000 then that loan of property may be outside the de minimis rule, and it may then make all loans fall back outside the de minimis rule.

There are very serious problems here. And, again, the conscientious advisor will look carefully to determine what gifts were made all the way back to 1932. I do not take much comfort from the fact that the Treasury says its officials may not go back that far. We are obligated to determine what happened all the way back to 1932. Only the less conscientious will ignore the law with relatively little likelihood that the Treasury will, in fact, go after them.

I would like to close with a personal note. I regard myself—like the other tax lawyers in our firm—as an honest tax advisor. We tell the clients what we think the law is, and we will tell them the result of this proceeding, whatever it may be. And if our clients have to file gift tax returns, we will tell them so. That will not be welcome advice. And there will be others who call themselves tax advisers who give different advice. I am not sure that good advice will drive out bad here. I think bad advice may drive out good.

Thank you so much.

Senator PACKWOOD. Thank you.

[The prepared statement of Mr. McCue follows:]

STATEMENT OF

HOWARD M. McCUE III

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

AND THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON PROPOSED LEGISLATION REGARDING

PROSPECTIVE APPLICATION OF

DICKMAN V. COMMISSIONER

April 4, 1984

My name is Howard M. McCue III. I am a member of the law firm of Mayer, Brown & Platt. I am also vice-chairman of the Federal Tax Committee of the Chicago Bar Association, and an adjunct professor of law in the graduate tax program at Chicago-Kent College of Law. However, I emphasize that I submit this statement not as a representative of either of these institutions, but rather as a practicing attorney who has spent substantially all of his professional career advising clients, of every economic status, regarding estate and gift tax matters.

Introduction.

There is an essential flaw in the position adopted by those who favor retroactive application of the Supreme Court decision in Dickman v. Commissioner, 104 S. Ct. 1086 (1984). Those who take this position apparently believe that all competent tax advisors clearly should have foreseen the Dickman conclusion at least 11, and perhaps as many as 52, years prior to the date of the decision. On the basis of this assumption, it is concluded that all honest taxpayers, competently advised, either should have avoided interest-free loans altogether or systematically should have reported all such loans as resulting in gifts subject to gift tax.

This conclusion is erroneous, for the reasons set forth herein. If not corrected by the Congress, it will lead to a result that will be seriously unfair. Further, if Dickman is applied retroactively, it will further undermine the self-enforcement system, upon which the gift tax is utterly dependent, and it will discourage the taxpayers from consulting with honest and capable advisors.

Retroactive Application of Dickman Is Fundamentally Unfair. To suggest that taxpayers should avoid interest-free loans altogether is to disregard human nature. Parents will make loans to children while the children are pursuing education and starting families. Children, in turn, after they achieve some measure of economic success, will make loans to elderly parents who require support, medical care or nursing care.

Most interest-free loan transactions arise out of an interview in which the client has some family, non-tax reason for wishing to transfer funds, on a temporary basis, to other family members. In the usual case the client seeks advice as to how this best should be accomplished. Alternative techniques, including outright gifts, Clifford trusts and interest-free loans, among others, are discussed. Of course, taxpayers take into account the estate, gift and income tax consequences of each of the alternative approaches, and tax consequences in many cases do affect the structure of the transaction. In almost all cases, however, tax considerations are not the only considerations. Interest-free loans are simple, they require a minimum of paperwork, and they do not create new artificial entities which require the filing of tax returns and separate accountings.

Before 1966, there was no suggestion that interest-free loans led to taxable gifts. In 1966, the case of Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966) came to the attention of tax advisors. In that case, the Internal Revenue Service (the "Service") contended that a number of interest-free loans, extended on a demand basis to the taxpayer's children, were gifts in amounts equal to the value of the use of the money for several years in question. The Johnson court held for the taxpayer, analyzing essentially the same statutory language which was considered by the Supreme Court in Dickman. The Johnson court concluded specifically that there was no gift arising either from the contractual arrangements between the parties or from the statute. It concluded that any law which sought to tax such transfers would have to come from the Congress, not from the courts. 254 F. Supp. at 77.

The Service waited seven years to respond to the Johnson case. In 1973, it issued Rev. Rul. 73-61, 1973-1 C. B. 408, which indicated that it did not acquiesce in the Johnson result. Those tax advisors who followed such matters advised their clients, beginning in 1973, that the Service did not agree with the Johnson result. (Prior to 1982, however, there was absolutely no case law to support the Service's position.)

The next significant event in this history was the Tax Court decision in Crown v. Commissioner, 67 T.C. 1060 (1977).

When the Service first raised its argument in the Tax Court, the Tax Court ruled in favor of the taxpayer, unequivocally rejecting the position of the Service, and noting both the long-established practice of interest-free lending and the logic of the only case authority, Johnson. 67 T.C. at 1063-1064.

When the Seventh Circuit Court of Appeals reviewed this issue in the Crown case, it also ruled for the taxpayer, and it also concluded that the Service had tarried too long. 585 F.2d at 240-241 (1978). As had the Johnson court, both the Tax Court and the Circuit Court of Appeals in Crown indicated that a statutory change was appropriate if interest-free loans were to be characterized as resulting in gifts subject to tax. For reasons that are not clear from the published record, the Service chose not to appeal the Crown decision to the Supreme Court of the United States.

There are more than twenty million people who live in areas subject to the jurisdiction of the Seventh Circuit. Under the circumstances summarized above, responsible tax advisors in my community - even if cognizant of the Service position - almost invariably advised clients living in the Seventh Circuit that the law was clear. By reason of the Crown decision, an interest-free loan made by a client could not result in a taxable gift to the borrower unless one of three things happened: (1) the Seventh Circuit reconsidered its decision, (2) the Supreme Court came to a contrary result, or (3) the statutory provisions were changed by the Congress. Of course, any one of these possibilities could occur, but tax advisors are not in the business of predicting the future. With the caveats indicated, the advice was unequivocal. Most clients, getting such advice (even with the caveats), did not choose to file gift tax returns reflecting interest-free loan transactions.

The next significant event occurred in the fall of 1982 when the Eleventh Circuit Court of Appeals rejected the Crown conclusion in Dickman v. Commissioner, 690 F.2d 812 (1982). In this regard, it is interesting to note that in 1980 the Tax Court had ruled summarily against the Service in Dickman, in a memorandum opinion. Apparently the Tax Court, like most tax advisors, thought that the matter was clear. When the Eleventh Circuit rejected Crown, however, it became apparent that the Supreme Court might be asked to consider the issue because of a split in the circuits.

At that time in late 1982, the possibility of an adverse decision was again brought to the attention of many clients by responsible tax advisors. Some taxpayers filed gift-tax returns in 1983 for 1982 gifts, and in early 1984 for 1983 gifts, in order to take advantage of the applicable statutes of limitations. (The six year gift tax statute of limitations was available, even if t.e loan transaction was not disclosed, so long as there was no fraud.) The record is clear that some tax advisors, including myself, recommended this course in appropriate circumstances. E.g., McCue and Brosterhous, The Clouded Future of Interest-Free Lending, N.Y.U. Inst. on Fed. Tax. 4th An. Conf. on Est. Plan. (RIA 1983). In my experience, however, returns were filed only by the most affluent taxpayers who spend the greatest amount of time and concern discussing these matters with tax advisors. Thus, ironically, if the Supreme Court decision in Dickman is to be applied retroactively, the people most likely to escape its effect will be the most affluent who generally made the largest loans.

The Revenue Impact of Dickman is Uncertain.

It is not possible for an individual practitioner accurately to estimate amounts of gift-tax that will be collected by the Service if Dickman is applied retroactively. If all taxpayers who have made interest-free loans in amounts sufficient to require the preparation and filing of gift tax returns were indeed to file the returns required of them, the overwhelming majority of those returns would result in little or no tax. That result will obtain without regard to the final determination as to the imputed interest rates to be applied. (The rate determination has not been made to date.)

Retroactive Application of Dickman Will Encourage Non-Compliance.

Under these circumstances, I am not greatly concerned about the possibility that responsible attorneys or other tax advisors will be held to be liable to clients for advice to clients who made interest-free loans in the past. I am much more concerned about what we are to say in the future. If Dickman is to be given retroactive effect, responsible attorneys will, of course, advise their clients of that fact.

Most attorneys do not prepare gift tax returns for their clients. More commonly, the attorney will advise the client of the necessity of filing, and the returns are prepared for the client by an accountant chosen by the client (usually the same accountant who prepares the client's income tax return). Some clients use professional fiduciaries to prepare their gift tax returns. I have already spoken with enough clients to know that the Dickman decision is regarded as being seriously unfair. While clients have learned to live with many tax laws that they individually view as unfair, I fear that few will be anxious to file returns for prior years, even if advised that under the law they must do so.

The gift tax law is entirely dependent upon voluntary compliance. There are no forms W-2, K-1 or 1099 in this area. If, as I suspect, a significant number of clients simply will refuse to file, the self-assessment system will be the loser.

One of the questions presented in the press release announcing this hearing suggests that legislation to limit the retroactive application of Dickman might increase tax compliance problems, particularly in the tax shelter area. While I tend to represent individual taxpayers, rather than promoters of tax shelters, I conclude that the administration of the tax laws will be made more difficult unless Dickman is made prospective only.

A significant number of clients will conclude that they will not file gift tax returns for years prior to 1984, even if advised that they must do so under the law. Having once disregarded such advice, I believe that it will be easier for a client to disregard an honest advisor in the future. At least as significant, those individual taxpayers who comply with this retroactive change in the law by filing gift tax returns for prior years will do so convinced that they are victims of an arbitrary reversal of positions, not by their advisors but by their government. The system will seem more capricious than before.

Voluntary compliance is encouraged by simplicity and predictability in the law; voluntary compliance is less likely to occur when the taxpayers perceive the system as arbitrary and inconsistent. If what was A yesterday is not A today, then who can guarantee that what is B today will be construed as B tomorrow.

<u>Retroactive Application Will Create Problems for Estate Administrators, the Service and Others.</u>

The retroactive application of the Dickman conclusion will create serious administrative problems to taxpayers, their advisors, estate administrators and the Service. Obviously, if the decision is not limited, it will require that taxpayers identify and compute the value of all interest-free loans that they have made since 1932. This may not be difficult for a few taxpayers who have loaned large sums and kept careful records. It will be difficult or impossible for most individual taxpayers. It will be particularly difficult for individual taxpayers who have made a number of small interest-free loans of cash or extended the use of property for non-tax motives and who accordingly have not provided records of the loans to their tax advisors in the past. Many individuals make annual exclusion (formerly \$3,000, now \$10,000) gifts regularly to children. These individuals, to name only one group, will have made taxable gifts under the Dickman decision whenever they loaned money or property in any amount to a child who was also the recipient of an annual exclusion gift.

Estate administrators have a particularly difficult problem. They are required to file an accurate federal estate tax return within nine months after the death of a decedent. To prepare each such return, they must determine the amount of all prior taxable gifts made by the decedent and perhaps by the decedent's spouse, as well. (Specifically, the estate tax computation depends on the determination of all "adjusted taxable gifts" with certain credits for transfer taxes paid or payable.) The estate administrator cannot properly prepare and file the estate tax return without determining the amount of all prior taxable gifts.

Note, however, that the estate administrator cannot rely upon the gift tax returns (or the absence of gift tax returns) filed by the decedent and the decedent's spouse. The law has been changed, retroactively. The estate administrator is compelled, under threat of personal liability, to reconstruct records that may not exist. This problem has no solution. Honest estate administrators will try to generate the necessary records, but they cannot have any confidence that they will be able to do so. Administrators that are less conscientious or less scrupulous will disregard the problem with little likelihood of adverse consequences in many cases. Consistent application of the law by the Service will be impossible.

Conscientious Tax Advice Will Be Discouraged by Retroactive Application of *Dickman*.

I would like to close with a personal statement. If *Dickman* is applied retroactively, taxpayers will be encouraged to avoid the advice of honest and conscientious tax advisors. Rev. Rul. 73-61 to the contrary notwithstanding, the *Dickman* result was not the law until 1984 in the place where I practice. If it is applied retroactively, I will advise my clients of their responsibilities, but it is inevitable that some, who call themselves tax advisors or planners, will indicate that the decision can be ignored without adverse affect. In most cases, this advice will be correct, even if it is entirely inappropriate. I may be powerless to prevent this result, but I cannot accept it without comment.

Thank, Messrs. Chairmen. I would welcome your questions.

Senator PACKWOOD. Let me ask you this. You talked about the seventh circuit, and at least in that circuit the law was determined, apparently, in the *Crown* issue. It may not have applied to my circuit or some other circuit.

Mr. McCUE. There are about 21 million taxpayers out there that thought so, sir.

Senator PACKWOOD. Now tell me the response, if you might, to Mr. Chapoton's argument—that case could not be appealed. The Supreme Court would not take jurisdiction. You had no controversy between the circuits.

Mr. McCUE. I believe Mr. Chapoton said that the Service policy was that it wouldn't be appealed. I don't believe that it couldn't be appealed. I don't know why it wasn't appealed. I don't know why *Johnson* didn't go to the circuit court in Texas. Taxpayers look at the record as we see it. I wasn't involved in that case. But my own understanding of the law is it could have been appealed. It's not clear the Supreme Court would have taken it.

Senator PACKWOOD. Mr. Hughes, it looked like you were ready to say something.

Mr. HUGHES. Mr. Chairman, this year the Supreme Court took a case in which there was no conflict, a tax case, the *Bob Jones University* case. The Supreme Court also took one of the first cases I worked on in law practice in which there was no conflict. There were five cases contrary to the Service position and none in support. And I was a law clerk at the U.S. Supreme Court. I can tell you that any time the Government says it is an important matter either of policy or of revenue, the likelihood is the U.S. Supreme Court will take that case with or without a conflict and that is borne out by the *Baggot* case, the *P.G. Lake* case, *Bob Jones* case, and others.

Senator PACKWOOD. Here's the irony in this situation. Let's say the *Dickman* case had gone up and had been decided the other way—no gift tax. And we had thought that was bad policy, and Congress enacted a law. We would not make it retroactive. We don't do that very often here. We would have made it prospective. And I keep coming back to this interest of fairness or equity, let alone the problems that you have all raised about administration of this law. Is it fair if our policy would be no retroactivity because we don't think that's fair, to say but if the Supreme Court in essence decides to do the same thing we would have decided to do, then retroactivity is all right? And it just rubs my grain the wrong way in terms of fairness.

Mr. McCUE. Well, I note the Supreme Court has not itself decided the issue finally. It has remanded the rate determination which is absolutely crucial to all those taxpayers out there trying to figure what they are supposed to do today. I do not believe anybody here has suggested that as a policy matter the law should be that the *Crown* conclusion apply prospectively. I think we are only trying to talk to the one simple issue of retroactivity.

Senator PACKWOOD. Any other comments on my comment?

Mr. HUGHES. Well, I think that your fairness point is unusually appropriate here because it's very seldom that you have a 50-year history of a given direction and then a Supreme Court reversal. You had the first 34 years without any kind of a suggestion of a difference. That was up until the *Johnson* decision. That was 1932 to 1966. The Service didn't do anything for 7 years, and then they issued a Revenue ruling. Not a regulation but a Revenue ruling. Then in another 5 years you have the Tax Court of the United States sitting en banc deciding that an interest free demand loan does not give rise to a taxable gift. You have the seventh circuit deciding it is not a taxable gift. And then in November 1982 you have the eleventh circuit saying it is a taxable gift, the first time in 50 years that a taxpayer is on notice except for the fact the Service had raised the issue and lost until that time.

That has an ex post facto effect or smell or feel, or touch. That's not like a case that has just been on the books a short time where you are talking about the last 2 years, the last 6 years, the last 10 years. You have 50 years. And it's almost like a criminal sort of thing—an ex post facto application. And, indeed, it gets into that in terms of filing future returns.

Senator PACKWOOD. Russell.

Senator LONG. I would like for you to talk about these two cases that you cited.

Mr. HUGHES. Sure. I remember very well. The *Hendler* case was a wonderful case where the Treasury won a victory. They won a battle and lost a war. They won the case in the Supreme Court and came up with—but the facts were whether or not "boot" caused a reorganization to be taxable instead of whether or not——

Senator PACKWOOD. Whether or not what?

Mr. HUGHES. Boot [b-o-o-t]. Cash payments in addition to stock caused a transaction to be—whether boot caused what was thought to be a tax free reorganization to be taxable.

The Supreme Court said, in fact, it did. Now the byproduct of that was thought that both taxpayers and the corporation got stepped up basis on all their property, and so Treasury came up immediately and asked that Congress reverse it. And Congress, in fact, did reverse the Supreme Court.

Now what happened in *Spiegel* was a little different situation. The question there was whether or not you would include in a taxpayer's estate property that could come back to him by operation of law. Let's assume this type of situation. He sets up a trust, and everybody enumerated in the trust dies. And it comes back. He didn't retain anything. He didn't say it comes back to me, but comes back by operation of law.

The Supreme Court said if it could come back by operation of law, it was properly includable in his estate. Congress said not so, thus reversing the Supreme Court. If the settlor of the trust doesn't say anything in an instrument about it coming back to him, and if, in fact, he has less than a 5-percent interest—that is to say he couldn't set up a trust for his 95-year-old mother and say he had no interest—but if he has less then a 5-percent interest then it's not going to be in his estate, regardless of what the Supreme Court said.

Now the more recent one is over in the House side. The bill includes retroactive reversal of *Diedrich.* For many, many years taxpayers had thought that if the donee of property paid the gift tax, that had no income tax effect. The Supreme Court in *Diedrich* said not so. It has the effect of a sale. So the House bill contains a provision overruling *Diedrich* retroactively.

Now this is the sort of thing that you wouldn't want to do in all types of situations obviously. It doesn't make any sense at all to have this forum act each time when you have a court system. But there are times when the court system doesn't function either because no one thought about the way language works or because of the fact that situations change. And, indeed, that is what Treasury has asserted here. It says the situation changed; that people didn't do this before the days of high interest rates. Well, that just simply isn't true.

Senator LONG. The law, sir, is an ass.

Mr. HUGHES. Yes, sir. Mr. Bumble was right on that one. But by proper cooperation I think Congress can keep it from being a big ass.

Senator LONG. We pass the law, and the Supreme Court construes the law. The Court case might involve some obscure point that wasn't even discussed. By the time the Court gets through construing the law, we say, well, if that's what we had in mind, that law is an ass. So the Congress changes the law.

If we see that we have created a problem we would be the first to say we were idiots to do that; let's change it. But if the Court so construes it, then someone says, "Oh, wait a minute, that's sacred; you can't touch that;" that's something the Court did.

I don't know why something that is wrong and doesn't make any sense is immutable and beyond change, just because some court might have construed us as doing something that no longer makes sense. When you really get down to it, it does not matter whether we knowingly made a mistake or unknowingly made a mistake. If it's a mistake, we ought to change it. And if it's not a mistake, then, of course, we ought to leave it the way it is. So when you have got a real problem like this it is no real answer to say, oh, wait a minute you can't change that; oh, no, my God, no, that's something the Supreme Court did. Some people have the idea that the Supreme Court can make no errors. That wasn't any blindfolded lady that made that mistake up there. That was some guy who was divinely inspired, even though he reversed himself. [Laughter.]

He was divinely inspired both before he reversed himself and after he reversed himself. That theory just doesn't make a lot of sense to me. If I ever had worn those judicial robes, I would want you to look at it that way. But just as a fellow who practiced law on the other side of that desk up there, it doesn't make any sense to me to think that that fellow suddenly has all the judgment of the diety, when he construes something that we up here did.

I know we are not perfect. I know enough Senators and know enough about myself that I'm not perfect. When we pass something and the courts try to construe it, I don't know why it's perfect all of a sudden because they construe something that we did. The construction is perfect and it suddenly becomes right and beyond debate because the Supreme Court said something about it. If it is not good, we ought to try to change it.

Senator PACKWOOD. Steve.

Senator SYMMS. Thank you very much, Mr. Chairman.

If I understand this correctly, Mr. McCue, what you said is that as a practicing attorney who prides himself in giving accurate legal advice that you would be constrained then to go back retroactively to 1932 on advice to your clients. Is that correct?

Mr. McCUE. Well, I think that I would feel constrained to contact all of my clients, who I think either have or might have made interest free loans, and advise them what the law is. As I indicated in my written statement, I do not typically file gift tax returns for my clients. I find it is easier, and they find it easier to have their accountant do the necessary returns. A few do them themselves. Most of my clients have accountants.

But I would tell them all what they would have to do. And if I prepared an estate tax return, I would then insist on getting the information myself.

Senator SYMMS. What about the statute of limitation on this from the taxpayer's point of view?

Mr. McCUE. Well, there is no statute of limitations if no return was filed. Some advisers—and I was one of them, I wrote this down for an NYU institute a year ago—suggested that for 1982 and 1983 you might make taxable gifts, that you knew were taxable gifts, and at least file a return and get a statute running. It might be a 6-year statute; it might be a 3-year statute.

But this problem goes back to 1932. There is nothing we could do after *Dickman* for 1981 and prior years. We have got to go back and determine whatever Treasury says were gifts, over their de minimis rule. We have got to find them.

Senator SYMMS. Mr. Brink.

Mr. BRINK. Senator, I just might add to that that it seems to me that this is compounded by the fact that these people who made loans back in whatever, the 1930's, don't know who they are. They don't know how to compute the gifts. They don't know what the current interest rates were at the time or how the loans they had may have gone above or below current rates, if they had interest on them. The problem is for the honest taxpayer to engage in taxpayer compliance. He just doesn't know how to do it at this point.

Senator SYMMS. Well, Mr. Hughes, did I understand you, when you were talking with Senator Packwood or answering his question, that this happened in six or seven other cases? Or it has not?

Mr. HUGHES. It clearly has happened.

Senator SYMMS. Where the Court ruled, and it's prospective only?

Mr. HUGHES. Yes, Senator. I cited three cases in which the Court ruled and the Court's rulings would have been retroactive if Congress had not overruled the Court in each instance.

Senator SYMMS. Overruled what the Court did.

Mr. HUGHES. If Congress does that in this case, it is going to probably let some transactions go through that most of us would agree shouldn't. My problem is not with those. My problem is with the broad sweep of everybody out there who is covered one way or another. Now they say, for example, Senator Symms, that the $3,000 annual exclusion covers most people. That's not so. What happens many times would be either the single parent would give $3,000 or a married couple give $6,000 so every interest free loan, every noncharged use for property is a gift under the sweep of *Dickman*. Every one of them. And then how do you file a return?

On the gift tax return, there is a line that says "prior gifts." And in the estate tax return, it says "prior gifts."

Senator SYMMS. You mean the implication is that if somebody has an aunt that has a cabin on the lake and they use it, that should be filed on a tax return?

Mr. HUGHES. Yes, sir. *Dickman* goes that far. Chief Justice Burger finally gets around to saying, well, maybe it will be administered reasonably, and we will look at those cases when they come up before us.

Senator SYMMS. That's the most asinine thing I've ever heard of.

Mr. HUGHES. I think that will be the general public reaction. And that's why I totally agree with my colleagues here that it will encourage taxpayers in ignoring the law; not cause a failure of taxpayer compliance.

Senator SYMMS. Thank you very much.

Thank you, Mr. Chairman.

Senator CHAFEE. Mr. Chairman, I just came in so I did not hear all the testimony. Could I just ask Mr. Hughes a question? What do we do about the people who made extremely large loans and knew that they were treading on thin ice? Perhaps they had an opinion from their lawyer or their tax accountant, but their tax accountant said beware because although there is a case which says this is OK, that is not the final word. Nevertheless, they plunged ahead. What do we do about them?

Mr. HUGHES. Senator Chafee, as much as it galls me to say so, I would let those people go free. Rather let a few of those go free than to have the whole American public be in the possible posture of lawbreakers because of such gifts in the past. And how many of those there are, I don't know. I have no idea. And I'm sure there are some.

But I think that the scope of the *Dickman* case is such that it sort of fits in the criminal area. There you say better not have 5 innocent people in jail even if 10 guilty ones stay out of jail. The scope of this is so broad, so broad that I don't want to pick up taxes on those unintended gifts under *Dickman* that arise in common everyday situations.

Senator CHAFEE. The scope is going to be just as broad in the future, isn't it?

Mr. HUGHES. Not necessarily.

Senator CHAFEE. I mean the case that Senator Symms cited of somebody lending their cabin to their nephew, that's not going to disappear. And to me that's no problem. You are not seriously suggesting that the IRS is going to come after somebody in a case like that.

Mr. HUGHES. Well, let me tell you one that they have come after already and see if this shocks you. It shocked me. Mrs. Dorn lived in South Carolina and was in her 90's, and had $800,000 or $900,000 deposited in a demand account in her bank. Mrs. Dorn's daughter owned 25 percent of that bank. The Internal Revenue asserted that there was a taxable gift not only to Mrs. Dorn's daughter, who had 25 percent of the stock, but to the other 75 percent stockholders who were unrelated. They based that on the *Dickman* case as it came out of the eleventh circuit Now that is absolutely absurd to think that somebody, just because they have a demand deposit, is trying to make a gift to someone. And that case was handled by Mr. Johnny Walters, who was formerly Commissioner of the Internal Revenue. And he said you can't believe it. He could not believe that this was asserted.

It was, in fact, asserted, and had to be settled because of the age of the executors of the estate.

Senator CHAFEE. Mrs. Dorn was getting very bad financial advice, I would say, from somebody.

Mr. HUGHES. But many older people much prefer demand deposits to anything else. In my practice, I agree with you. Of course, up until the time of higher interest rates, people didn't pay much attention to cash management. You are right. Mrs. Dorn was in her 90's.

Senator CHAFEE. I'm not sure I see the great problems you see here, though. Is that the gist of the testimony of you, gentlemen, also?

Mr. McCUE. Well, I think we would certainly say, Senator, if the owner who lent her summer cottage to her nephew died at the end of the year and we were advising an executor saying he must file an estate tax return, we would tell him that he may have to file a gift tax return. If that deceased woman had already made a $10,000 annual exclusion gift to the same nephew, we would say that under the *Dickman* case as the Treasury appears to have construed it, he has got to file a gift tax return, and value the use of that cottage. And if she had named me as her fiduciary—which does not often occur—I would do that.

Senator CHAFEE. Yes; but you are going to have that problem anyway. That's what the case says. Now you will have to wrestle with it in the future. This law that we are considering isn't going to change that. That's all prospective.

But the question I want to ask you is the same question I posed to Mr. Hughes: What do we do about these people? These people knew what they were doing. There was no innocence in this. People don't lend the sums of money that we are discussing here without having it calculated to avoid paying a gift tax.

Mr. HUGHES. Senator, I beg to differ with that. You missed a part of my testimony. The situations where it occurs can frequently be for a son or son-in-law who is in financial difficulty because of a bad business deal. And in order to get them out of a bad business deal, they would lend money at no interest.

I have this case that I know of where there is a son-in-law that wanted to make a big success in business because he was in a rich family and he thought he had to do his thing. Well, he did his thing all right, but it was a disaster. So the father-in-law lent him $500,000. He lost not only his money; he lost his pride. And they were afraid he was going to commit suicide. That had no tax planning whatsoever. That was a very, very difficult family situation.

And there are many others that work very similarly to that.

Senator CHAFEE. Yes; but that is going to come up in the future. *Dickman* doesn't solve that.

My time is up.

Senator SYMMS. I would say to my colleague the problem is you take all across the farm belt in the United States and there have been farms that have been sold from grandfathers to sons or whatever, or fathers to sons, at what might be viewed by some IRS agent that didn't have enough to do as some kind of a chicanery or something if the interest rate was lower than the prime rate. But there are business people that can go out and borrow money right now from the banks below the prime rate, if they have good enough credit ratings. And that's OK. But yet if they lend it to somebody in their family, they would be subject to a gift tax. So you can go out right now if you have a good enough credit rating.

Senator CHAFEE. But that is still going to be there. The *Dickman* case isn't going to settle that matter.

Mr. HUGHES. But, Senator, it is one thing to write a set of rules that looks forward.

Senator SYMMS. It would mean that all these farmers that sold their farms to their sons at what might be viewed by the IRS as a preferred interest rate would be subject to a gift tax. That goes back to 1932, isn't that right?

Mr. MCCUE. That is correct. And at least prospectively we will have the opportunity to advise our clients that this is what they are getting into and that they should structure their transactions with a view to what the law is.

Senator SYMMS. It's a mockery of the law.

Mr. HUGHES. The Court of Claims said this needs the scalpel of legislation and not the meat ax of litigation.

Senator SYMMS. Well, thank you very much. You were excellent witnesses. We will move on here.

The next panel is Jerome Kurtz, former Commissioner of the IRS, practicing attorney; Robert McIntyre, program director for Citizens for Tax Justice; and Stuart Smith for Shea & Gould in New York.

Gentlemen, please be seated. And Mr. Kurtz, you may commence.

STATEMENT OF JEROME KURTZ, ATTORNEY, FORMER COMMISSIONER OF INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. KURTZ. Thank you, Mr. Chairman.

I have submitted a prepared statement, and with your permission I would like it to be inserted in the record.

Senator SYMMS. All of your entire statements will be part of the record.

[The prepared statement of Mr. Kurtz follows:]

SENATE FINANCE COMMITTEE

SUBCOMMITTEES ON TAXATION AND DEBT MANAGEMENT

AND ESTATE AND GIFT TAXATION

HEARING ON DICKMAN V. COMMISSIONER

APRIL 4, 1984 10:00 a.m.

TESTIMONY OF JEROME KURTZ

CHAIRMEN AND MEMBERS OF THE SUBCOMMITTEES:

My name is Jerome Kurtz. I am a lawyer practicing in Washington, D.C. and served as Commissioner of Internal Revenue during the last administration. I testify today in response to the Subcommittees' invitation to share with you my views on proposed legislation which would reverse, in whole or part, the application of the Supreme Court's decision in Dickman v. Commissioner. These are my own views; I represent no client in this matter.

In Dickman v. Commissioner, the Supreme Court held that the value of an interest-free demand loan made by a parent to a child was a taxable gift under the existing gift tax law. The question before you, therefore, is not what the law is but whether Congress should change that law.

Amending the gift tax law to exempt interest-free loans from transfer taxes would open a hole in our estate and gift tax system big enough to drive a truck through carrying much of the country's wealth. It would reduce this tax largely to one on stupidity - -

on poor planning. The estate tax is a critical element in providing what little progressivity there may be in our overall federal tax system and it should not lightly be gutted[1/].

If an individual with substantial investments and investment income decided to reduce his taxable estate, he might transfer, let us say, a million dollars a year to children. Obviously, such transfers would be subject to substantial taxes as well they should since the donor's estate for tax purposes is being diminished. An equal reduction of his estate could be achieved by lending $10 million to the child and having the child receive the income from that amount directly. Dickman recognized that the second transaction is economically the same as the first and should be treated the same for tax purposes. A different rule would, as I have said, largely limit the application of the estate tax to those so poorly advised as not to take advantage of what would be a giant loophole. Indeed, the parent who happened to be short on liquid assets could borrow large amounts of money and transfer the loan proceeds to a child with the same result, and presumably receive a deduction for interest paid on the loan. Again, from an economic point of view, this is the same transaction

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1/ Graetz, To Praise the Estate Tax, Not to Bury It, 93 Yale Law Journal, 259 (1983).

as the child borrowing the money and the parent reimbursing him for interest each year, and yet if Dickman had been decided differently, these two transactions with identical economic consequences, would produce vastly different results. And the amounts of money involved would be enormous for there is no reason why wealthy taxpayers would not take advantage of such a loophole. The transaction is simple to do and requires no commitment. The funds advanced can be retrieved on demand and presumably such loan could even be made to trusts for the benefit of others if the transferror did not want the debtors to have the immediate enjoyment of the income. The point is too obvious to belabor. While I do not believe this committee will seriously consider enacting such an exception to the law generally, the seriousness of the problem must be borne in mind as you consider petitions by taxpayers for retroactive relief.

I'd like to say a word about semantics. Taxpayers will argue that the decision in Dickman is "retroactive;" that retroactivity is bad; and, therefore, that legislation is required to prevent such "retroactive application" of the law. In fact, quite the contrary is true. It is not Dickman that is retroactive under any normal useage of that term but rather that any legislation changing that decision would be retroactive. Almost all tax decisions and, in fact, virtually all court decisions of any kind, are "retroactive" in the sense that taxpayers here are using the word. Any tax case considering a taxpayer's liability, of necessity is addressing a year prior to the time the case is being considered. The question, therefore, is whether the normal application of the Dickman decision should be changed legislatively; whether Dickman is in some way different from the thousands of other tax cases decided every year. I think it is not. In that connection, I would like to make a few points.

You have seen countless examples of taxpayers who enter tax motivated transactions in which there is virtually no chance of having the sought after tax result sustained. They go ahead on the grounds that the transaction may not be discovered by the Internal Revenue Service and that while there is little chance of winning the controversy, the cost of losing is not great. Entering into transactions of this kind has become known as playing the "audit lottery." Playing the audit lottery is a matter of deep concern to tax administrators and to Congress. When a taxpayer loses a tax shelter case in court, the Congress does not give the taxpayer his sought after deductions. And yet he could argue that the law is being applied retroactively to him. In fact, the reaction of Congress has been quite the reverse. Congress has enacted new enforcement and penalty provisions in an attempt to create a downside risk to discourage taxpayers and their advisors from engaging in such conduct. And yet here, you are being urged to give taxpayers the benefit of their sought after benefit after the courts have decided the issue adversely to them. To reverse the application of Dickman to prior years would run directly contrary to Congress' constant concern about the audit lottery and about the damage to the tax system done by overaggressive taxpayers and their overaggressive advisors. Retroactive relief would greatly reward taxpayers who were wrong in their interpretation of the gift tax law as applied to interest-free loans over other taxpayers and advisors who correctly appraised the state of the law and acted accordingly. We cannot run a tax system under which good guys finish last.

You will hear arguments from taxpayers and their advisors that they were mislead by the state of the law. I can only tell you that competent tax advisors and well-advised taxpayers were not mislead at all. The Internal Revenue Service stated its position that these transactions resulted in taxable gifts in a Revenue Ruling published in 1973[2/] and at least since that time

2/ Rev. Rul. 73-61, 1973-1 Cumm. Bul. 408 (1973).

has been clearly on record that taxpayers who entered into such transactions would be assessed a gift tax if their returns were examined. While it is true that the first Court of Appeals to consider the issue held in favor of the taxpayer3/, the Service did not retreat from its position and continued to challenge taxpayers in other cases. That is not an uncommon state of affairs and just as taxpayers do not necessarily feel bound by a decision in favor of the government in a particular case, neither is the government bound by reason of one decision in favor of a taxpayer. Anyone practicing in the tax field knows, or should know, that one case does not resolve an issue unless that case is in the Supreme Court. The position of the IRS put practitioners on notice that the issue was not resolved. Moreover, there were persuasive dissents in both the Tax Court4/ and the Seventh Circuit in Crown5/. Writers in the field believed the Crown decisi n was wrongly decided and would, in all likelihood, be reversed by the Supreme Court if the issue should reach the Supreme Court6/.

Why then did taxpayers in large numbers enter into these transactions? The answer is quite simple - - there was nothing to lose. If a taxpayer's return

3/ Crown v. Commissioner, 585 F.2d 234 (7th Cir., 1978).
4/ 67 T.C. 1060, 1065 (1977).
5/ 585 F.2d 234, (7th Cir., 1978).
6/ See, e.g., Pulliam, Income and Gift Tax Implications of Non-Business Interest-Free Loans, 58 Taxes 675 (1980), Joyce & Del Cato, Interest-Free Loans: The Oddysey of a Misnomer, 35 Tax L. Rev. 459, 495-500 (1980).

were not subject to examination, the taxpayer would have succeeded in reducing his estate by the amount of income deflected to his heirs without the payment of any gift tax. If it turned out that his return was examined and gift taxes were asserted and sustained, such tax would only apply to the amount by which his estate had actually been reduced so that there would be no disadvantage in having entered into the transaction. If Congress were to reverse Dickman retroactively, it would produce a result which no one contemplated. It would reward a taxpayer by permitting him to reduce his taxable estate through transfers free of gift taxes after the Supreme Court has resolved the issue adversely. This would be like changing the rules to award the purse to the losers rather than the winners after all the bets are placed.

Competent tax advisors play an important role in the administration of our tax system. They must be relied on to discourage taxpayers from taking overly aggressive positions - - to explain the risks in the outcome of doubtful cases. This is frequently a difficult role for an advisor to play because taxpayers would rather hear about tax saving potential than risks. In the interest-free loan area, careful advisors cautioned taxpayers about the tax risks of the transaction. To reverse the result in Dickman would be to undermine the more careful and conservative tax advisors and taxpayers for the benefit of those who act more aggressively. Such precedents do serious damage to tax administration. It cannot fairly be said that the Supreme Court's decision in Dickman was in any way surprising or unexpected. It should be viewed simply as reaffirming the adage in tax law that anything which appears to be too good to be true usually is.

Legislation should not be enacted which would give taxpayers who entered into these transactions and who knew or should have known of the risks involved, the benefit of taking those risks. It should be recognized that during this period there were taxpayers who did not enter into transactions of this kind because they correctly recognized that they would be subject to tax. The tax system cannot function by rewarding the aggressive over the conservative; by rewarding those who were wrong over those who were right.

It is probably worth saying a word about the alleged administrative problems which arise under Dickman. It has been asserted, for example, that if an interest-free loan to a child results in a taxable gift, so would a loan of an automobile to a child to drive to the prom or indeed, a loan of jewelry to a daughter to wear to that dance[7/].

7/ See, Dickman v. Commissioner, Brief for the Petitioners, p. 32.

I would characterize this imaginary parade of horribles as debating points rather than substantive arguments. Our income tax has a completely comprehensive definition of income, and courts have construed it as being all encompassing. Under the statute and judicial interpretation, it seems quite clear that if I lend you my automobile and in exchange you cut my grass we both have taxable income and yet I know of no instance where the IRS has attempted to tax such income. On the other hand, if I traded my yacht for your house, a tax would certainly be in order. The point is that tax laws must be applied in a reasonable way and have, in fact, over the years been so applied. To say that allowing a child the interest free use of $10 million cannot be distinguished from the loan of an automobile for an evening is to be completely out of touch with reality.

I would be pleased to answer any questions you might have.

Senator SYMMS. Go right ahead.

Mr. KURTZ. I would like to address myself to a few issues that seem to be at the forefront of concern, and try to put them in context a little bit.

Senator Symms, you mentioned the situation of the assumed sale of a family farm or another business property taking back a note which may bear zero interest.

Let me try to put *Dickman* in perspective. It has been the law for many, many years, and there is no dispute about it, that if one lends money to a relative and takes back a term loan, there is a taxable gift. No one disputes that. That is, if you sell the family farm and take back a 20-year mortgage, there may be a gift if the mortgage is not at the market rate, based on the difference between the face of the mortgage and its value, taking into account its term and interest rate.

The only thing *Dickman* did was extend what I think everyone has always assumed the law to be on term loans to demand loans. That's the only move that *Dickman* made. And it made that move after, as was pointed out, the seventh circuit in *Crown* had said that demand loans were different from term loans simply because the document that was received was valued on the day it was received at the amount of money advanced. That is, a demand note which could be called today, the court in *Crown* said did not result in a gift.

I think it's fair to say that careful tax advisors and the authorities recognized that that was a very narrow distinction; a very artificial distinction that was unlikely to stand. The tax literature written in the tax magazines and the professional journals at that time expressed considerable doubt as to whether the *Crown* result would hold.

It was not a foregone conclusion that it was right. I might also say that going back to 1932 would be very unusual except, perhaps, in extreme cases. Remember interest rates for many years were so low that even if there were a gift by a demand loan the amount involved probably would not rise to the exemption.

Certainly since 1973 when the Internal Revenue Service issued its Revenue ruling, it has been quite clear that the matter was not settled. The Internal Revenue's position was clear. It persisted in that position after the *Crown* case was lost, and continued to litigate other cases. *Dickman* has been in litigation for a while. Taxpayers were aware that if they took that position on their return, and the return was examined, the issue would be challenged.

In terms of how badly people would be hurt by letting *Dickman* stand and apply to prior years, it ought to be kept in mind that no one comes out a net loser. That is, we have a gift tax in order to protect the estate tax in large measure. If one transfers property out of one's estate, one has gained the estate tax advantage. The estate is smaller.

All that *Dickman* says is that the gift tax should be paid. People who made those gifts have, in fact, reduced their estates. The only question is whether they should be allowed to reduce their estate tax without the payment of gift tax.

If they had been competently advised as to the consequence, they might have gone ahead anyhow. People went ahead with these transactions notwithstanding what I think was the general advice of competent tax advisors, that there was some risk, on the grounds that they had nothing to lose. And that was good advice. The law was unsettled. You make an interest free loan. If you win the case or the law stays as it is, fine. You have saved estate taxes at no gift tax cost.

If, on the other hand, you lose the case, then you have saved estate taxes at the regular gift tax cost as if you had made a cash gift. So nobody comes out a net loser in this transaction.

There are a few other points I would like to make. One goes to the administration of the tax system as a whole. You are presented with issues dealing with tax shelters over and over again, and have sought in the last two tax bills to legislate rather strenuously to try to discourage taxpayers from taking overly aggressive positions on their tax returns.

I would say that retroactive legislation in this area, rewards the aggressive taxpayers over those who accepted the advice and acted more conservatively. I don't think we can, in the long run, run a tax system where the good guys finish last, if I might put it that way. There are other taxpayers who didn't make these loans.

If I may extend for 1 minute on the administrative point, which I think presents an imaginary parade of horribles. We've had an income tax which is all inclusive. It taxes income from whatever source derived. The courts over and over again, have said that means everything from everybody, from everywhere that is earned. It is absolutely clear, as a matter of theory under the income tax law, that if I lend my car to my neighbor and he, in exchange, cuts my grass that we both have taxable income. Nobody is taxing that income. Historically, the law has been administered in a reasonable way. And I think the fears expressed are completely unfounded. The fact that someone can point to one case that has arisen is not in any way an indication that the law would not be competently administered.

I might say that there is a paragraph in the *Dickman* decision by the Supreme Court that draws that distinction. It says people do these things and they assume that the law will be administered in a reasonable way.

Thank you.

Senator SYMMS. Thank you very much, Mr. Kurtz.

We will now hear from Mr. McIntyre and then Mr. Smith, and then have the questions. Probably the only reason the IRS hasn't taxed that guy who mowed his lawn is they can't find him. So as long as we keep spending around here like we do, they will be getting more and more ways to find him.

Mr. McIntyre.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. McINTYRE. Thank you, Mr. Chairman.

I would like to start off here with an analogy that I think might relate to the issue here.

Imagine, if you will, that the plumbing code of some particular city—we can call it Metropolis—has a rule that provided that wastewater shall be emitted either into the city sewage system or to some other suitable holding and treatment facility. And suppose further that there is an enterprising plumbing contractor who begins advising his major clients that they can avoid the expense of complicated septic tanks simply by sending their sewage into the Metropolis River. As precedent, the contractor cites the fact that that was common practice and acceptable in the 18th century, when Metropolis was just a tiny hamlet.

The contractor also points out or hints at least that it is unlikely that the clients will be caught because the plumbing inspector's office is understaffed. Well, soon a number of the other plumbing contractors get into the act, and begin advising their customers to take advantage of this supposed loophole in the plumbing code. And there are other contractors who say, well, we don't think this thing will survive a court test, but we will help you set these things up as long as you assume the risk.

Well, contrary to expectations, the plumbing inspector does find out about the practice, and he quickly orders it halted. And after many years of legal wrangling, the courts uphold the plumbing inspector's position. In fact, in the court decision, the court says that the practice of dumping sewage into the Metropolis River clearly and plainly violates the spirit and the letter of the plumbing code.

The plumbing inspector then orders the illegal dumpers to stop their practice, and also imposes substantial fines to pay for cleaning up the river. Well, one would expect that to be the end of the story, but it's not because these polluters on being caught petition the Metropolis City Council for a waiver of their fines.

They maintain they had acted in good faith in reliance upon the plumbing contractor's opinion about the 18th century sewage practices. They also argue that the burden of cleaning up the Metropolis River ought to be borne by Metropolis taxpayers generally.

Joined in this petition by their advisors who are worried that they may be liable for malpractice suits from the clients if, in fact, the fines become due. Well, one would hope that the Metropolis City Council wouldn't listen to that kind of petition and that it would require those fines to be paid, both in justice to the other Metropolis taxpayers and as a lesson to others who might be considering taking a ticket in what might be called the plumbing inspection lottery.

Well, I offer that analogy because it seems to me to be similar to what we are facing here, where taxpayers who have taken aggressive positions on the gift tax, positions that the Supreme Court found to be clearly and plainly wrong, are now coming and asking for retroactive relief from the gift taxes that they hoped to avoid in the past.

If they succeed in that, they will have shifted the burden of their taxes onto the other American taxpayers. They will have frustrated the purposes of the estate and gift tax, as the Supreme Court said. And they also will have offered us a lesson that playing the tax audit lottery is a game that is even more lucrative than we had imagined.

Now this committee in particular and the Congress has taken the lead over the last few years in trying to make it more expensive, more dangerous to play the tax audit lottery. We hope that

that will continue with the kinds of steps you have been taking, and we hope that you won't backslide by giving a very few, very wealthy tax avoiders retroactive relief from the gift taxes they have attempted to dodge in the past.

Thank you.

[The prepared statement of Mr. McIntyre follows:]

Citizens for Tax Justice

2020 K Street NW • Suite 200 • Washington, DC 20006 • (202) 293-5340

Statement of Robert S. McIntyre
Director, Federal Tax Policy, Citizens for Tax Justice
Before the Subcommittee on Estate and Gift Taxation &
The Subcommittee on Taxation and Debt Management
Of the Senate Committee on Finance
Concerning Proposals to Grant Retroactive Relief from the Gift Tax
For Gifts Made in the Form of Interest-Free Loans Prior to February 22, 1984
April 4, 1984

I appreciate the opportunity to appear before the Subcommittees today on behalf of Citizens for Tax Justice. Our coalition of national public interest organizations, labor unions, and state and local citizens groups represents tens of millions of average American taxpayers, who have a vital stake in fairer, simpler, economically more sensible tax laws.

Imagine, if you will, that the plumbing code of a particular city—call it Metropolis—provides that "waste water shall be emitted to the city sewage system or to a suitable holding and treatment facility." Suppose that an enterprising plumbing contracting firm begins advising its major clients that they can avoid the expense of complicated septic tanks by simply sending their sewage into the Metropolis River. As precedent, the contractor cites the fact that such a practice was considered "suitable" during the 18th century, when Metropolis had been but a small hamlet. Moreover, he hints, the chances of detection are relatively low, due to a lack of staff at the Metropolis Plumbing Inspector's Office.

Soon, a number of other plumbing contractors begin advising their customers to take advantage of this supposed loophole in the plumbing code. Still other contractors—more careful, if not more scrupulous—tell their clients that, while they don't think the loophole will withstand a court test, they will be happy to install sewage systems emptying into the river, so long as their clients assume all legal risks.

To the code violators dismay, the Metropolis plumbing authorities eventually do discover the polluting practice, and they quickly order it halted. After years of legal wrangling, the courts finally uphold the plumbing inspector's position. In fact, the highest court finds that dumping sewage into the Metropolis River "clearly" and "plainly" violates both the spirit and the letter of the law. Pursuant to their statutory mandate, the plumbing authorities then order the illegal dumpers both to correct their sewage systems and also to pay steep fines to cover the cost of cleaning up the Metropolis River.

This should be the end of the story, but it's not. Upset at being caught, the plumbing code violators petition the Metropolis City Council for a waiver of their fines. They maintain that they had acted "in good faith" and argue that the burden of cleaning up the river should be borne by Metropolis taxpayers generally. The polluters are joined in their petition by the plumbing contractors who had advocated the illegal practice—and who fear that they might be liable to pay the fines should their clients sue them.[1]

One hopes that the Metropolis City Council will refuse to listen to the spurious claims of the polluters and contractors, and will make sure that they pay their fines—both in justice to other Metropolis taxpayers and as a lesson to others who might be considering taking a ticket in what might be called the "plumbing inspection lottery."

Similarly, one hopes that the Subcommittees and the Congress will reject the claims of those taxpayers and their advisers who are currently asking for retroactive relief from the gift taxes they have attempted to avoid through the use of interest-free loans.

The impetus for the hearing today is a recent Supreme Court decision, *Dickman v. Commissioner*, decided in February of this year. In that case, by a 7-2 margin, the Supreme Court upheld the IRS's position that interest-free loans result in gifts potentially subject to gift taxation—and that the tax must be paid if the value of the use of the loaned money exceeds the statutory exclusions and credits.[2]

In rendering its opinion, the Court found, first, that the "language of [the gift tax] statutes is clear and admits of but one reasonable interpretation" that interest-free loans result in potentially taxable gifts. The Court went on to point out that the "committee reports accompanying [the gift tax statutes] make plain that Congress intended" the same conclusion, and that decisions of the Supreme Court "reinforce th[at] view." And, the Court noted, "[f]ailure to impose the gift tax on interest-free loans would seriously undermine" the purpose of the estate and gift tax laws and, to some degree, the income tax laws,[3] "at the expense, ultimately, of all other taxpayers and the government."

In addition, the Court explicitly rejected the claim by the taxpayers in the *Dickman* case that they had justifiably relied on the IRS's pre-1966 silence on the interest-free loan issue, noting, among other things:

that the "Treasury Regulations implementing the gift tax provisions have always reflected the broad scope of the statutory language" (language that is "clear and admits of but one reasonable interpretation");

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1. On the other hand, the contractors who had installed the illegal sewage systems at their clients risk smugly note that they always had though dumping in the river was illegal.

2. Because of the large annual and lifetime exemptions from gift and estate taxes, only a tiny fraction of interest-free loans are subject to transfer taxation.

3. In both the House and Senate versions of the pending tax bill, steps are taken to try to curb the income-tax advantages of interest-free loans.

that "the explanation for the dearth of pre-1966 cases presenting this precise issue is probably economic. the low interest rates that prevailed until recent years diminished the attractiveness of the interest-free demand loan as a tax-planning device and reduced the likelihood that the value of such loans would exceed the annual gift tax exclusion"; and

that the interest-free loans at issue in the *Dickman* case all were made after the IRS officially took the position in 1966 that interest-free loans resulted in taxable gifts, and that half of the loans were made after publication of a 1973 revenue ruling precisely on the issue.

The Court also implicitly rejected an appalling argument raised by the two dissenting justices, who asserted that applying the gift tax to interest-free loans made in 1971-76 results in "the assessment of gift taxes that might have been avoided lawfully if the taxpayer could have anticipated the Court's holding in this case."

As the majority opinion forcefully states, the taxpayers in *Dickman* in fact could have anticipated the Court's holding.[4] But, even more important, it would make a mockery of tax law enforcement if taxpayers whose shelters failed to survive an audit were allowed to contest their assessments for back taxes by pointing to other shelters they "might have" taken advantage of had they only "anticipated" losing their case.

For the past several years, Congress—under the leadership of the Finance Committee—has been attempting to make "tickets in the audit lottery" more dangerous and more expensive. Increased penalties for understated income and overstated deductions, improved disclosure rules, added substantiation requirements, and a variety of other measures have been adopted in furtherance of this goal. We hope that the Committee will continue in this direction and not backslide by granting a small group of very wealthy tax avoiders retroactive relief from the gift taxes they have attempted to dodge in the past

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4 Subsequent to the tax years involved in the *Dickman* case, a divided Tax Court ruled against the IRS in an interest-free loan case, *Crown* v. *Commissioner*, 67 T.C. 1060 (1977). Practitioners commenting on the *Crown* case, however, were reluctant to give whole-hearted endorsement to the use of interest-free loans as a tax-avoidance technique. One commentator, for example, called the now-discredited interpretation of the gift tax statutes in *Crown*, "a very important estate planning tool"—"*[i]f upheld*," that is. He then quoted extensively from the dissenting opinion in *Crown*, apparently to illustrate the logic and force of the since-sustained IRS position. His bottom line advice was heavily (and, as it turns out, prudently) qualified.

> "The *Crown* case is subject to appeal by the government . . . In the meantime, estate planners should *consider* the *possibility* of recommending family loans as a means of avoiding the transfer tax."

Tidwell, "*Lester Crown* Points the Way to Estate Tax Reduction Under the 1976 Tax Reform Act," 55 *Taxes* 651, 652, 655, 656 (1977) (emphasis added).

Similarly, another author, after suggesting that interest-free loans might be worth trying in light of the *Crown* case, added.

> "There is something fundamentally inequitable about not subjecting interest-free loans to income or gift tax. The I.R.S.'s position that the free use of property is itself an interest in property, the gratuitous transfer of which should constitute a gift, is difficult to refute. . . . In addition to producing an inequitable result, the case law is erroneous from a conceptual tax viewpoint."

Mitchell, "Interest-free loans: opportunities for tax planning," 65 *ABA Journ* 634, 636 (1979). It's hard to imagine that Mr. Mitchell (or his readers) would have been suprised that the Supreme Court eventually agreed with Mitchell's analysis

Senator SYMMS. Mr. Smith.

STATEMENT OF STUART A. SMITH, SHEA & GOULD, NEW YORK, NY

Mr. SMITH. Thank you, Mr. Chairman.

My name is Stuart Smith. I am a partner in the New York City law firm of Shea & Gould and formerly served in the Department of Justice as the Tax Assistant to the Solicitor General. In that capacity, I was in charge of the Government's tax litigation in the Supreme Court. Although I played no role in the presentation of the Government on the merits in the *Dickman* case, I was involved in the planning stages of that case, and I am fully familiar with the Internal Revenue Service's position, which is being discussed.

From my perspective both as a former Government official and as a private practitioner, I believe that retroactive legislative relief has a generally negative effect on the administration of tax law. Under our system of tax administration, which has been discussed this morning, Supreme Court decisions that interpret existing statutes passed by the Congress apply with definitive finality to taxpayers for all open years. If the Government had lost the *Dickman* case, it would be highly unlikely that Treasury officials would be importuning this committee to overrule the decision retroactively to impose gift taxes on these interest free loans. And, conversely, the Supreme Court, having decided the matter with finality in favor of the Government, it seems that as a matter of fairness to the American people, that the gift tax apply to these interest free loans.

I couldn't agree more with former Commissioner Kurtz's observation that this issue is far less settled than the previous panel has indicated. The gift tax statutes since 1932 have always been broadly interpreted, speaking in terms of gifts direct or indirect. Since 1936, the Treasury regulations have spoken about gifts in terms of interest in property, and that if the transferor has any control over the transferred property, the transferor will be liable for gift taxes on the transferee's use of that property.

I think what we face here is the simple fact that money is a form of property. And when you lend somebody, as Mr. Crown did, $1 million interest free, the recipient of such a loan has a very important and valuable right to use that property. And that right is a taxable gift in the same way that a person gets a taxable gift when he gets $1 million outright. It's not $1 million outright, but it's the value of the use of the money.

I think it's also fair to say that practitioners for a long time recognized that term loans were subject to the gift tax. So what we have here is the simple extra step that the Supreme Court finally clarified that demand loans are really no different than term loans. In fact, in the family setting, it is very difficult to see a distinction between term loans and demand loans, because in a family setting a demand loan is likely to be forgiven or extended rather than called in the way a bank would call a demand loan.

I think the entire history of this interest free loan problem confirms the fact that taxpayers have always received advice from responsible practitioners that there was a risk involved in granting interest free loans. For example, careful practitioners, I think, would have told their clients that if they wanted to engage in a transaction like this to file a gift tax return and start the statute of limitations running. As one of the other practitioners suggested, the lender could file a claim for refund if he thought that the Service's position ultimately would be rejected by the highest court. And the fact that people have not done so or perhaps have not done so or perhaps have engaged in trivial transactions like lending the weekend house to a nephew does not support the notion that Congress should enact retroactive relief to overrule the Supreme Court decision that confirmed what most responsible practitioners always thought the law was.

I want to respond a bit to the discussion this morning about why the Internal Revenue Service did not appeal the *Crown* case because it's something that I am singularly aware of from my prior Government experience.

As a general matter, the Supreme Court does not grant certiorari in technical tax cases where there is no conflict in the circuits. The fact that the Supreme Court has granted certiorari last year in the *Bob Jones University* case, which was hardly a tax case—but rather a case of enormous social implications—contradicts the notion the Supreme Court does not take these technical tax cases in the absence of a conflict. The Solicitor General for whom I served has always been very careful not to ask the Supreme Court to take a tax case in the absence of a conflict or unless there is demonstrable revenue significance.

In the *Crown* case where there was neither—the responsible decision was to let the matter lie, especially given the fact that the Internal Revenue Service had announced to taxpayers nationally that it would not agree with the notion that interest free loans were not subject to the gift tax.

Thank you.

Senator SYMMS. Thank you.

[The prepared statement of Mr. Smith follows:]

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SUMMARY OF TESTIMONY

As a general rule, Supreme Court decisions in federal tax cases apply to all years that are still open under the applicable statute of limitations. This is so whether the decision favors the taxpayer, and the Treasury loses revenue, or the decision favors the government, and the taxpayers thereby face additional liability. Absent extraordinary circumstances, proper tax administration requires that the decisions of the Supreme Court in tax cases should apply to all similarly situated taxpayers.

The general rule should be applicable to the recent Supreme Court decision in Dickman v. Commissioner, holding that interest-free demand loans constituted taxable gifts by the donor. There is no realistic prospect that taxpayers will face additional gift tax liability for transactions going back to 1932. To begin with, the low-interest rates that existed until a decade ago did not provoke the spate of interest free loans as an income-splitting device. Furthermore, most taxpayers who made interest-free loans in all likelihood made more conventional gifts that were reported on gift tax returns. For those taxpayers, the statute of limitations has long since expired. Finally, the possibility that the Treasury could unearth such long-ago transactions is itself remote. Many of the donors and donees who were lenders and borrowers in such transactions have presumably died and the enforcement of gift tax liability for such persons is not likely. Guidance by the Treasury, rather than the inappropriate precedent set by retroactive legislative relief, is sufficient to provide certainty to the private tax bar.

The Dickman issue is itself a most inappropriate candidate for retroactive legislation. From the very outset, the gift tax statute, Regulations, and decisions have broadly defined taxable gifts to include every form of gratuitous transfer, whether direct or indirect. Practitioners have long been aware that under the Regulations the rent-free use of property constitutes a taxable gift by the owner. The interest free loan is conceptually no different. Moreover, the decisions upholding the Service's right to impose gift taxes on interest-free term loans provides the analytical basis for the Supreme Court's ruling in Dickman.

Hence, the careful tax practitioner has long been sensitive to the potential gift tax liability arising out of the interest-free loan. Clients who engaged in such transactions would have been well advised to file gift tax returns and seek refunds. There is, accordingly, no reason to limit the retroactive effect of the Dickman decision. At all events, if some legislative relief is deemed necessary, it should be fashioned to insulate transactions that occurred prior to 1966, the date of the district court's decision in Johnson. While the government lost that case and did not appeal, it constituted a signal of the Treasury's substantive position. And if that event is not deemed to be a sufficient warning, surely the Internal Revenue Service's 1973 published ruling that it would not follow the Johnson case is an explicit watershed that should mark the outer limits of any legislative relief.

My name is Stuart A. Smith. I am pleased this morning to address the question whether the Dickman decision requires any legislation that would limit its retroactive application.

I am a partner in the New York City law firm of Shea & Gould, and formerly served as Tax Assistant to the Solicitor General in the United States Department of Justice. In that capacity, I was in charge of the government's tax litigation in the Supreme Court. Although I played no role in the government's presentation on the merits in the Dickman case, I was involved in the planning stages of that case and am fully familiar with the Internal Revenue Service's position that interest-free demand loans are subject to the federal gift tax.

From my perspective as both a former government official and a private practitioner, I believe that the retroactive legislative relief has a generally negative effect on the administration of the tax laws.

Under our system of tax administration, Supreme Court decisions that interpret existing statutes apply with definitive finality to all open tax years. Thus, if the government loses a tax case in the Supreme Court, it must be prepared to make refunds to similarly situated taxpayers whose taxable years are still open for adjustment. If such were not the case and the government deemed it appropriate to seek legislation limiting the retroactive effect of an adverse decision, I think it would be fair to say that the Congress would be constantly importuned by the Treasury to limit the retroactive effect of adverse decisions. Conversely, when the government wins a case in the Supreme Court, the usual consequences should be that similarly situated taxpayers whose taxable years are still open should be prepared to comply with the Court's ruling.

The question before this Committee is whether the Dickman case presents an exceptional situation calling for suspension of the usually applicable rules. I think not. It has been argued that because there is no statute of limitations for assessment of gift taxes where no return is filed, the Dickman decision may apply to gift tax periods all the way back to 1932, when the gift tax was first enacted. But persons who are sufficiently wealthy to be able to make interest-free loans that would be subject to the gift tax would very likely have been required to file returns in any event because of other outright gifts they had made, not involving loans. Consequently, if those individuals filed gift tax returns as they were required to do, the assessment of any additional gift tax liability would be barred by the applicable three-year statute of limitations.

Moreover, the gift tax has always included a provision permitting taxpayers to make substantial gifts to an unlimited number of persons each year without resulting in a gift tax liability. This exclusion was $5,000 for gifts made from 1932 through 1938; $4,000 for gifts made from 1939 through 1942; $3,000 for gifts made from 1943 through 1981; and $10,000 for gifts made after 1981. In addition, the gift tax has always included a substantial "life-time exemption" (now a credit) applicable to the total amount of gifts made by resident taxpayers. This exemption was $50,000 from 1932 to 1935; $40,000 from 1936 through 1941; and $30,000 from 1942 through 1976. In 1976, Congress converted life-time exemption to a credit. This credit increases each year to 1987, when it will be $192,800, equivalent to a lifetime exemption for gifts worth

$600,000. Thus, for a taxpayer to have incurred gift tax liability in 1932, he would first have had to exhaust his life-time exemption of $50,000 and, in addition, have given more than $5,000 to one person. For an interest-free demand loan to result in a gift of $5,000, even assuming an interest rate of 3% in 1932, a taxpayer would have had to have lent more than $166,000 to one person for a full year. Plainly, the Dickman ruling reaches only the most substantial transfers.

What is more, many donors and donees who may have been parties to interest-free loans as early as 1932 have long since died and the possibility that those loans be the subject of gift tas assessments is indeed remote. The popularity of the interest-free loan is itself a consequence of the high interest rates we have experienced only in the last decade. Hence, the perceived administrative problems from the retroactive effect of the Dickman case are largely, if not entirely, illusory. Guidance by the Treasury as to its enforcement of Dickman, rather than the inappropriate precedent of retroactive legislative relief, will be sufficient to provide certainty to the private bar.

Moreover, the history of the entire interest-free loan problem demonstrates that well-advised taxpayers have long been aware of the potential gift tax liability arising from such transactions. The original statutory language of the federal gift tax establishes that it reaches any gratuitous transfer of any interest in property. The committee reports accompanying the original legislation in 1932 emphasize Congress' specific intent to reach all gratuitous transfers of any type of interest in property. It is hardly surprising that as early as 1945 the Supreme Court explained that "Congress intended to use the term 'gifts' in its broadcast and most comprehensive sense," and noted "the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech". Commissioner v. Wemyss, 344 U.S. 303, 306 (1945). Likewise, the Treasury Regulations have always recognized that taxable gifts may result where the donor retains an interest in the property transferred, as when he makes a term or demand loan. Section 25.2511-2(c) of the Regulations provides that a transfer of a term estate results in a taxable gift equal to the value of that estate. Surely, a sensitive practitioner would have recognized the possibility that the Internal Revenue Service could have taken the position that a term loan is no different in any relevant respect from a term estate in property. And, significantly, the Treasury Regulations since 1936 hav provided that in the case of a transfer of property which is not a taxable gift of that property because the transferor retains power over the disposition of the property, any "receipt of income or of other enjoyment of the transferred property by the transferee" during the period before the gift is complete "constitutes a gift of such income or of such other enjoyment taxable as of the calendar quarter...of its receipt." 26 C.F.R. 25.2511-2(b).

In light of the broad language of the statute and the regulations, a strong case can be made that the Commissioner's view that prevailed in the Dickman case is in accordance with long-established interpretations. Indeed, further support can be found from the body of case law holding that a taxpayer making a term loan at below market interest rates confers a taxable gift equal to the difference between the amount lent and the fair market value of the promissory note received in exchange. Precisely the same principles apply when the loan is not for a set term and the interest rate is reduced to nothing. In the case of the below market or interest-free, term loan, there is an immediate gift of the right to use the money for the predetermined period, where in the demand loan situation there is an on-going gift of the right to use the money for as long as the lender allows. This difference, however, relates only to the valuation of the gift; it does not justify different tax treatment of the gift itself.

A careful tax practitioner would have had to have been aware of the Commissioner's success in the below market interest rate term loan cases and the fact that any distinction between term and demand loans in close family situations such as the present case is largely artificial. In the family setting, a demand loan is likely to be forgiven rather than called. Moreover, the conclusion that interest-free loans, whether term or demand, result in taxable gifts has received strong support from the tax literature in a series of articles beginning as early as 1967. Given these authorities, it is safe to assume that those practitioners who gave careful legal advice to their clients making interest-free demand loans counseled that the Internal Revenue Service could take the position that they were subject to gift taxes. Indeed, a careful practitioner who believed that the IRS would ultimately not prevail would have advised his client to report an interest free loan as a taxable gift and file a claim for refund within the open period. It is hard to imagine a responsible practitioner advising a client not to file a gift tax return disclosing these transactions.

At all events, if some legislative relief is deemed necessary, it should be fashioned to insulate only those interest-free loans that occurred prior to 1966. That is the date of the district court's decision in Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966). While the government lost that case and failed to take an appeal, the well informed practitioner would have recognized that the decision was a signal of the Internal Revenue Service's substantive position. And if that event is not deemed to be a sufficient warning, surely the Internal Revenue Service's 1973 published ruling that it would not follow the Johnson case is an explicit watershed that should mark the outer limits of any legislative relief.

Senator SYMMS. Senator Long.

Senator LONG. Let me ask a question of you, Mr. Kurtz, because I think you have made a very interesting statement.

I think you served this country with distinction and I for one appreciate the dedicated service you gave the country beyond the call of duty. I think when a person of your talent comes up here, loses a lot of money, and holds that job at the IRS—you do anything and get booed every time they present you at a business meeting and things like that. I don't know why in hell a guy takes a job like that. [Laughter.]

At the same time it has got to give you some credentials.

Mr. KURTZ. I appreciate that, Senator.

Senator LONG. There might be some small reward.

Now we have repeatedly had Treasury come in here and presented us a whole bunch of so-called reforms and half the time the reforms look like a list of all the cases they have lost in the courts. They have asked us to reverse those cases or rather, reverse the holdings of those cases for situations that will arise in the future. We are urged to do this in the name of reform, and we have done a lot of that. I have voted for many such proposals, so I'm not here to quarrel with that approach.

During your days in the Service, why didn't Treasury come up and ask us on the committee just to change the law more in line with the way Treasury thinks it ought to be and the way the Court has now decided?

Mr. KURTZ. Well, I would assume, Senator, that there was no sense that the law needed to be changed. There was no sense that it had been finally resolved adversely. I think the *Crown* case, for example, which was the case that everyone cites which said that demand loans did not produce taxes came as a great surprise to tax practitioners. I think most tax professionals were surprised at the *Crown* result; they thought it would have come out the other way. And when it was all over, they thought it was wrong.

Now, clearly, it stated the law for the seventh circuit for that period. But it was a case with a very persuasive dissent. It was not an overwhelming decision. It was not, in my view, a well reasoned decision. And, in the context of the overall administration of the estate and gift tax law made no sense at all. And the Service's view and the Department of Justice's view at that time, I think, was that they have got other cases coming up—let's see if that's just a sport or whether anybody else agrees with it.

The administration, as you know, can't come to Congress everytime it loses a case. It loses a lot of cases, and the judicial system must work its way.

I would assume that if *Dickman* had been lost in the Supreme Court there would be discussion as to what to do about the gift tax in the future because that would have virtually repealed it. But I think there was a feeling that *Crown* didn't require congressional action; that in time it would work out.

Senator LONG. For 14 years of that period I was chairman of this committee. During part of that time, we were looking for ways to finance some of the things we wanted to do. We wanted to raise some revenue on one hand and reduce some taxes on the other, because we had a whole lot of ideas of things that we would like to do, but they all cost money.

Mr. KURTZ. With all due respect to this committee, Senator Long, and to the Congress, over the past few years the estate and gift taxes have been moving in the other direction. There didn't seem to be much stomach, I must say, for provisions which would tighten the estate tax. The exemption levels have been raised enormously. The rates have been lowered. The generation skipping tax has been teetering on the edge, as you know. And the revenue involved in total, is not great. This is a lot of money but to few people.

Senator LONG. Do you have an estimate as to what the revenue impact of this provision might be?

Mr. KURTZ. No. And I can't imagine anyone could do a very accurate one. But in total, the estate and gift tax will only yield $3 or $4 billion a year—the whole tax.

Senator LONG. I would have thought that, during the years when I was chairman of this committee, you would have come up here and said, look, here is a thing in the Tax Court that we differ with, and we differ with the decision by the court of appeals, and the question is, Did Congress mean to tax this or not? The question is not whether the court is right. The question is whether the law is right.

Mr. KURTZ. That's true.

Senator LONG. But if you had said, here is a big loophole in the estate tax law because of the way the law has been construed up to this point, and we don't think someone should be able to loan $10 million out in interest free loans without paying a gift tax, I think I would have gone along with you and supported your position. And I think a lot of other people on the committee would have done so.

I would be the first to agree that in some respects the laws have been liberalized on gift taxes. But I just wonder why the Treasury didn't come up here and say, here is a case where we just think that, for better justice, equity, and also to eliminate what we believe to be a loophole, we think you ought to straighten this matter out.

Mr. KURTZ. Maybe in retrospect, considering today's hearing, that would have been a wise thing to do. But also, in retrospect, considering how the case came out in the courts, legislation wasn't needed.

Senator LONG. Well, I find myself looking at the following situation. In the overwhelming majority of cases, I have not the slightest doubt that by the time it is all over with, the IRS is not going to collect the tax imposed under the case. Treasury is not going to push the IRS to collect it and we are not going to push anybody to collect it. In at least 90 percent of the cases, we are not going to get any revenue out of a case like this because we just won't make the effort to go get it. You know that is probably the case.

Mr. KURTZ. Yes.

Senator LONG. So somebody, either the IRS or the Congress, is going to draw a line somewhere. When they draw the line, they are going to say, those who fall on this side of the line, you pay the gift tax; those who fall on the other side of the line, you don't pay the gift tax. So what we will be doing, in effect, either by administrative decision or by law, is saying that about 90 percent of the people are not going to pay the tax, and about 10 percent will. When we do, that's going to look like retroactive taxation to a great number of people involved.

I know we can say, well, we are forgiving the 90 percent. We are also saying that we should go ahead and collect from the 10 percent. Wherever we draw that line, isn't that going to look like retroactive taxation to the 10 percent who do get taxed?

Mr. KURTZ. No. I don't agree with that. I think someone who made a series of $3 or $10 million loans—there are big numbers involved in this issue for small numbers of taxpayers—who substantially reduced their estates through some very substantial interest free loans were advised, I am convinced, that this was a transaction with some risk. And this is a point that must be kept in mind. There was nothing to lose. That is, if I were fortunate enough to be extremely wealthy and wanted to lower my estate tax, I could go to my advisor and say I want to give away $1 million a year to my kids to lower my estate tax because there is still some advantage in doing it. How should I do it?

And my advisor would say, well, you can give $1 million a year in cash or securities or whatever, if you want, but the gift tax would be so much. Now there is another way you can try to do it. It may not work. You may have to pay the gift tax in the end, but if you pay it, you are no worse off than giving the cash. What you should do is lend them $10 million and let them go out and buy Treasury bonds and hold them. And that way they will get $1 million a year interest, and it's $1 million that won't be in your estate. And it is better than giving the million cash because you have got a chance. Now, do you want to take the chance? The taxpayer says, yes, I will do it that way. I will take the chance.

And what he is saying is that he may not be examined, in which case he will win. Or, in the end, the courts may decide in his favor. That is possible. It may not get to the Supreme Court for years and the statute of limitation will run. A lot of things could happen.

What he didn't put in that bargain, though, was that after all the bets were placed, Congress would change the law to make the losers the winners.

Senator LONG. You say they could do this with nothing to lose. Are you back in private practice?

Mr. KURTZ. I am in private practice.

Senator LONG. Representing people who don't want to pay a large amount of taxes.

Mr. KURTZ. Of course. And let me say that if this issue came up in practice, if a client asked me what to do before *Dickman,* I would have laid out those two alternatives and told him what the risks were. It's perfectly all right. You had a substantial case in your favor, but I would tell him that I didn't believe that case would hold if it got to the Supreme Court. And he might say I will take my chances. Well, he took his chances.

Senator LONG. Let me ask you this now. Suppose a client came to you with $10 million and discussed the possibility of doing this, but then decided he did not want to make any interest free loans. Could you have thought of other things he could have done to minimize the gift tax and the estate tax he would have owed?

Mr. KURTZ. Around the margin a little bit perhaps. But, no, if you really wanted to move a million dollars a year out of the estate, you would have to pay taxes.

Senator LONG. Well, I met a nice lady down in the Caribbean Islands during the last year and she happened to mention her legal status. As for her politics—she was a Republican, but she was a very nice person. [Laughter.]

Senator CHAFEE. That's not a contradiction in terms, you know.

Senator LONG. She couldn't vote. She favored the President, but she couldn't vote for him. I couldn't understand why not. I think she said she was a nonresident citizen of the United States or some such thing as that. Now are you familiar with that relationship where a person being outside the United States is a citizen, but a nonresident of the United States?

Mr. KURTZ. I'm not sure that has any effect on estates taxes, though.

Senator LONG. I don't know whether it does or does not. That's why I'm asking you the question.

Mr. KURTZ. It does not. Citizens are taxed.

Senator LONG. Well, if she liquidated her holdings and moved them outside the United States——

Mr. KURTZ. And renounced citizenship.

Senator LONG. We are talking about a nonresident citizen. Apparently she had no right to vote. That would indicate that she didn't have the kind of citizenship where she could vote. I just wondered if that is one of those situations where a person could move assets outside the United States and not pay.

Mr. KURTZ. Well, there are those who have moved their stuff outside the United States and renounced citizenship. That's a different kind of a plan.

Senator LONG. We are just talking about what people's options are. I'm not saying that I would advise her to do that. I'm not saying that you ought to advise her to do that. But if somebody comes to you and says, look, I've got $10 million here and I don't want Uncle Sam to take it for a gift tax. If he liquidated his holdings and simply moved outside the United States, could he avoid the estate tax?

Mr. KURTZ. If they just moved out, no. Not to my knowledge.

Senator LONG. What about renouncing citizenship?

Mr. KURTZ. Well, yes, then there is a particular provision which would still continue to include some of it in the estate if the reason for expatriation was tax motivated. They have to survive 10 years after they do that to get everything out.

Senator LONG. Well, my guess is that if that person is in the Caribbean, you would play hell getting that money.

Mr. KURTZ. I think you are right.

Senator LONG. That's just one possibility, which I am not advocating. It seems to me as though there are others.

Mr. KURTZ. Well, I'm not sure there are others. If we are talking about liquid assets and transfers of that size, I'm not sure that there are other feasible ways to make transfers each year without incurring a gift tax.

Senator LONG. The fact that the person took this approach meant that they would have to forego taking the other approach. In other words, to make interest free loans they couldn't be doing some other things that they might have done.

Mr. KURTZ. I'm just not convinced that that's the case. The fact is that they have moved out $1 million a year, and if they pay gift tax on $1 million a year, so be it. That much is out of their estate tax.

Senator SYMMS. Senator Chafee.

Senator CHAFEE. Mr. Kurtz, let's just review the bidding here a minute. First I understand that this has to be a very peculiar type of loan. It has to be a demand loan rather than a term loan.

Mr. KURTZ. Well, if it's a term loan then it is subject to gift tax and always has been.

Senator CHAFEE. Yes. But the *Dickman* case dealt solely with a demand loan.

Mr. KURTZ. That is correct.

Senator CHAFEE. And, secondly, that there was a decision in the seventh circuit that was 2 to 1.

Mr. KURTZ. That's correct.

Senator CHAFEE. And then came a decision subsequently in the eleventh circuit. I don't know what the vote was on that. But in any event, it then went to the Supreme Court under the terms that Mr. Smith pointed out.

Mr. KURTZ. Yes.

Senator CHAFEE. And following the decision in the *Brown* case, there was a host of literature saying that's the way it came out but the Treasury hasn't acquiesced in this.

Mr. KURTZ. Well, it was quite clear that the Treasury maintained the opposite view. I mean there was a revenue ruling which had been outstanding since 1973 saying it was taxable, and that was not withdrawn. And the Treasury proceeded on the basis of that.

Senator CHAFEE. So that any tax attorney worth his salt who was consulted on this warned the people that they were pressing up to the edge.

Mr. KURTZ. Well, yes. I believe taxpayers should have been advised, and were advised, that there were risks, continuing risks involved. Well, they certainly knew, Senator Chafee, that if the return were picked for examination the Service would assert the gift tax and they would have to fight it. They knew that. That was the Service's stated position.

Senator CHAFEE. So these people rolled the dice and they lost. Now, as I understand it, the legislation under consideration today would say to these people, even though you lost, we are going to excuse you. That's the gist of what we are considering here today. Isn't that it?

Mr. KURTZ. Yes.

Senator CHAFEE. I have some trouble with that theory.

Mr. KURTZ. And let me emphasize again, if I may, that it is not a net loss. The person does not come out worse paying the tax than he would have come out not doing the transaction because he did move the money out of his estate.

Senator CHAFEE. Review the bidding on that a little bit.

Mr. KURTZ. Let's take this situation.

Senator CHAFEE. Take the $10 million case.

Mr. KURTZ. A $10 million case. I'm sitting with an investment portfolio of $10 million, a diversified portfolio. I then lend $10 million—I either borrow against my portfolio or I sell some bonds or whatever—and I lend the $10 million to my child. My child probably, at my direction, invests that in bonds, CD's, or whatever.

Senator CHAFEE. You don't have the income on the $10 million?

Mr. KURTZ. He gets $1 million interest.

Senator CHAFEE. And he gets the income?

Mr. KURTZ. He receives the cash. If I had not done the transaction, I would receive the cash so my estate would be growing, as estates do grow simply by the passage of time, and the accumulation of interest. Now my estate does not grow.

Senator CHAFEE. You would be paying income taxes on that?

Mr. KURTZ. The income tax issue is, as yet, unresolved.

Senator CHAFEE. All right.

Mr. KURTZ. That's even a much more serious question in terms of money. And that issue is unresolved, and I think recognized as unresolved.

I could wait until the end of the year, collect my million dollars in interest—me being the father in this case. Then I give the million dollars to my child and I pay the gift tax.

Senator CHAFEE. You pay the gift tax.

Mr. KURTZ. Pay the gift tax.

Somehow if I lend him the bonds, instead of giving him the cash interest, and let him clip the coupons or collect the checks, somehow it was asserted—and the court in *Crown* did hold—that that avoids the gift tax. But I might say that represents a very narrow exception. Let me say the more general rule is if I lend my child the $10 million and say pay me back in a year, and took a note back for a year, the difference between the value of that note, which had no interest on it and would therefore be discounted, and the amount of money would be a gift. Everyone agrees with that. Then you have got this strange case that comes along. It says, well, if you don't set a term, but you make it demand, somehow or another it's not a taxable gift.

I describe this as a strange case because I think people who analyzed the case would have to decide it as just a crazy result. That result can't stand. It created this great big hole in the gift tax. And the court one of these days is going to look at that result and say it doesn't make sense.

Senator CHAFEE. Well, let me ask you this. What happens if the Congress does nothing, and the Internal Revenue Service goes back and collects the gift tax from these people? Does the IRS also collect interest on that?

Mr. KURTZ. Interest, yes.

Senator CHAFEE. Interest would be payable?

Mr. KURTZ. Yes.

Senator CHAFEE. So the people, in effect, do come out a little worse.

Mr. KURTZ. No; because they had the use of the money all these years. The tax has not been paid. They have had the cash presumably earning interest.

Senator CHAFEE. That's a good point.

Mr. KURTZ. Interest is payment for the use of money. It's not a penalty. They've had the use of the money.

Senator CHAFEE. Now has anybody submitted for the record, Mr. Chairman, various articles? Here is one. "The Journal of Taxation," March 1979. This is commenting on the *Crown* case. "Thus, *Crown* is probably just the first battle in a long war between tax planners and the IRS, the law to be ultimately decided by the Congress or the Supreme Court." That's what the literature was saying.

Mr. KURTZ. Generally, yes.

Senator CHAFEE. Well, here is another one. "The Practical Accountant," September of 1978. It's entitled "How to Use Interest Free Loans in Family Tax Planning," by Michael A. Tracher. And so he goes along and—listen to this one. It kind of supports your position, Mr. Kurtz. "The interest free loan provides an excellent tax planning tool, especially if the IRS position does not prevail. But even if the IRS is successful in its position and the *Johnson* and *Crown* cases are overturned, the interest free loan can still be used and can be more beneficial than a revocable or short-term trust in reducing the family's tax burden."

So I don't think we are dealing with some barefoot boys here who just stumbled into these matters, Mr. Chairman I think we are dealing with people who were very sophisticated in dealing with substantial sums. They had warning, and decided to play it in a certain direction. I won't even say they lost. They have to pay just like they would have if they had paid in the beginning.

Mr. KURTZ. Or break even.

Senator CHAFEE. They break even.

Senator SYMMS. Senator Boren.

Senator CHAFEE. Mr. Smith had one comment.

Mr. SMITH. I just want to make one observation. I think that Senator Chafee's point is applicable to the taxpayers who are living in the seventh circuit as well because of the Internal Revenue Service's 1973 ruling of which taxpayers in the seventh circuit should have been advised. In addition to this authority, I think that a careful advisor would have gone on to say that the literature was such that the *Crown* decision was under some question, and whether it would ultimately stand up was a matter of some conjecture. And that the better authorities felt otherwise.

Senator SYMMS. Did not the appeals court ask the IRS to issue regulations on it?

Mr. SMITH. Well, I think that's a good point, Mr. Chairman.

Senator SYMMS. And the IRS never did.

Mr. SMITH. As I think everyone who is familiar with this process knows, regulation projects are not something that can be done overnight.

Senator SYMMS. There is not as much enthusiasm from the IRS to issue regulations when a taxpayer wins as when the taxpayer loses.

Mr. SMITH. No. But there is another point. And that is that when an issue is in litigation in the courts, the Treasury had taken the position generally that it's unwise and offensive to the courts to issue regulations in their teeth. Thus, it's not simply a question of the seventh circuit inviting regulations. There were cases pending in other courts. And if you issue a regulation while things are in midpassage, while litigation is in midpassage, another court could take the position, that, this is simply an ipse dixit of the Internal Revenue Service and we are not going to give this much weight. This is an after-thought that they did after they lost this case.

However, I do not mean to suggest that it's never done.

Senator SYMMS. Senator Chafee.

Senator CHAFEE. I just wanted to ask one question. You talked about a man who gave a loan to his son to help him out who was in extreme financial difficulty. You have heard that illustration.

Mr. SMITH. Yes.

Senator CHAFEE. Now give me an answer to that. Post-*Dickman,* that would be a gift.

Mr. SMITH. Absolutely, it would be a taxable gift to the extent of the value of the use of the money.

Senator CHAFEE. The son is in difficulty and the father makes him a gift, and has to pay a tax on it.

Mr. SMITH. Precisely.

Senator CHAFEE. That's life. That's the Internal Revenue Code.

Mr. KURTZ. May I make two points in regard to that?

Senator CHAFEE. Yes.

Mr. KURTZ. The gift tax today has an exemption for gifts of up to $10,000 a person, $20,000 on a joint gift tax return. The purpose of that exemption is to permit the normal kinds of gift giving that occur. And I must say $20,000 in gifts for a child is considerably above normal gift giving. That's the intention of that exception. Plus, when fully effective, the estate tax cumulative exemption is on top of that—another $600,000. So we are talking about the wealthiest 1 percent of the people in the United States to begin with.

Now when people say, well, even if you made a small gift you would have a tax because they already used the $10,000 exemption, well there are people who are engaged in very careful estate planning. And they are using an exemption which is really intended to take care of these minor problems by giving cash, and using it up. Then they have to face the issue of the minor problems.

But if they leave the $10,000 for these minor problems they don't face this issue.

One other point. And I'm reading now from the Supreme Court's decision in *Dickman,* which I assume the Internal Revenue Service will read also. "Nonetheless, it is not uncommon for parents to provide their adult children"—they specify adult because there is an obligation to support minor children. It's not a gift.

> Nonetheless, it is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages simply on the basis of family relationships. We assume the focus of the Internal Revenue Service is not on such traditional, familial matters. When the Government levies a gift tax on routine neighborly or familial gifts, that will be time enough to deal with such a case.

I think that's quite a clear direction to the Internal Revenue Service as to how to administer this case.

Senator SYMMS. Thank you.

Senator Boren.

Senator BOREN. Mr. Chairman, I apologize. I have been tied up on the floor and I'm going to have to go back shortly. But what would the rate of interest be that would be charged on an interest free loan now by the IRS? Say we have something that occurred in 1945 or 1950. What rate of interest would be applied in terms of penalty?

Mr. KURTZ. In terms of penalty?

Senator BOREN. Well, in terms of interest.

Mr. KURTZ. That has not been specified. Presumably it would be the rate that prevailed at that time—prime rate, Government rate, refund rate, some rate would be specified. Generally, as you know, in the statute where rates are specified for income tax or other purposes they are well below the normal market rate for most people.

Senator BOREN. Well, as I understand in the *LaRosa* case that the IRS argued that the rate should be twice the average of the prime rate for the preceding 5 years.

Mr. KURTZ. Well, the prime rate for each year, I guess.

Senator BOREN. That could be something like 31 percent. I just wonder if this matter has been resolved.

Mr. KURTZ. No; I don't think that matter is resolved at all.

Senator BOREN. So there is still a question as to what rate of interest the IRS would charge if they did go back retroactively.

Mr. MCINTYRE. The Assistant Secretary suggested they might use the rates in the tax reform bill, which are set at the Government rates basically.

Senator BOREN. Thank you, Mr. Chairman. Senator Symms. Thank you very much, gentlemen.

Senator SYMMS. The next witnesses are David Berenson, Albert Ellentuck, and Paul Tyson.

Senator Boren, did you want to make a comment?

Senator BOREN. Mr. Chairman, I just want to say that I want to give a special welcome to Mr. Tyson, who is from my home State of Oklahoma. He's an attorney with Arthur Young & Co. in Oklahoma City and an expert in the area of estate and gift taxation. And I might add on an impartial note that he is a graduate of the finest law school in the country by any objective standard, the University of Oklahoma College of Law. [Laughter.]

So I'm very, very glad that he's able to join this panel.

Senator SYMMS. Well, I don't know how good the law school is, but they have got one of the finest football teams. [Laughter.]

Senator BOREN. We built a law school that even the football team can be proud of, Mr. Chairman.

Senator SYMMS. Well, that is great. We are happy to have you all here. And just in wrapping up the last witnesses, I just think that I would be remiss if I didn't say before the witnesses left that I have a hard time interpreting an aggressive taxpayer's attitude, if they only are complying with the law. And particularly in the circuit where there are 21 million taxpayers that were affected by that. All they were doing was complying with the law. I don't think we should sit here on this committee and go back and say this person gets a better break because he had a more aggressive tax accountant than the other one. It was just what the law said. And the law is either one way or the other, and there shouldn't be any discrimination, whether it's $10 million or $10,000 that is being dealt with.

Now let's hear from our witnesses.

Senator LONG. I don't think that someone is necessarily an aggressive taxpayer because he happens to agree with a court decision.

Senator SYMMS. Absolutely. And it doesn't seem to me like the taxpayer is under any obligation to try to make his estate bigger so that he can pay a bigger estate tax or his family can when he dies. His natural motivation would be to have more of the estate go to his family and less to the Government.

Senator LONG. Notwithstanding the fact that the IRS might say we don't like that decision; we instruct you to ignore it; we are not going to appeal this one because we think we would lose here, but we are going to wait until——

Senator SYMMS. Yes. They win one case and then all of a sudden they are out there trying to apply the law. It's a double standard.

Senator Boren, did you get your introduction completed?

Senator BOREN. Yes.

Senator SYMMS. Well, let's hear from our witnesses here. The hour is late. And, gentlemen, we are happy to have you here. And we will start off with Mr. Berenson.

STATEMENT OF DAVID A. BERENSON, ERNST & WHINNEY, WASHINGTON, DC

Mr. BERENSON. Good afternoon. I'm David Berenson. I'm the partner in charge of the Washington National Tax Services for the international accounting firm of Ernst & Whinney. I appreciate the opportunity to be appearing at this hearing. And I have several comments on the practical retroactive application of the *Dickman* decision.

First of all, I do commend the points and very valid policy concerns that were expressed by Treasury this morning as well as the panel that just preceded us. But we have to acknowledge that for years taxpayers have relied, as Justice Powell so cogently pointed out, on consistent judicial interpretations, although disputed by the

Government unsuccessfully for 18 years, that these interest free demand loans had no gift tax consequences.

The purpose of most of these loans was generally to assist family members in areas such as education, support or home purchase. We keep hearing about these $18 million, $20 million interest-free family loans. I think those are the ones, really, that may be least affected by the retroactive implications of *Dickman*. And that's what we are concerned about.

You see, generally the transactions that I have just referred to in the areas of education, support, home purchase, and family farm area, were not motivated by gift tax considerations, although a shifting of assets did occur. They were interested in using pretax rather than after-tax dollars. But we have a situation now where the Supreme Court's decision in *Dickman* has effectively reinterpreted the law for all prior years. Now for some taxpayers who made interest free loans, however, the Supreme Court decision is irrelevant for these prior years because their gift tax liabilities attributable to interest free demand loans will be eliminated, or already have been eliminated, and more will be eliminated April 15, 1984, by the statute of limitations, except to the extent that it may affect future gift tax computations, for those not already in the top brackets.

Now these taxpayers who benefit from the statute of limitations are generally the very, very wealthy individuals who file gift tax returns anyway reporting unrelated taxable gifts. The people with the sophisticated planning who are involved in the larger amounts of interest free loans were also probably filing gift tax returns because they were involved in other types of estate planning.

In contrast, less wealthy individuals may not have filed such returns and thus the statute of limitations has not begun to run for them. If *Dickman* is applied to all prior years, substantial inequities between these classes of taxpayers will result.

What do we do? And I realize the valid policy concerns. Do we create a permanent state of uncertainty and incorrect return problems by leaving *Dickman* retroactivity intact to 1932? Difficulties will arise not only for taxpayers, not only for advisers, but I believe for the Service as well. There is a question of adequacy of records in this class of taxpayers when you try to follow out whether there is a daily demand loan, when it was repaid, when it even originated. There are valuation questions that have been raised as to the proper interest rate to be used in such retroactive computations.

Other forms of property given as gifts must be valued before you can determine whether or not you exceed the $3,000 or $10,000—post 1981—threshold for gift tax exemption. When you have parents living rent free and board free in a house it is very easy to get over the $3,000 joint or $6,000 or even $10,000 and joint $20,000 threshold nowadays. The same thing can happen with adult children because there are many situations under today's economic conditions where there are now adult children living at home.

Irrespective of the merits supporting the Government's contention or that of taxpayers, I have some serious questions as to whether or not the Service or taxpayers can properly—either party—ignore the rent free use of the family house while taxing the interest free loan in light of the law as set forth by the Supreme Court in *Dickman.* Should we say it's all right to ignore the rent free use of the family Chevrolet but not the family Mercedes?

Irrespective of the merits, I have difficulties with the administration of a tax law that leaves that area to discretionary enforcement.

Unanticipated income tax results can also ocour in those areas dealing with what we call Clifford trusts, or 10-year trusts, where interest free loans have been commonly made to trusts which now have less than 10 years to run. You may now have income tax consequences that flow off such common arrangements under *Dickman* that affect the returns that are coming up April 15. That's a very serious technical area of substantive concern.

Also estates that have already been closed with accountings filed and all assets distributed can be affected by these interest free loans. There will be impacts on the Government, impacts on the beneficiaries, on the administrators and their fiduciary responsibilities with respect to retroactive liability and accumulative interest thereon.

In effect, for these and other reasons, I basically support legislation that would apply *Dickman* prospectively or in the alternative no earlier than the commencement of the calendar year closer to the first adverse judicial decision, which would have been January 1, 1983 because such treatment would avoid the substantial inequities that I have referred to.

In addition to the inequity problem resulting from an unlimited retroactive application of *Dickman,* we believe the administrative complexities of filing many prior year gift tax returns could possibly wind up in more revenues being generated for attorneys and accountants than even for the Government. And such costs may even outweigh what I think may be a generally minimal amount of tax revenues generated by unlimited retroactive application.

As I said, many taxpayers are not protected by the statute of limitations and don't have accurate gift tax records going back that far. The proper interest rate required by *Dickman* is uncertain. With these conditions, many taxpayers may choose to forego filing gift tax returns even though advised to file such returns by their advisers. The end result of such actions may do more to taint the perceptions of equity in our tax system than any relief provision would.

Senator SYMMS. Thank you very much.

[The prepared statement of Mr. Berenson follows:]

UNITED STATES SENATE

COMMITTEE ON FINANCE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARING ON GIFT TAX RELIEF LEGISLATION

STATEMENT OF DAVID A. BERENSON

ERNST & WHINNEY

APRIL 4, 1984

SUMMARY OF TESTIMONY

I am David A. Berenson, Partner in Charge of Washington Tax Services for the international accounting firm of Ernst & Whinney. Thank you for the opportunity to appear at this hearing. I have several comments on the retroactive application of the Dickman decision.

- For years, taxpayers have relied on consistent judicial interpretations, although disputed by the government, that interest-free demand loans have no gift tax consequences. The purpose of these loans was generally to assist family members in areas such as education, support, or home purchase by means of using pre-tax rather than after-tax income dollars. Generally, such transactions were not motivated by gift tax considerations, although shifting of assets did occur. The Supreme Court's recent decision in Dickman effectively reinterpreted the law for all prior years.

- For some taxpayers who made interest-free loans, however, the Supreme Court decision is irrelevant for prior years because their gift tax liabilities attributable to interest-free demand loans will be eliminated (or already have been eliminated) by the statute of limitations (except to the extent it may affect future gift tax computations). These taxpayers are generally wealthy individuals who filed gift tax returns reporting unrelated taxable gifts. In contrast, less-wealthy individuals may not have filed such returns, and thus the statute of limitations has not begun to run. If Dickman is applied to all prior years, substantial inequities among taxpayers will result.

- For these and other reasons, we support legislation that would apply Dickman prospectively or, in the alternative, no earlier than the commencement of the calendar year closest to the first adverse judicial decision (January 1, 1983) involving this issue. Prospective application avoids the substantial inequities regarding the statute of limitations.

- In addition to the inequity problem resulting from unlimited retroactive application of Dickman, we believe the administrative complexities of filing many prior year gift tax returns and the resulting potential for noncompliance by taxpayers outweighs the minimal amount of revenue generated by unlimited retroactive application. For example, many taxpayers no longer have sufficient records to file accurate gift tax returns. Also, the rate used for valuing gifts attributable to interest-free loans is uncertain. Given these conditions, taxpayers may choose to forego filing gift tax returns, even though advised to file such returns by their tax advisers. Accordingly, we believe limiting the retroactive application of Dickman will avoid further tainting of the tax system as being subject to inequities and capriciousness.

INTRODUCTION

For years, interest-free loans have been used for purposes such as aiding children with college education, helping children purchase homes, and supporting elderly parents, as well as achieving these purposes with pre-tax rather than after-tax income dollars. The avoidance of gift taxes was generally not the prevailing motivation, although no doubt such shifting of assets did occur. These transactions were structured by relying on judicial decisions, even though disputed by the IRS, which held that such loans had no gift tax consequences. Thus, many taxpayers did not retain sufficient records of such loans, and few, if any, gift tax returns reporting such loans were filed.

Due to the Supreme Court's recent decision in Dickman v. Comm'r., 52 U.S.L.W. 4222 (U.S. Feb. 22, 1984), taxpayers who made interest-free demand loans now face the prospect of having to file gift tax returns without adequate records. For those affluent taxpayers who filed original gift tax returns reporting unrelated taxable gifts, the statute of limitations is running (or may have already run) with respect to any interest-free demand loans that they may have made. In contrast, because less-wealthy taxpayers generally did not have to file gift tax returns, the statute of limitations has not yet begun to run. Thus, we believe the administrative burden and inequity inherent in this application of the statute of limitations justifies legislation that would apply Dickman only prospectively. Further, we believe the loss of revenue from such legislation would not be substantial.

The decision of the Court of Appeals for the Eleventh Circuit involving Dickman was handed down November 1, 1982. It was only at this time that the conflict with the Seventh Circuit (Crown v. Comm'r., 585 F.2d 234 (7th Cir. 1978)) was created. Most interest-free demand loans outstanding in 1982 were made prior to the decision and, therefore, some grace period allowing taxpayers to rearrange their financial affairs should be allowed--e.g., a 60-day period such as permitted in Section 162 of H.R. 4170, which deals with the income and gift tax consequences of interest-free loans. Also, the Economic Recovery Tax Act of 1981 increased the annual gift tax exclusion to $10,000, which more easily allows taxpayers to meet a de minimis amount. Thus, the effective date of the Dickman decision should in no event be earlier than January 1, 1983 and should preferably coincide with the March 1, 1984 effective date in H.R. 4170.

Assuming that Congress grants retroactive relief, it is also appropriate to exclude all prior interest-free demand loans for purposes of redetermining the availability of gift and estate tax unified credits or the gift and estate tax rates in later years. In other words, taxpayers and their advisers should not be required to calculate interest-free-loan values for demand loans before a retroactive date, so that such values can then be added to the tax base for proper gift tax calculations after such date.

Further, we suggest extending or reopening the period of limitations for filing refund claims until one year after the date the retroactive legislation is enacted so that taxpayers who filed gift tax returns and paid taxes may receive refunds. Thus, all taxpayers, regardless of whether they filed returns and paid taxes, will be treated the same. This provision is similar to Section 802 of H.R. 4170 concerning legislation to retroactively limit the effect of the Supreme Court in Diedrich, 457 U.S. 191 (1982).

The following pages contain responses to the specific questions asked in the notice of this hearing.

QUESTION 1

What actual amounts of gift tax liability would be forgiven if the scope of the Dickman case were to be retroactively limited?

Our experience with interest-free loans indicates the gift tax liability actually forgiven by limiting the effect of Dickman's retroactivity to years after 1982 would not be substantial, but we do not have sufficient information at this point with respect to this determination. The difficulty in obtaining on a nationwide basis any statistical information is evidenced by the many factors noted below.

The lack of information in this area results from a number of reasons, including the unique nature of estate and gift taxes. For example, gifts are potentially subject to gift taxes only after the total gifts made to an individual during a year exceed the $10,000 annual exclusion ($3,000 for years before 1982). Thus, the tax liabilitity associated with interest-free loans depends on whether the maker also gave cash or other property to the borrower during the year. In many cases, however, records containing this information are no longer available. Moreover, because the progressive gift tax rates are based on total lifetime gifts, incomplete records inherently result in incorrect computations of gift tax liabilities in subsequent years. Further, gift taxes are actually paid only after a donor's gift tax liability exceeds his or her gift tax unified credit (or for pre-1977 years, when gifts exceed his or her lifetime exemption). Most individuals, however, did not incur gift tax liabilities after 1976, and therefore the only effect of taxable gifts has been to reduce estate tax unified credits. For this reason, there is no current forgiveness of gift tax liabilities in many cases. Finally, the interest rate for valuing gifts attributable to interest-free demand loans is uncertain, and it therefore seems likely that taxpayers reporting such gifts will use different rates. For all the foregoing reasons, it would be difficult to approximate the total gift tax liabilities associated with interest-free demand loans that would be forgiven.

Even if the total gift tax liabilities associated with interest-free demand loans were known, however, it is also difficult to estimate the number of individuals throughout the country who will file either initial or amended returns, even though advised to do so by their tax advisers. For example, many taxpayers routinely destroy their financial records after three to six years and therefore may be unable to reconstruct sufficient records to accurately file gift tax returns. Also, wealthy taxpayers who have actually filed gift tax returns may be unwilling to file amended returns because their gift tax liabilities may be eliminated when the three-year (or six-year) statute of limitations expires. Given these circumstances, many less-wealthy individuals who have retained their financial records may be unwilling to voluntarily file returns and pay gift taxes when some other taxpayers will not file returns because of statute of limitations considerations or a lack of records.

We also believe that retroactive legislation would benefit the upper-bracket taxpayer much more than the truly wealthy. The reason, as discussed below in response to the third question, involves the gift tax statute of limitations. Like the income tax statute of limitations, the gift tax statute of limitations does not begin running until a return is filed. However, unlike income taxes, gift taxes are cummulative, and require an actual gift tax liability, i.e., the tax-~~liabil~~ity arising after the annual exclusion and unified credit, on the specific gift(s) in question to truly obtain a prior year bar. With the current $10,000 per donee gift tax annual exclusion ($3,000 for years before 1982), only wealthy taxpayers usually file gift tax returns. Thus, the statute of limitations will "forgive" (or has already forgiven) the gift tax liabilities associated with interest-free demand loans of many wealthy individuals who have engaged in significant gift-giving programs. Although to the extent they are not in the top gift tax bracket, future liabilities may be effected.

QUESTION 2

What types of transactions would be provided relief by such legislation? Specifically, would the legislation largely apply to transactions entered into intentionally to avoid estate and gift taxes, or would it largely affect taxpayers who structured transactions as interest-free demand loans for nontax purposes?

We hope that legislation providing retroactive relief would apply to all interest-free and low-interest demand loans prospectively or at least no earlier than January 1, 1983.

These transactions were not, as a general rule, used to avoid gift taxes although shifting of assets did occur. Indeed, it is difficult to conclude that taxpayers harbored such intent given that prior to late-1982 when the Eleventh Circuit decided Dickman in favor of the government, the courts have previously ruled that interest-free demand loans had no gift tax consequences. In fact, interest-free demand loans were typically used for purposes such as educating a taxpayer's children, helping them purchase homes, and supporting elderly parents, as well as achieving these purposes with pre-tax rather than after-tax income dollars.

QUESTION 3

A. What legal advice was typically given to taxpayers making interest-free demand loans? Specifically, were taxpayers advised of the IRS interpretation that interest-free loans were subject to gift taxes?

We believe taxpayers generally were advised of the Internal Revenue Service's position as publicly announced in 1973. We also believe that taxpayers were advised that the IRS position was rejected by the courts facing the issue during the nine-year period subsequent to the announcement of the IRS position. During this period, taxpayers and their advisers did not just believe that the IRS position might have been incorrect, but they reasonably believed that the IRS position was incorrect. In fact, if taxpayers had lost every litigated case during a nine-year period, the IRS might have asserted that taxpayers who failed to report interest-free loans as resulting in gifts were damaging the integrity of the taxing system by playing the "audit lottery." Certainly, it would appear that if this type of situation arose in the income tax context, the Service could argue that such taxpayers lacked "substantial authority" for their positions and might therefore be subject to penalties.

B. <u>Were taxpayers advised not to file gift tax returns disclosing their transactions? Or were taxpayers advised to consider filing gift tax returns in order to take advantage of the three-year statute of limitations, or the six-year statute of limitations?</u>

Taxpayers generally were advised not to file gift tax returns reporting interest-free demand loans because, as discussed above, taxpayers and their advisers reasonably believed that the IRS position was incorrect. For this reason, it is difficult to conclude that taxpayers filed returns with the specific intent to toll the statute of limitations on interest-free demand loans. In fact, we believe few gift tax returns actually reported such loans.

Nevertheless, for many wealthy taxpayers, the statute of limitations is running (or has already run) on unreported interest-free demand loans as a consequence of unrelated gifts actually reported on gift tax returns (although the computation of future gift tax liabilities may be effected). This result occurs because wealthy individuals generally gave money or other property to individuals in amounts that required the filing of gift tax returns. As previously stated, such returns start the statute of limitations running for <u>all</u> gifts made during the year, including gifts attributable to interest-free demand loans. In contrast, the statute of limitations has not yet begun to run for many less-wealthy taxpayers because their gifts generally did not require the filing of gift tax returns. Accordingly, without legislation, the government has an unlimited period of time to assess gift tax deficiences against less-wealthy individuals, whereas the statute of limitations will protect (or has already protected) more-affluent individuals who made and reported unrelated gifts.

C. What is likely to be the effect of the Dickman decision, in the absence of legislation, on attorneys or tax advisers who counseled clients to make interest-free loans?

This question presumably is intended to invite a discussion of whether tax advisers who counseled clients concerning interest-free loans are potentially subject to malpractice suits.

We believe that the absence of legislation in this area would not encourage malpractice suits for a number of reasons. First, taxpayers won every litigated gift tax case until late-1982. Second, based on the overall weight of authorities, tax professionals who counseled clients to avoid interest-free loans may not have adequately fulfilled their role as advisers. Finally, as Justices Powell and Rehnquist stated in the first two sentences of their dissent to the Dickman opinion, "[t]he Court's decision today rejects a longstanding principle of taxation, and creates in its stead a new and anomalous rule of law. Such action is best left to Congress." Thus, it is doubtful that the absence of retroactive legislation would encourage malpractice suits. The more likely effect of not enacting retroactive legislation will be additional fees for tax advisers who assist clients in determining their filing requirements and preparing the necessary gift tax returns.

QUESTION 4

A. <u>What is the likely effect of retroactive legislative relief on the administration of the tax laws generally?</u>

We are aware of and concur with the government's interest in having taxpayers file proper and timely returns. Our concern, however, is that the administrative complexity that would occur with the retroactivity of the decision would be inequitable and unjustified.

As previously noted, there were no adverse cases in this area until late in 1982 when the Eleventh Circuit overturned the Tax Court's earlier decision in <u>Dickman</u>. Thus, as we propose, it is inappropriate to apply <u>Dickman</u> in any instance to tax years before 1983.

Given that few, if any, taxpayers have filed returns in which interest-free demand loans were reported for gift tax purposes, retroactive relief would not single out certain taxpayers for beneficial application. Indeed, a group of taxpayers which had relied on the judicial interpretations of the law would be treated in a fair, uniform manner.

A strong case exists for retroactive legislative relief in light of the implications for tax compliance during the relief period. Taxpayers filing gift tax returns that report interest-free demand loans might be singled out for income tax audits by the IRS. Moreover, the Supreme Court has not yet addressed the issue of imputed interest income to the donor. Lacking conflict in the circuits presently, it could be several years before this issue is settled. Nonetheless, the IRS could choose to hold open the statute of limitations on the income tax returns of those filing gift tax returns with interest-free demand loans. This could be a significant detriment to compliance, because some taxpayers may not file back gift tax returns to avoid the income tax exposure.

Although Supreme Court cases normally would be applied retroactively, the high degree of complexity and prospect of low compliance in following Dickman could, in reality, make it prospective in application. Few instances of this magnitude, where the retroactive period could exceed 50 years, have occurred before.

Finally, failing to grant retroactive relief will reward those who maintain no records or poor records. Any law whose application rewards the nonretention of records will harm the overall administration of our tax laws.

B. Is such legislation likely to increase the tax compliance problems caused by aggressive tax shelters, and taxpayers playing the audit lottery?

It should be remembered that most taxpayers file income tax returns, not gift tax returns. Although there may be an overlap in compliance or noncompliance between the two, the use of tax shelters and the audit lottery are usually thought of in an income tax context. With respect to taxpayers using these devices, they are typically availed of when there is only slight or conflicting authority, which was not the case in the present situation until late 1982.

In the instant situation, there were no cases supporting the IRS's position until Dickman was decided in 1982. Thus, taxpayers have not been faced with complying with conflicting interpretations until now. This means, of course, that taxpayers were not playing the audit lottery.

It is not common for taxpayers or their advisers to seek relief from Congress because of an unfavorable judicial decision. Other recent Supreme Court cases--e.g., Tufts v. Comm'r., 103 S. Ct. 1134 (1983); Hillsboro National Bank v. Comm'r., 103 S. Ct. 1134 (1983)--have not prompted calls for congressional relief, because the retroactive effects of these cases have taken into account the normal three-year statute of limitations. In contrast, the result in Dickman creates a considerably more burdensome retroactive effect spanning 50 years.

QUESTION 5

<u>What administrative problems are likely to be faced by taxpayers, estate administrators, and the IRS, if the Dickman decision is not limited?</u>

We believe that taxpayers, their advisers, estate administrators, and the IRS would face innumerable administrative problems. Though many of these items could be discussed at length, our comments are merely summarized below:

- Taxpayers and their advisers would have a major hurdle to overcome in obtaining adequate records to ascertain loan origination and repayment dates. Lacking a formal note, such loans and the relevant dates are often evidenced only by a cancelled check when borrowed and an unannotated deposit slip when repaid. Moreover, taxpayers do not keep their records indefinitely; records are usually kept for only three to six years. Thus, many taxpayers may have discarded their records for years prior to 1980. The ability to prove the existence, amount and period of interest-free demand loans may be extremely difficult for both taxpayers and the IRS.

- Neither the IRS nor the courts have provided any clear method for valuing interest-free demand loans. Arguably, several rates from 3 1/2 percent and up could be substantiated under current law. If taxpayers were to retroactively file gift tax returns for these loans, similar taxpayers with comparable loans (amount and period) could be paying different amounts of tax according to the interest rate selected.

- Because Dickman implies that virtually all forms of property used without consideration could be gifts (e.g., autos, vacation homes), it will be extremely difficult to value such amounts if, indeed, they are to be included on any original or amended gift tax returns. A related concern is the determination of prior gifts that were not recorded because they were believed to be under the annual exclusion ($3,000 or $10,000), but which now must be determined to accurately calculate any excludible portion arising from the interest-free demand loan.

- There are many taxpayers who would forego filing original or amended gift tax returns, even though advised to do so by their tax professionals. Under the audit lottery theory, such taxpayers might simply choose to take their chances. Strongly in their favor would be the unavailability of any information--say, if they were required to file returns for the 1960s and 1970s. After all, there would be minimal risk concerning a return never filed or a filed return with the statute of limitations about to lapse. Taxpayers may therefore be encouraged to play the audit lottery on other tax matters. Obviously, this would only breed contempt for the entire tax system. As a result, such administrative difficulties coupled with the inequity of retroactively applying the Dickman decision could further undermine taxpayer compliance, while generating only a small amount of tax revenue.

- If a taxpayer's adviser has knowledge of interest-free loans that produced taxable gifts in the past, he or she should advise the taxpayer to file a return. But again, the records may no longer exist, be incomplete, or require tedious searching--all of which the taxpayer may use as an excuse to avoid filing. The adviser, however, cannot use such excuses, and under ethical guidelines may be required to tell the client to seek another adviser. In the latter instance, such a client may go from one adviser to another until he finally finds one who either does not know of the prior loans or will unethically overlook them. The playing out of this scenario, many times over, is not the way in which a tax system should operate; taxpayers and their advisers should not be put in adversarial roles because of efforts to collect a small amount of back taxes.

- The Dickman decision may have unanticipated income tax consequences to the grantor of a short-term trust who also made interest-free demand loans to the trust. Under one possible interpretation, if the gifts attributable to the interest-free demand loan were made within 10 years of the trust's termination and the grantor is considered to retain a reversionary interest in such gifts, a portion of the trust may be considered a "grantor trust."

- There also may be significant adverse effects on the available unified credits and/or gift (and estate) tax brackets of taxpayers who do not file gift tax returns reporting interest-free demand loans. More importantly, taxpayers who *cannot* file such returns are also adversely affected. For example, taxpayers who cannot file gift tax returns because of insufficient records in a prior year may have their unified credits and/or gift (and estate) tax brackets redetermined at any time in the future. Treas. Reg. §25.2504-1(d). The federal estate and gift tax liabilities of such individuals may therefore be permanently clouded.

- Estate administrators may have a particularly difficult time. When an estate has already been closed, the estate tax return may be inaccurate. Retroactivity could require reopening the estate to recalculate the estate tax if interest-free demand loans have caused the unified credit to be absorbed in whole or part or the tax liability to otherwise change. Because the residual estate already has been distributed to the beneficiaries in such instances, any additional taxes due would be assessed to them. In situations involving significant amounts, the beneficiaries may not have the wherewithall to pay this unanticipated additional tax liability. Moreover, both current and closed estates would have difficulty in obtaining records to accurately reflect any interest-free loans, particularly given that the deceased may never have recorded the nature of certain transactions, resulting in their origin and purpose not being ascertainable. This predicament could be a great source of consternation to estate administrators, and without retroactive legislation would produce difficulties for heirs and the government alike.

CONCLUSION

We believe that the Supreme Court's decision should be applied prospectively to a date conforming with H.R. 4170, but in no event should its retroactivity apply to years before 1983. To do otherwise may further taint tax law administration as being subject to inequity and capriciousness. Such perceptions might be found among all types of taxpayers, whether or not benefited by the legislation. Accordingly, it is our belief that the benefits to tax law administration from retroactive legislative relief far outweigh any slight perceptions of inequity, problems with compliance, or promotion of the audit lottery among other taxpayers.

We are aware of the policy concerns with respect to retroactive relief. Nevertheless, any valid interpretation of the tax law that can result in the increased probability of prior year tax noncompliance, spanning decades of tax returns, does more harm to our tax system than any relief provision.

Senator SYMMS. Mr. Ellentuck.

STATEMENT OF ALBERT B. ELLENTUCK, CHAIRMAN, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. ELLENTUCK. Thank you. My name is Albert Ellentuck. I'm chairman of the Tax Division of the American Institute of Certified Public Accountants. We appreciate the opportunity to speak on the subject of the *Dickman* case, which is a matter of concern to the members of our Institute. In a nutshell, our position is that for administrative simplicity and fairness, the *Dickman* decision should not be applied retroactively.

The impracticality of applying *Dickman* retroactively is apparent to us as practitioners. Consider what is involved in the reconstruction of records to show with sufficient certainty the amounts which may have been loaned for any purpose. Consider also the years to be covered in this search for records, which extend back through the seventies, the sixties, and even the fifties, and, in fact, back to 1932 when the gift tax was first imposed.

What about other gifts which constitute a base for testing taxability of interest free loans? In this regard, there may be no help from prior gift tax returns. In many cases, there may not be any returns because the gift came within the annual exclusion.

What I would like to do now is address the questions posed in the Senate Finance Committee's hearing announcement. First, the amounts of gift tax liability which would be forgiven if retroactivity were limited. We don't know the answer to that either, nor do we think does anyone else. And we must emphasize the difficulties for taxpayers, for ourselves, and for the Internal Revenue Service in tracing back and measuring the loans, the gift elements of those loans, and the gift tax that would be payable. We don't believe that even after extensive investigation a reliable figure can be obtained by anyone.

You also asked whether limiting retroactivity might afford relief to transactions entered into avoid taxes. The motivations behind interest free loans are several, and certainly for some taxpayers avoidance of the estate and gift taxes has played a role. But many such transactions are primarily for family purposes. To provide a child with a source of income, to purchase a home, or pay for the child's schooling.

Limiting retroactivity of *Dickman* would not be a precedent which is harmful to the administration of the tax laws. Instead, in this instance we believe it's a practical resolution of the problem. And Congress is already considering this type of approach in an analogous situation, section 802 of the tax reform bill of 1984.

Senator LONG. What does section 802 deal with?

Mr. ELLENTUCK. This section provides that payment by a donee of the gift tax on gifts made before March 4, 1981 will not result in income to the donor. It's very analogous. The date that they chose for that legislation was the date of the *Diedrich* case, which was upheld by the Supreme Court in 1982. And that was the first time that taxpayers knew that they had a liability in this situation.

We think the same approach should be used in *Dickman*.

Senator BOREN. So that's a precedent, a similar sort of situation?

Mr. ELLENTUCK. It's a precedent.

Senator BOREN. Some other cases where the Congress has acted to make it prospective.

Mr. ELLENTUCK. Exactly. And there may well be other precedents, but this is the most current and the most immediate.

It's important to ask what is fair when considering the *Dickman* situation. Between 1932 and 1966, the Service did not indicate that it viewed interest free loans as having any gift tax consequences. The first sign of a change was when the Service brought the *Johnson* case in 1966. In that case the Service was defeated, did not appeal, and did not announce nonacquiesce for 7 years.

Eleven years after *Johnson,* the Service brought the *Crown* case to the tax court. Once again, it was defeated, it did appeal in that case, lost in the seventh circuit, and did not appeal to the Supreme Court.

Thus, for 50 years, between 1932 and 1982, the record upon which taxpayers and their advisors relied and upon which even popular magazine columnists made recommendations was that interest free demand loans did not result in a gift. Further confirmation was furnished by Congress which repeatedly amended the gift tax rules but did not address the standing decisions of the courts in *Johnson* and *Crown.*

We urge you to start fresh on the subject of interest free loans. Now while you are considering legislation dealing with the income tax aspects of interest free loans is the appropriate time to also set a new starting date regarding the gift tax aspect.

Thank you.

Senator SYMMS. Thank you very much.

[The prepared statement of Mr. Ellentuck follows:]

TESTIMONY OF

ALBERT B. ELLENTUCK

CHAIRMAN, FEDERAL TAX DIVISION

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

SUBMITTED TO THE

UNITED STATES SENATE COMMITTEE ON FINANCE

HOLDING HEARINGS ON

GIFT TAX RELIEF LEGISLATION

APRIL 3, 1984

American Institute of Certified Public Accountants
1620 Eye Street, N.W., Washington, D.C. 20006
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I am Albert B. Ellentuck, Chairman of the Executive Committee of the Tax Division of the American Institute of Certified Public Accountants. The Division is the senior technical body of the Institute authorized to speak for the AICPA on matters of taxation. The AICPA represents its 210,000 members, many of whom devote a high percentage of their time to practicing in the area of federal taxation.

We greatly appreciate the fact that the Chairmen are holding hearings on limiting the retroactive application of the Dickman case, a matter of enormous concern to the members of the AICPA.

Our position is, that for administrative simplicity and fairness, the Dickman decision should not be applied retroactively.

We in the CPA profession have continuous exposure to the attitudes of clients and the Internal Revenue Service. We find that few of the taxpayers who use CPAs to advise them willfully fail to pay the taxes properly imposed upon them. We believe that most tax practitioners make every effort to advise their clients of the correct amount of taxes owed by them. We also know that the Internal Revenue Service is made up of conscientious professionals who wish to enforce the rules fairly. Good law meets the needs of all of the parties to the determination, payment and collection processes. Good law is equitable, and practical to administer. When a rule of law is a reversal of the often confirmed understanding of key parties, and cannot reasonably be enforced, it fails to meet the tests of good law.

Congress is now considering bills which address the taxation of low-interest and interest-free loans. We do not comment at this time concerning these bills. However, the policy issues are joined, the consequences to taxpayers are being weighed, and the public and tax professionals are kept apprised of developments and can freely offer comments. All parties should be able to conclude, when the final decision of Congress is pronounced, that the rules will be the product of an unrivaled deliberative process. We presume that the proposed legislation will contain reasonable limitations and exceptions designed to prevent taxation where transactions are not abusive, for example, where family loans are made for higher education and for the purchase of personal residences. The Dickman rule contains no such exceptions. It provides no limit as to time or amount upon the obligation of taxpayers to resurrect transactions, and no limit upon the obligation of the Internal Revenue Service to investigate and assess.

The impracticality of applying the Dickman decision retroactively is apparent to us as tax practitioners. Please consider what is involved in the re-construction of records which will show with sufficient certainty the amounts which may have been loaned for any purpose: whether to provide a child with a source of income, or to purchase a home, or to pay for the schooling of the child or children of the child. Please consider also that the years to be covered in the search for records extend back through the '70s and the '60s and the '50s, and in fact, back to 1932 when the gift tax was imposed. We must also measure for all the years involved the gifts for which no gift tax return was filed because the gifts were deemed by Congress to be de minimis, i.e., they came within the annual exclusion. Those gifts would constitute a base which may, or may not, cause the gift tax element of interest-free loans to exceed the annual exclusions. In most cases the records are long gone, but the obligation under Dickman will remain, if not met, as a blot upon the record for voluntary compliance of taxpayers, and for the collection efforts of the Internal Revenue Service.

We would like to seriously address the questions posed in the Senate Finance Committee's hearing announcement. The first is the amounts of gift tax liability which would be forgiven if retroactivity were limited. If we knew the answer to that question, we probably would not have felt it necessary to be here today to testify. We must highlight for you the difficulties for taxpayers, for ourselves and for the Internal Revenue Service in tracing back and measuring the loans, the gift element thereof and the gift tax that would be payable. We are unable to present a fair estimate. We do not believe that after extensive investigation of the facts by the most thorough of tax practitioners that a reliable figure will be available upon which you can base an informed judgment.

You asked whether limiting retroactivity might afford relief to transactions entered into to avoid taxes. The motivations behind interest-free loans are several, and for some taxpayers avoidance of estate and gift taxes has played a role. But, many such transactions are in the family context, and have been intended to provide children with the means to begin their independent course in a costly and inflationary economic world.

Limiting retroactivity of Dickman would not be a precedent which is harmful to the administration of the tax laws. Instead, in this instance, it is a practical resolution of an extraordinary problem attending a sudden pronouncement reversing a chain of cases. Limiting retroactivity is as sensible here as it is in another correlated circumstance being considered for relief by Congress. Section 802 of the Tax Reform Bill of 1984 provides that payment by a donee of the gift tax on gifts made before March 4, 1981 will not result in income to the donor. The date chosen was the date of issuance of the decision by the Eighth Circuit in the Diedrich case which was upheld by the U.S. Supreme Court in a decision rendered on June 15, 1982. The Diedrich case decided that the donor was required to reflect income because of his release from liability to pay the gift tax. The decision is far more limited in its application to taxpayers generally than Dickman, yet Congress properly is considering limiting its application as a matter of fairness. Fairness has never hurt the relationship of government and its people; and would not, in the application of the principle to the Dickman situation, impact adversely upon future tax administration.

What is fair when considering the Dickman situation? Here are several vital facts that we believe should be weighed: Between 1932 and 1966, 34 years, the Service did not indicate that it viewed interest-free loans as having any gift tax consequences. The first sign of departure from the past policy was when the Service brought the Johnson case in 1966. In that case the Service was defeated, did not appeal, and did not announce non-acquiescence for seven years. Eleven years after Johnson, the Service brought the Crown case to the Tax Court. Once again, it was defeated, did appeal, lost in the Seventh Circuit, and did not appeal to the Supreme Court. For fifty years, between 1932 and 1982, the record upon which taxpayers and their advisers relied, and upon which popular magazine columnists made recommendations, was perfect: interest-free demand loans did not result in a gift. Further confirmation was furnished by Congress, which repeatedly amended the gift tax rules, but did not address the standing decisions of the courts in Johnson and Crown.

In the Dickman case, the majority made the following comment, "When the government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case." At this point in time, however, neither tax practitioners nor the Internal Revenue Service know how far the taxing authority reaches, nor how to measure the tax consequences. The Service may take literally the declaration by the majority in Dickman that Congress intended the "gift tax statute to reach all gratuitous transfers of any valuable interest in property." If the Service defines gifts less broadly, presumably it is not acting in conformity with Congressional intent. The good name of tax administration is ill-served by such confusion.

We wish we can promote the view that the problems would be minimized for taxpayers, practitioners and the Service if Congress would put a numerical safe harbor on the retroactive application of Dickman. We are unable to do so. Limits require a determination that the limits are not surpassed. So those taxpayers who must consider whether the rule may apply will be far greater in number than those who in fact will be subject. It should be understood that the gift tax is an area of the tax law heavily relying upon voluntary compliance. As a consequence, the search extending back to the years beyond those for which taxpayers normally retain records will penalize those who have happened to keep records and will immunize those who do not.

We urge Congress to start fresh on the subject of interest-free loans. Now, while you are considering legislation dealing with the income tax aspects of interest-free loans, is the appropriate time to also set a new starting date regarding the gift tax aspects. A disjointed approach to the taxation of interest-free loans is not in the best public interest.

A law taxing interest-free loans after Dickman and passed by Congress with due deliberation is one which will be accepted and complied with and enforced by all elements of the taxing community. But, we must appeal for relief from the chaotic situation caused by the retroactivity of Dickman—the application of indefinite rules to the virtually unlimited past.

Senator SYMMS. The last witness this morning is Mr. Tyson. Mr. Tyson, if our colleague, Senator Boren, is an example of what comes out of the University of Oklahoma Law School, I would have to say it must be a good law school also. Even as good as the football team.

STATEMENT OF D. PAUL TYSON, ARTHUR YOUNG & CO., OKLAHOMA CITY, OK

Mr. TYSON. We think so. [Laughter.]

My name has already been put in the record, but I am Paul Tyson. I am a tax partner with Arthur Young in Oklahoma City. In my statement that I have provided to the committee, I have attempted to respond to those questions that were set forth in the press release.

But I would like to make a few summary statements because I know we would all like to move on.

The first point is that there has been discussion about the audit lottery. In my opinion, taxpayers who were making interest free loans were not playing the audit lottery. They were relying on judicial decisions from the Seventh Circuit Court of Appeals, from the district court, and the tax court. To me that is not what is defined as the audit lottery.

Second, there has been reference made that the $10,000 annual exclusion would cover any interest from interest free loans. But that is not necessarily true because the annual exclusion does not apply to gifts of future interests. I can set up a scenario where you make a $1 interest free loan that will result in gift tax liability.

The next thing that causes a great deal of concern to practitioners is the fact this is a cumulative tax. It is not like the income tax where we rely on the annual accounting period, instead this is a tax where 1 year's return will affect all subsequent years' returns.

A point that has already been raised by Senator Boren and alluded to by others is the proper interest rate to use. I would venture to say—I have heard a lot of policy discussion here today, but I would guess I am one of the few people here that, in fact, will be signing returns in the next 11 days that has to address this issue. I have already signed returns for calendar year 1983, gift tax returns, that are wrong, if *Dickman* is applied retroactively. This is one of our busiest times of the year, and all of a sudden I am faced with whether or not any gift tax return that hits my desk, between now and April 15th, can be signed. If they have ever made an interest free loan then potentially we are understating their prior cumulative gifts.

Therefore, obviously from my position I think that retroactive application of *Dickman* is not the proper result.

Senator SYMMS. Thank you very much.

[The prepared statement of Mr. Tyson follows:]

STATEMENT OF D. PAUL TYSON

ARTHUR YOUNG & COMPANY

ON

GIFT TAX RELIEF LEGISLATION

BEFORE THE

ESTATE AND GIFT TAXATION

AND

TAXATION AND DEBT MANAGEMENT

SUBCOMMITTEES

OF THE

SENATE FINANCE COMMITTEE

APRIL 4, 1984

Summary of
Statement of
D. Paul Tyson
Arthur Young & Company, Oklahoma City, Oklahoma
on Gift Tax Relief Legislation
Before the Estate and Gift Taxation and
Taxation and Debt Management Subcommittees

April 4, 1984

o Gift tax liability could result even from small interest-free loans if the loan was to a trust.

o Until November, 1982 every judicial decision on point had held in favor of the taxpayer.

o Taxpayers should be able to structure their transactions in reliance on judicial decisions.

o The retroactive application of the Dickman decision causes more concern than usual because the gift tax is cumulative and the gift and estate taxes are unified.

o Reconstructing all prior interest-free loan transactions would be an extraordinary burden on taxpayers and practitioners.

Statement of
D. Paul Tyson
Arthur Young & Company, Oklahoma City, Oklahoma
on Gift Tax Relief Legislation
Before the Estate and Gift Taxation and
Taxation and Debt Management Subcommittees

April 4, 1984

Chairmen Symms and Packwood and Members of the Subcommittees:

My name is D. Paul Tyson and I am a tax partner with Arthur Young & Company. I am pleased to have the opportunity to present these comments to your subcommittees.

Introduction

Normally a Supreme Court decision on a tax issue which is given retroactive effect would not cause the problems that the Dickman case will cause. This is attributable to the fact the gift tax is a cumulative tax and the gift tax and estate tax are unified. Unless the interest-free demand loan was reported on a gift tax return, tax was paid and the statute of limitations has run the taxpayer that made the loan could be affected by the decision. If any one of those elements is missing, the retroactive application of Dickman leaves the taxpayer and ultimately his estate exposed to liability for tax and his tax advisor in a precarious position.

To Whom Would the Relief Apply

Although the Supreme Court indicated that generous exclusions absorb de minimis gifts and rendered illusory administrative problems, this is not necessarily true. First, the annual exclusion is only available for gifts of present interests; therefore, a small interest-free loan to a trust for your minor child could result in a taxable gift because it is a gift of a future interest. Second, all gifts in subsequent years are affected by this de minimis gift because the gift tax is cumulative. The relief would therefore apply to taxpayers making small loans to a nonqualifying trust. In addition, it would provide relief to parents that made loans to their children for education expenses or the down payment on a home.

The relief would assist tax practitioners who would be relieved of the burden of ascertaining whether an existing or future client ever made interest-free loan gifts that are not included in taxable gifts for preceding periods. The tax practitioner is signing the gift or estate tax return with the taxpayer under penalties of perjury.

Advice Typically Given

When advising clients with respect to the gift and estate tax aspects of an interest-free loan, I would typically tell them that the Internal Revenue Service had taken the position that a gift resulted but had been unsuccessful in sustaining that position in any decided case. One of my partners told me that he, the attorney and the client had the *Crown* case on the desk when they set up the notes.

I did not advise clients to disclose the loan on their gift tax returns, because I felt, based on Court decisions, the loans did not result in gifts. The Service was never successful in its argument until November, 1982 and even then, as previously stated, another court of equal authority had held in favor of the taxpayer.

Our legal system is founded on the use of precedent. Security and certainty in the administration of the tax laws dictate that taxpayers should be able to rely without detriment on decided cases.

Effect on Administration of Tax Laws

Taxpayers that were making interest-free demand loans were not, in my opinion, playing the "audit lottery." They were relying on a body of judicial decisions that had never held against them. I again reiterate that the harsh result in this case, if legislative relief is not provided, is attributable to the cumulative nature of the tax and the potential that the statute of limitations does not provide relief.

The legislation will not, in my opinion, increase taxpayer compliance problems. It is arguable that a lack of relief will result in taxpayer noncompliance because of the substantial penalties and interest that might be imposed, there is no statutory requirement for an amended return, and the very real problem of reconstructing prior transactions where the records are no longer available. The forced resolution is noncompliance. This could cause client relations problems for practitioners and result in taxpayers using advisors that are willing to compromise standards. In addition, a question exists as to the proper term and interest rate to use for self-assessing the additional tax.

Administrative Problems if not Limited

Legislative relief, if granted, should provide a grace period for the restructuring of the loans. If a parent has loaned a child money and the child has invested it in such a manner that it is nonliquid, the taxpayer should have a reasonable time to liquidate the investment without suffering financial loss.

There would also be problems for taxpayers attempting to reconstruct prior transactions. Some loans were outstanding for short periods of time and it could be difficult to determine the amount and the term of the loans that are no longer outstanding. Some of the loans to family entities were on open account and the account balances were continuously changing as payments and advances were made. Over the last several years interest rates have fluctuated frequently and the Supreme Court decision gave no guidance with respect to the appropriate interest rate.

With respect to tax practitioners, there would be an extraordinary burden placed on us in ascertaining all prior loans. This would be necessary in order to comply with statutory and ethical requirements in connection with preparation of gift and estate tax returns.

Summary

The House Ways and Means Committee has already recognized the potential inequity of retroactive application in some cases in that it has proposed to limit the effective date of the Supreme Court's decision in Diedrich.

Because of the uncertainty with respect to the interest rate, the cumulative nature of the tax and the prior judicial support for interest-free loans, relief legislation is the proper solution.

Senator SYMMS. Senator Long.

Senator LONG. Well, I don't guess anybody knows how much money we are talking about here. I asked the question of Mr. Kurtz and he didn't know how much. This is one of those things where by the time we get through with this, there are 9 people out of 10 who might have a tax liability who are not going to pay. I think that anyone looking at the realistic aspects of this thing would agree that 90 percent of the people affected are not going to pay anything. Isn't that right?

Mr. BERENSON. Well, I don't know, Senator. Because of the way the gift tax works, as has been pointed out, the cumulative aspect, once you get past the annual exclusion, you start absorbing what is known as the unified credit. They may not have an immediate tax liability, but their credit is reduced in the future. And, therefore, although there may be no immediate gift tax implication now, there definitely will be a higher estate tax situation upon the death of the individual that made that loan.

Senator LONG. Well, Mr. Kurtz was a former commissioner of the Internal Revenue, and his reaction was about what I would expect from one who has got that responsibility. His reaction was that, in the majority of the cases, the IRS is not going to make any effort to collect the tax retroactively from those who owed it prior to this time. I believe that that will probably be the administrative aspect of it. I think that if Congress acts on it, at a minimum Congress is not going to go back and try to get 90 percent of the people involved with this. I would just be willing to give you my political judgment, for whatever it's worth. It might not be worth anything, but that's just my offhand impression from 36 years experience in Congress.

So we are going to pick out a relatively small percentage of people who are going to pay the taxes. That leads me to think in terms of how much money is involved in all this, because if we bypass 90 percent and then we tax 10 percent of the so-called affluent, wealthy taxpayers, that's discrimination on the face of it. Assuming we are going to discriminate in doing all this, how much money are we going to make out of it? Do any of you have any ideas as to how much may be involved here?

According to Mr. Kurtz one of the reasons they didn't ask us to resolve the issue for them was because there wasn't much money involved. Do any of you know how much money is involved in this thing?

Mr. ELLENTUCK. Senator, it's really impossible to tell because of the statute of limitations factor. In other words, as was pointed out here, many more affluent taxpayers will have filed gift tax returns, and the statute would have run on them. We have given it a considerable amount of thought, and there is apparently no way to get a handle on this number.

My suspicion is that it will not be a major revenue raiser for the Government.

Senator LONG. Thank you.

Mr. BERENSON. Senator, in that point I agree. I really feel you are right in what you are saying about the practicalities. I know from the position of Mr. Kurtz and during the administration when he was commissioner that it would be applied that way. I have no question about that.

But it does trouble me from a policy standpoint that we are telling people—because remember the proposed law that is set forth in pending H.R. 4170 will tax interest free loans, but only interest free loans. It's not going to tax the value of the rent-free use of the family apartment or house or farm which the *Dickman* rationale reaches. We are really saying to many taxpayers that it is proper to file an incorrect return. File an incorrect return and pay no attention to what the Supreme Court is saying because they are really not going to bother 90 percent of you. That's a troublesome policy decision.

Senator SYMMS. Well, I think it's very troublesome because then you get an IRS commissioner or director of some State out here that has got it in for some businessman or something and so he goes after that guy, and he leaves out the other 90 people that just came up on the lottery. So I think you just open yourself up. That's why this ought to be repealed.

Mr. BERENSON. That's a good point. There are State gift taxes which are not going to be subject to the enlightened views of this body or the Internal Revenue Service.

Senator SYMMS. So you give, then, the IRS the power of selectivity of who is going to get nailed and who isn't, if you leave this on the books and take the assumption. As I agree with Senator Long, I don't think it's going to be worthwhile for them. They want to go out and get somebody where they can get money for their wages.

But you do leave yourself open to some taxpayers then who get on the wrong side of the political side can be harassed.

Senator Chafee.

Senator CHAFEE. Well, I hate to break up this harmonious session here. [Laughter.]

Senator SYMMS. We are glad to have a little——

Senator CHAFEE. Let me ask Mr. Tyson this. You have obviously advised clients. What do you do in the situation when the IRS has published a revenue ruling in a certain area, and two cases interpret the law differently? What do you do in a situation like that? Do you advise your clients to ignore the IRS ruling? How do you handle that?

Mr. TYSON. I would not say that I tell them to ignore the rulings. Traditionally, if someone was being advised with respect to the interest free loans, I would tell them that the Government had taken a contrary position but had been unsuccessful in any case to date on having their position sustained.

Senator CHAFEE. So the client goes away knowing he is taking a risk?

Mr. TYSON. If you want to say it is taking a risk, I don't know.

Senator CHAFEE. Well, let's take a specific case here. There were two cases, as I understand it, and the IRS said we are not going to observe those cases. So there you are. You are out there on the firing line. You have known about these two cases, but the IRS has taken a different position. The legal or accounting journals, such as the ones I cited today, beware. What do you tell your clients?

Mr. TYSON. Again, my reaction is if I have a circuit court opinion that is telling me this is not a taxable gift, it has much more weight than an Internal Revenue Service Revenue ruling telling me that it is a taxable gift. And if I was asked by a client, that's what I would tell them.

Senator CHAFEE. Well, I don't want to put you on the spot because I know you do an excellent job.

What about Mr. Ellentuck. As I look at it—and I must say I had never heard of the *Dickman* case until we got involved in this about 2 or 3 months ago—this whole issue did not just creep up on people by surprise. Am I correct? Were those articles that I quoted from, plus those that Mr. Chapoton refers to in his text, in his footnote, were those the exception to the rule? What was the situation?

Mr. ELLENTUCK. Well, Senator, what we are dealing with and what the tax advisor was dealing with in *Dickman* is a weighting of authority. That's what tax advisors do. And I think it's important to keep in mind that what we had was a ruling of the IRS which is nothing more than the position of the IRS, which carries no more weight than the position on the other side, namely, the taxpayer. I think in *Dickman* the great weight of authority was on the side of the taxpayer. And, despite these articles which warn of a possible long-term battle, what they were warning about was the IRS position. The IRS didn't like it and was going to fight it. But the IRS position carries no more weight than the taxpayers' position, as I said. And I think that what we were dealing with and what advisors were dealing with was the weight of authority was on the side of making the interest free loan as long as they were demand loans. And that had a strong chance of holding up.

Senator CHAFEE. But if the IRS audited their gift tax returns, these people knew, did they not, because you would advise them, that the IRS would assert the gift tax?

Mr. ELLENTUCK. Oh, yes, I think it was clear that the IRS would assert the gift tax if they were audited. It was not clear that the IRS would win. And I think many, many practitioners thought that the IRS would not win.

Senator CHAFEE. But it was a red flag. Can we say that? When people went into these transactions they knew, as we have said before in some of the discussion, that they were taking a chance.

Mr. ELLENTUCK. Well, there was risk as there is in just about any tax transaction that we get involved in.

Senator CHAFEE. Well, I'm not going to accept that. I'm not going to accept that there is a risk in every tax transaction we get into. Now I won't accept that statement on your part.

If you could see no difference between this situation and other types of transactions in advising your clients, I would be surprised. Is that what you are telling me?

Mr. ELLENTUCK. I'm not sure I understand.

Senator CHAFEE. Well, you were saying that every tax transaction has a risk.

Mr. ELLENTUCK. Every tax transaction has different degrees of risk. And what I am suggesting here is that there was risk, but that the astute tax advisor would have advised his client that this was likely to hold up, although there was clear risk that the IRS would attack and some slight risk that the IRS would win. But I think that risk was not that great.

Senator CHAFEE. Would it also follow with the advice that Mr. Kurtz pointed out that you could also tell your client, well, what have you got to lose. Would that be part of the advice too?

Mr. ELLENTUCK. I'm not certain, Senator. I think that some advisors may have said that.

Senator CHAFEE. But isn't that the truth? What did they have to lose?

Mr. ELLENTUCK. The interest.

Senator CHAFEE. No, they didn't have anything to lose, according to the example of Mr. Kurtz. Now maybe Mr. Kurtz gave a bad example. Could you point out the flaws?

Mr. ELLENTUCK. I'm not sure he did. I think, however, that there were other alternatives which weren't gotten into which could have accomplished this same purpose had taxpayers known that this would have failed. It think there are other ways to achieve it. So I think there was something to lose.

Senator SYMMS. Well, if I could just ask a question on that. Wouldn't we just be saying, then, if you are in your position, if this is allowed retroactively, then in the future when you are advising your clients you can say nothing matters? The court case doesn't matter. Nothing in the damn law matters. The roller ball guys are in charge, and if you do it one way, they are going to change the rules not only prospectively but retroactively. It's just like the old game of roller ball. If the guys learn how to play the game, they change the rules. Exactly what it is. If I understand it correctly, that's exactly the case.

Any farmer that sold his farm to his son in the last 30 years, just because there has been 17 years of court rulings, that doesn't mean anything. You may be the finest attorney in the land, but that doesn't mean a damn thing to Washington, DC because they will change it and they will rule it retroactively. They are going to go out there and try to squeeze the last drop of blood out of the taxpayers as long as they have got the spending machine working in Washington. [Laughter.]

Senator CHAFEE. That trespasses on what we might call a leading question. [Laughter.]

Give us a surprise answer to that.

Mr. BERENSON. Senator, there are some places where somebody would have a loss. Because of the concept of interest free loans, there were—and it was a very, very common device, and probably not necessary among the very wealthy, but in people providing for college education for their children—what was known as Clifford or short-term trusts for 10 years and 1 day. Frequently, there would have been interest free loans in those situations.

In that situation, I think there is an income tax risk as well as a gift tax risk. They are those individuals who will very probably be worse off.

Senator CHAFEE. When somebody is going to make a tax free loan to their children to go to college—and we are talking relatively small amounts compared to the big sums at issue here—they are not going to go to a tax advisor and say, well, should I do this; or shouldn't I; should I set up a Clifford trust? That's not being realistic.

Mr. BERENSON. That is being realistic, Senator. The reason being because what we are talking about is not the loan itself but the interest that flows on a loan. Now how much loan do you have to make to provide sufficient interest to enable somebody to pay tuition at the first year of Oklahoma Law School? You have got to have more than a $100,000 loan. But we are not talking about the loan being a gift. The loan is a valid loan that does get repaid. We are talking about the interest that flows off the loan. The amounts of those loans that have to be utilized to provide even partial tuition, at even 10 percent interest, are substantial. And there are many, many more people involved in those things than in all those $18 or $19 million situations that get thrown around in discussions and which generally have returns for other gifts, thus enabling statute of limitation protection.

Senator CHAFEE. But would any of those people think of going to a tax accountant and say, well, I read somewhere about Clifford trusts. I think I will get one of those set up.

Mr. BERENSON. You are right, Senator. There are many articles that very clearly set forth the Government opposition to interest free loans. But there are also many articles that have been floating around on how to fund the cost of college educations, especially in light of the cutbacks that have happened in the student loan programs and so forth. This has gotten very high profile in many layman type journals on what is known as family financial planning for the escalating cost of a college education where other financial sources are not available. Many upper bracket, not very wealthy—with the bracket creep it's very easy to get into an upper bracket—use this approach to try and meet some of the educational costs of higher education. That was not uncommon, Senator.

Senator CHAFEE. Thank you, Mr. Chairman. Senator Symms. Senator Boren.

Senator BOREN. Mr. Chairman, one of those on the panel mentioned the fact that in the earlier circuit decisions in the *Crown* case and the case before *Crown*, the *Johnson* case, that the IRS did not appeal those cases to the Supreme Court. Is that correct?

Mr. ELLENTUCK. That is correct, Senator.

Senator BOREN. And so we had a certain period of time, as I recall, 7 years in one case—what was the actual length of time that the Service let those cases then stand? Obviously, it was the law of the land for that period of time.

Mr. ELLENTUCK. I believe it was a 7-year period before the next case came up.

Senator BOREN. Mr. Chairman, that's another point that ought to be considered, too: That you are dealing here with cases that were allowed to stand by the Service. And it seems to me that one of the worst things we do in Government is to inject uncertainty into all elements of the private sector of our economy. If anything, it has held back our economic development and held back investment decisions across the board with this element of uncertainty. I think a lot of times people would rather have an unfair result or a bad tax policy than to continue with uncertainty about what the law is.

So I think that is something we should consider as we look at this whole issue. And, Mr. Chairman, I want to commend you for convening these hearings. I think they have been very useful. And also the witnesses that have been here, I think, have certainly contributed to our understanding of the issue.

Senator SYMMS. Well, I thank you very much, Senator. We appreciate your interest in this. And we have had some very excellent witnesses this morning. I apologize that I wasn't here when the Treasury testified, but I would like to say that—from my viewpoint of this—that if Treasury takes the attitude of retroactivity, and it is not corrected by this committee and the Congress, well, then, what we are doing here in Washington is encouraging good, honest taxpayers and the producers in this country to instead of wasting their time with tax lawyers and CPA's, simply go down to the local coin shop and buy Krugerrands and hide them and gradually go through the period of time that you paid your income taxes and the statute of limitations run out on them, and those end up in the basement of the children of the family. And it's a nonproductive asset that way, rather than have it all out above the board. That's why I think the estate tax ought to be abolished completely so that we don't have a double taxation. Most people that have estates paid taxes to get the estate in the first place, and it was money that they paid taxes on to save to have the estate. So what's wrong with the whole tax policy right now is that the spending machine in Washington is spending so much money that the poor people down at Treasury are just desperate, looking for some way to cover next month's bills. That's really what the problem is. So they go out here and look around the room and see who has got any money left.

And if you tax everybody for all the income over $75,000 a year that they are earning, it would be just enough to run this Government for 7 days. Take 100 percent of it. Stop fooling around. Let's tax the rich. And that's really what this whole issue is about. People think somehow there are rich people out there that we can take all this money from and run the Government.

And the fact of it is most of the people—90 percent of the taxpayers—are in an income bracket with $35,000 or less. And 90 percent of the Government revenue comes from people that earn $35,000 or less. So this is almost a waste of time.

And there will always be a way to get around it. But we will drive people to ways that discourage productivity, if that is going to be the continued direction that the Treasury Department is going to go on the IRS. And that's why I suppose there will be a move at some time in the future to simplify the Tax Code.

But I thank you all very much for your effort and your interest. And we appreciate the quality of the witnesses that we had here this morning. Thank you.

The committee is adjourned.

[Whereupon, at 12:55 p.m., the hearing was concluded.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

STATEMENT OF

AMERICAN COLLEGE OF PROBATE COUNSEL

submitted to the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

and the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

of the

FINANCE COMMITTEE

of the

UNITED STATES SENATE

on the subject of

GIFT TAX RELIEF LEGISLATION

with respect to

INTEREST-FREE AND BELOW-MARKET INTEREST LOANS

Hearing, April 4, 1984 and Hearing
Scheduled for, but not held, April 12, 1984

Mr. Chairman and members of the Subcommittees:

The following statement is submitted by the American College of Probate Counsel, an organization whose membership is composed of more than 2,500 lawyers specializing in the practice of trusts and estates law and related tax matters. For a number of years, the College, and specifically its Estate and Gift Tax Committee, has taken an active role in consideration and recommendations regarding various estate and gift tax legislation proposed and enacted over the last several years. The recommendations set forth below have been specifically approved by the College's Board of Regents, and are submitted at the express direction of the President of the College, J. Thomas Eubank, Jr., of Houston, Texas. The membership of the College's Board of Regents, and its Estate and Gift Tax Committee, is listed on Exhibit A attached to the statement.

The College earnestly recommends to the Congress that it enact relief from retroactive enforcement of the recent decision in the Dickman case. The College expresses no opinion and takes no position with respect to whether all loans, regardless of size, should be excluded from retroactive application of Dickman. The College makes its recommendations set out immediately below for reasons of equity and administrative necessity. These recommendations are three in number:

1. Loans of $100,000 or less outstanding at any time from one lender to one borrower should be excluded from retroactive application of the Dickman case.

2. Low-interest demand loans should not be subject to retroactive application of the Dickman case.

3. Loans of non-income producing property, such as summer homes, automobiles, etc. which are not used to produce income for the

borrower should not be subject to gift tax under the Dickman case, either retroactively or prospectively.

With regard to the first recommendation, the College observes that its views appear to be echoed in the statement by the Honorable John E. Chapoton, who informed the Subcommittees on April 4 that literal application of the Dickman decision to loans of small amounts among family members would result in an uncessary burden on taxpayers and their tax advisors. The College shares these concerns. Mr. Chapoton stated that, for this reason and taking into account the effect of annual gift tax exclusions, the Interal Revenue Service will disregard all interest-free loans of up to $100,000 per recipient for any married couple ($50,000 for a single individual) for the period prior to the Dickman decision. Mr. Chapoton also stated that loans not greater than this amount will also be disregarded for purposes of computing the gift tax on future gifts and the estate tax on the taxpayer's estate.

The College believes that the position of the Treasury Department accords with its own views except that the College believes that the exempt amount should be $100,000 in all cases. If the amount which will be disregarded for a married couple is double that for a single individual, unnecessary complexity will be introduced. If one member of a married couple made a $100,000 interest-free loan to a child and the couple were later divorced or the non-lending spouse died, Mr. Chapoton's proposal would mean that the lender would thereafter become subject to gift tax for each year that the loan remained at the $100,000 level. The College also believes that the proposed Service policy should be statutorily mandated to eliminate any question as to its propriety.

With respect to the College's second recommendation, to the best of the College's knowledge, the Internal Revenue Service has never sought to impose gift tax on an interest-bearing demand loan. While below-market interest term loans had been held in a number of cases to give rise to taxable gifts, until Dickman individuals making interest-bearing demand loans had little or no reason to believe that they had gift tax exposure. The only litigated cases involved interest-free loans, and until the Court of Appeals decision in Dickman, no court had ever held that such loans gave rise to taxable gifts, much less that an interest-bearing loan did so.

Taxpayers seeking to achieve income-shifting or other desired tax results generally utilized interest-free loans. Where interest was charged, even though in retrospect it might be said that such interest was less than the market rate, tax avoidance was generally no part of the parties' thinking. Much more common was the situation in which a parent was willing to make a loan to a child and felt that it would be good financial discipline for the child to learn the responsibility of making regular interest payments, albeit at an affordable rate less than such child would have been able to obtain commercially. No gift was then intended; none could reasonably have been believed to have been made. It would be inequitable now for the Service to attack such loans simply because the interest rate was set below a rate which the Service now determines to be the "market" rate. There should be no retroactive application of Dickman to interest-bearing demand loans.

Finally, Dickman held that the gift tax reaches "all gratuitous transfers of any valuable interest in property." Dickman also recognized that "it is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of family relationship." The Court expressed its assumption that "the focus of the Internal Revenue Service is not on such traditional familial matters." It should make no difference whether parents invite their children to spend three weeks with them at the family vacation home, or whether the children are given three weeks alone in such home. In neither case are the tax avoidance motivations described by the Court in Dickman present and in neither case should a gift be found to have been made. Yet the Court said that the gift tax reaches "all gratuitous transfers of any valuable interest in property," and stated that a tenancy at will is such an interest.

Neither the House nor the Senate version of the provisions dealing with below-market interest loans deals with loans of property. Therefore, the College urges that legislation be enacted which will make clear that the principles of Dickman as well as the new statutory provisions are inapplicable to transactions, whether characterized as loans or otherwise, which involve the transfer of a right to use non-income producing property, unless such property is converted to income producing property, the income of which flows to the borrower. Where income producing property is involved, the rules against assignment of income should be sufficient to prevent abuse. However, loans of non-income producing property, such as summer homes, boats, automobiles, etc., used and enjoyed by the borrower, but not converted into income producing property, are extremely commonplace in familial situations. Such loans are never thought of as gifts by the parties involved, do not usually involve and documentation, would be impossible for the Service to detect, and should be exempted from the reach of the gift tax. In fact, many of such situations result in a benefit to the owner, rather than to the user, viz, where adult children reside in the family home for a period of time to be of assistance to aging parents.

It is not possible to place a dollar limit on loans of non-income producing property, as to do so would leave open to attack short term use of a summer home, or an automobile. In many cases the annual exclusion offers no real relief in this area, since many families regularly utilize the full annual exclusion in outright gifts, leaving any loan of property open to challenge. The College believes that loans of non-income producing property offer little opportunity for abuse, and that the difficulty of enforcement of a different rule renders it essential that such loans be placed in a different category than cash loans or loans of income producing property.

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STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
AND THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
REGARDING GIFT TAX LIABILITY OF NO INTEREST/LOW INTEREST LOANS

Presented by
Grace Ellen Rice, Assistant Director, National Affairs Division

April 12, 1984

-- SUMMARY --

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
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1. The American Farm Bureau Federation is the nation's largest general farm organization with three million member families throughout the country. Many farmers and ranchers have used interest free or low interest loans (demand notes and installmen loans) to sell or transfer property to their children or other family members. These loans have been made for non-tax purposes to finance the continuation or expansion of the family farming operation.

2. Intra-family loans used by farmers and ranchers are made upon general borrower-lender principles that the loans will be repaid on demand or under terms of an installment. No gift is made in these situations.

3. As an organization that has supported the repeal of the federal estate and gift tax, Farm Bureau does not support the retroactive application of the gift tax for interest free and low interest loans nor do we support the prospective application of gift tax.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
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Presented by
Grace Ellen Rice, Assistant Director, National Affairs Division

April 12, 1984

Mr. Chairman and Members of the Subcommittees, Farm Bureau appreciates the opportunity to offer comments on the issue of gift tax liability on no interest and low interest loans. We recognize that the recent U.S. Supreme Court decision in Dickman v. Commissioner of Internal Revenue has brought this issue to the forefront.

The American Farm Bureau Federation is the nation's largest general farm organization with over three million member families throughout the country. Many farmers and ranchers have used interest free or low interest loans (demand notes and installment loans) to sell property to their children or other family members. Most of these loans have been made so that younger family members could purchase farm land or other business assets to continue or expand the family farm operation. On occasion, these low interest or interest free loans are the only way that a young purchaser can buy farm assets. This is particularly true when new purchasers have not been able to use the more traditional means of farm lending such as banks, PCAs, and the Farmers Home Administration. If such traditional funding is not available or sufficient, the borrower in question might not be able to enter the business without the assistance of family members. The continuation of a family farm or other family business is an income generating activity that should be encouraged because it means more income tax revenues for the government. Moreover, private lending, such as intra-family loans, eases credit demand in the commercial markets. The loans are made upon general borrower/lender principles that they will be repaid on demand or under terms of an installment loan. Certainly, tax evasion or tax avoidance has not been an overriding consideration in the making of these loans.

With the current emphasis on private initiative rather than government assistance, isn't it preferable for intra-family loans to be made rather than requiring borrowers going into the credit market? In addition, the federal government has a variety of lending operations that make low interest or subsidized interest loans with no gift tax consequences. These agencies include the Federal Housing Administration, the Farmers Home Administration, and the Small Business Administration. Obviously, the federal government does not assess tax to itself, but we fail to see any basic difference between this type of subsidized lending activity where no "gift" is made and a farmer loaning funds to a family member at a low interest rate. If the government makes no gift through its lending activity, why does the IRS now attempt to characterize a similar activity as a gift because it occurs in the private sector? This position reverses longstanding IRS policy not to recognize low interest or interest free loans as gifts.

There are many other unanswered questions stemming from the Dickman case and the position taken by the Internal Revenue Service. How will valuation be conducted for the "gift" of interest free loans? What constitutes a low interest rate? How will the Internal Revenue Service enforce filing and payment of gift tax returns? Does the Dickman decision affect low interest installment loans as well as interest free demand loans? How does gift tax liability for interest free loans relate to the issue of imputed interest rates on intra-family installment loans for land purchases? What types of transactions would be covered? Would other types of family loans such as loans for college education or down payments on homes be subject to the gift tax? In the majority opinion in Dickman, Chief Justice Burger wrote that "We assume that the focus of the IRS is not on such traditional familial matters." We do not share the Chief Justice's confidence that the Internal Revenue Service would not involve itself in such matters.

These loans can have a legitimate business purpose and are not structured to evade taxes. In addition, many taxpayers have relied upon the advice of their tax counsel concerning the use of these loans. We do not believe that there should be any change in the administration of the tax laws which would negate previous estate planning. Any suggestion that the unified credit could be used to offset gift tax liability is not a good argument with farmers. Most of their major estate tax planning has been based upon the maximum use of the credit in ways other than the reduction of unexpected gift tax liability for these loans. Nor can the IRS assume that split gifts will be made to take advantage of the $20,000 annual exemption. Some transferors may be single or a married couple may decide not to make a split gift.

We understand that there is under consideration a proposal to allow for the retroactive application of gift tax liability for no interest and low interest loans. While Farm Bureau supports legislation that would prohibit the retroactive application of gift tax liability in these cases, we also oppose any prospective application of the gift tax. Based upon the long-standing history of the IRS with regard to this matter, we believe that there is no reason to assume that these loans are, in fact, gifts. Farmers use these loans as part of legitimate business activity to transfer the farming business as well as to help their family members. The imposition of gift tax liability after such a long history of no gift tax only fosters the conclusion that the government is often an obstructionist to businesses and individual taxpayers rather than an ally. We re-emphasize that these loans are not gifts and that no gift tax liability should be assessed.

Thank you for your consideration of our comments and we ask that our statement be included in the hearing record.

ARTHUR ANDERSEN &CO.

STATEMENT

OF

ARTHUR ANDERSEN & CO.

BYRLE M. ABBIN
MANAGING DIRECTOR
OFFICE OF FEDERAL TAX SERVICES

<u>APPLICATION OF THE RULE OF DICKMAN V. COMMISSIONER</u>

SENATE FINANCE COMMITTEE

APRIL 12, 1984

My name is Byrle Abbin. I am a tax partner in the international accounting and consulting firm, Arthur Andersen & Co. In addition, I am Managing Director of the Office of Federal Tax Services, and have published extensively in professional journals on estate and gift tax issues. Arthur Andersen & Co. provides tax advisory services for thousands of taxpayers who may be affected by this Committee's decisions on interest-free loans, but the views I will express are the views of the Firm itself and are not provided on behalf of any client or affected taxpayer. Our comments will principally address the issues delineated in Press Release 84-130, and will suggest issues the Committee may wish to address in resolving this problem.

We favor prospective application of the gift tax rule of the Dickman case. We urge you to adopt this position in the interest of sound tax administration, since the potential compliance problems for both taxpayers and the Internal Revenue Service (IRS) are formidable.

Special action by Congress to apply the holding in the Dickman case prospectively only is appropriate for the following reasons:

- The nature of the gift tax law will magnify the administrative burdens on taxpayers and the IRS beyond what would normally occur if an income tax law were changed retroactively.
- From 1932 until the Dickman case there was nearly universal agreement that no gift arose under Federal gift tax laws as a result of an interest-free loan.
- The reporting of many interest-free loan transactions would result in little or no gift tax liability.

From administrative and theoretical points of view, there are significant differences between the income tax and the gift tax. The income tax is levied annually and, but for certain averaging, basis and carryover rules, the taxable income in year one has no effect on income taxes for years two, three, or, for that matter, for year 20. Gift taxes, however, are cumulative, so that taxable gifts made in one year will have an impact on the amount of gift tax paid on any taxable transfers in all subsequent years. More importantly, since 1976, the gift taxes paid over a lifetime have a substantial effect on the amount of estate taxes due upon the death of the taxpayer. This cumulative effect arises because of the integration of both taxes--in effect, the gift tax is a prepayment of estate taxes. (In years prior to 1976, the cumulative impact applied only to lifetime gifts and the gift tax had no bearing on the estate tax.)

The practical effect of this distinction between gift taxes and income taxes is manifest when amendments must be made to previously filed returns. A modification of an income tax return usually will not require amendments of every subsequent return. Conversely, a modification of a previously filed gift tax return will necessitate, in virtually all cases, the amendment of all subsequent gift tax returns. The administrative burden of this cumulative effect on the taxpayer and on IRS is evident in any situation where a retroactive gift tax modification might be imposed.

Until Dickman was decided, there was fairly widespread agreement among estate and gift tax specialists that an interest-free loan did not give rise to a gift.

Luther Avery, a national leader of the Bar and a well-established estate and gift tax authority, argued in a paper presented at the New York University Institute on Federal Taxation that as a matter of sound tax policy the rule of Crown (an earlier case favorable to taxpayers) should be the appropriate treatment of interest-free loans. He made this argument based on considerations of ease of administration, and pointed out that imposing either a gift tax or an income tax consequence on an interest-free loan would result in "ruinous complexity." He even suggested means that the IRS might employ to protect the tax base through existing code sections. This paper had broad distribution in the widely read published proceedings of the Institute. A copy of the paper is attached to the statement. (Avery, "The Lester Crown Case: Its Implications and Applications," 38 NYU Tax Inst, §36, 1980.)

In theory, the rule of the Dickman case reaches back to 1932, when the gift tax was first enacted, and would apply to any open year. It was not until 1966, in Johnson v. U.S., 254 F. Supp. 73 (N.D. Tex. 1966), that the government so much as raised the possibility that an interest-free loan had any gift tax consequences. The government lost in that case, and lost again in 1978 in Crown v. Commissioner, 585 F.2d 234 (7th Cir., 1978). Crown received widespread attention at that time.

Thereafter, the government did not release any regulations, published rulings or private letter rulings, nor was there any decisional authority contrary to Crown until 1982, when Dickman was decided favorably to the government. (In fact, the only authority in support of the government's position until Dickman was its own Revenue Ruling 73-61, 1973-1 C.B. 408.) No legislative proposal was ever made until November 1983. Congress could have codified the government's position at any time after 1932, 1966 or 1978, but chose to not to do so.

The history of this issue in the courts, in Congress and in IRS administrative practice leads us to conclude that taxpayers were fully justified in believing that, as a matter of law, an interest-free loan did not give rise to a taxable gift. While the government's position was made known in 1966 and published in 1973, the Commissioner's uniform and continuing lack of success in establishing that rule certainly provided taxpayers with virtual certainty that the interest-free loan technique, particularly within families, carried no gift tax consequence. Indeed this technique undoubtedly would have withstood the rigorous "substantial authority" standard of the TEFRA-enacted Section 6661.

It should be noted that the House Ways and Means Committee has seen fit to propose in H.R. 4170 that the income tax ramifications of interest-free loans be specifically provided in statute. These provisions, in effect, change the results reached under a line of cases beginning with Dean, namely that interest-free loans have no income tax consequences. This is relevant to the consideration of the issue before the Committee in that legislative action is now considered necessary even in light of the broadly worded Section 61, that taxes "...income from whatever source derived." It is evident that taxpayers were justified in concluding that interest-free loans did not result in a gift under the more narrowly worded Section 2501.

This is not a matter of a few aggressive taxpayers taking positions that were without support. Until 1982, every court considering the issue decided it in favor of the taxpayers and against the government, and Congress was silent. Requiring taxpayers now to go back to prior years and file gift tax returns where none had previously been required would seem an undue burden on taxpayers and on the IRS. Serious impediments to adequate compliance can be foreseen. For example, records will have been lost, parties will have died, or estates will have been liquidated or become insolvent. These difficulties should underscore the need for a statutory bar against the assertion of tax liabilities generated by transactions long past and maybe forgotten.

As stated previously, the tax consequence of each lifetime gift carries on and has an impact on total transfer taxes, whether due to lifetime gifts or transfers at death. Thus, if the rule of the Dickman case is permitted to be retroactive, loans originating after 1976 could affect estate tax obligations 30 or 40 years hence, i.e., into the twenty-first century. (In fact, Dickman arose from the audit of an estate). Unsuspecting widows, widowers, and heirs would suffer. This potential result of the integrated transfer tax system should be made applicable only to activities that were clearly understood by the government, taxpayers and their advisors to be taxable gifts at the time they took place. The treatment of interest-free loans was not clear to all these parties until the Supreme Court ruled in Dickman. For this reason, we favor a prospective rule.

Forgiven Tax Liability

It is not possible for us to accurately quantify or even estimate the amount of gift tax liability that would be forgiven if the rule of Dickman were made inapplicable to pre-1984, or even pre-1982 loans. First of all, we have no data on the volume of loans or the dollars involved. In fact, we believe the collection of such data would be virtually impossible. Many tax advisors are no doubt unaware that some of their clients ever made these intrafamily loans, since the technique was often promoted through the daily press and through industry and trade journals. Furthermore, the amount of tax liability would depend not only on the dollars involved, but also on each lender's particular circumstances. The gift tax attributable to a particular loan transaction depends on whether other lifetime gifts were made and their amount.

Prior to 1982, the gift tax exclusion was $3,000 ($6,000 if gift-splitting techniques were used). Given the low interest rates that predominated until the late 1970's, it is safe to assume that many, if not most, loans would have resulted in immaterial taxable gift amounts. For example, if we assume an implied benefit to the borrower at a 6% rate (not an unreasonable rate until the late '70's), only loans in excess of $100,000 would have produced reportable gift amounts. Moreover, in view of the $30,000 lifetime exemption prior to 1976 and the unified credit since 1976, even larger sums could have been loaned without generating any gift tax liability.

Even though the benefit conveyed through an interest-free loan might be below the excludable amount ($3,000 or $10,000), in most cases it would still have to be reported on a tax return. This requirement is a practical one, rather than statutory. The need arises due to the cumulative nature of the gift and estate tax and the need to fix with certainty (that may not be later attacked by IRS) the unused amount, if any, of the unified transfer credit that a taxpayer has available to offset future transfer tax liabilities.

Affected Transactions

The Dickman rationale would affect a broad range of intrafamily transactions and also transactions between closely-held corporations and their owners. Interest-free demand loans were typically made for family income tax planning purposes, i.e., to shift income from high-bracket taxpayers to lower-bracket taxpayers, such as children or other close relatives.

Given the state of the law prior to Dickman, this was universally viewed as an effective and legitimate tax planning technique. In many ways, it was simpler and more flexible than a 10-year or Clifford trust arrangement, another method that courts and, eventually, Congress approved to shift income. The superiority of the interest-free loan over the 10-year trust lay in the lender's ability to recall the principal amount on a moment's notice without having to wait ten years. In our experience, the use of the loan method was not undertaken primarily with a view to effect a savings in gift or estate taxes.

Justice Powell's dissent in Dickman shows the range of transactions that could be reached, even under a reasonable application of the rule. We do not believe that the dissent is a mere "parade of horribles," because the clear rule of the majority applies to use of any property, not just money. In-kind transactions among family members would be affected, as would rent-free or below-market rental transactions. A whole series of affected transactions may be found within the scope of the statutory framework of the gift tax. For example, for years prior to 1982, the Dickman rationale would treat the payment of education or medical expenses of another as a gift in some circumstances. IRC Sec. 2503(e) was enacted specifically to limit that result.

The Committee should be cognizant that applying the Dickman rule retroactively could give rise to disputes about acts such as the loaning of funds for paying the tuition expenses of a child who has become a displaced homemaker or those of a grandchild who has a unique talent or special problem requiring private education. Similarly, the rule could create problems about a gift tax consequence when an adult child has provided funds for the medical expenses of an elderly parent. Other problem areas include family loans made for the acquisition of a principal residence or family business, transactions involving the use of farm and grazing land by family members and the purchase of land using the below-market interest rates of Sec. 483(g). All of these transactions tend to be motivated by family, not tax, considerations.

Again, as a matter of tax administration, the Committee should note the potential hardships that could arise with a retroactive application of Dickman. Using the examples above, where the funds transferred have been consumed, there may not be cash available to pay the tax. Of course, it is the donor who is primarily liable for the tax, and not the donee. (The donee, as transferee, does have secondary responsibility for the tax.) However, if Dickman is retroactive, there will certainly be situations where a donor/lender will be unable to pay the gift tax, or where the donor is no longer living and the estate lacks sufficient funds or liquidity to pay the tax. If the Dickman rule is prospective only, taxpayers will be on notice about the gift tax consequences of their transactions, and can plan accordingly.

In considering its decision on retroactivity, the Committee should bear in mind that many estates that have already closed would be adversely impacted under a retroactive application. Many disputes about interest-free loans have arisen between taxpayers and the government during IRS audits of estates. In circumstances where the estates have closed, a retroactive rule will have an adverse effect on many more parties than just the lender and the Commissioner. New conflicts regarding gift valuation and liability for tax will be inevitable between heirs and administrators, between the heirs themselves, and between partners or shareholders in closely held businesses. Congress should carefully weigh the consequences of intruding into these largely private transactions.

Role of Tax Advisors

Our firm was certainly knowledgeable about the popularity of the interest-free loan technique during the past 10-15 years, as were most tax advisors. However, for reaons stated above, we believed that until Dickman was decided unfavorably at the Circuit Court level in 1982, there was no gift tax consequence to the taxpayer that necessarily required the taxpayer to file a gift tax return. The Committee should bear in mind that advisors assist taxpayers in analyzing their obligations under the self assessment system. For all the reasons stated above about the state of the law, advisors stood on firm ground when they told clients that interest-free loans gave rise to no gift, and that no gift tax return was required for that particular transfer.

Thus, the problems for both advisors and the IRS that would arise with a retroactive application of Dickman are problems of administration. Many taxpayers will not realize that transactions entered into a number of years ago have now been determined to be reportable gifts in prior years. Even those who regularly engage tax advisors such as lawyers and accountants for their annual income tax return filings and other tax planning activities often entered into these transactions without consulting their advisors. Often, the technique was marketed by financial institutions or by trade and professional journals. Thus, it is impossible even for the tax advisors to know whether their clients are subject to the retroactive application of the Dickman case. Moreover, the contractual relationship between client and advisor may have terminated.

The cloud of possible prior transactions will cast a shadow far into the future because advisors cannot advise clients appropriately unless they are sure the clients properly have complied with the law for prior years. Commentators have observed that the Crown case provided clear justification for using the interest-free loan technique without filing a gift tax return. At the prestigious University of Southern California Institute on Federal Taxation, Stephen Newnham and Robert J. Durham stated, At the present time, the Crown case is unchallenged and provides solid planning opportunities. The Crown decision was limited to interest-free demand loans where the substance of the loans was well-documented and the transaction was treated as a loan. Within those parameters, the making of such a loan should not give rise to a gift and, in fact, it is difficult to see why a gift tax return should be filed.

Newnham and Durham, "Interest-Free Loans: Crown, and After," 33 U.S.C. Tax Inst. §2001, 1981.

Conclusion

Application of the Dickman case to all previous and existing interest-free intrafamily loans can cause an administrative nightmare for the Internal Revenue Service, affected taxpayers and their tax advisors. As a matter of equitable and sensible tax law administration, we believe that Dickman should be applied only prospectively, since it signals a change, and not a clarification, of the law.

We appreciate the opportunity to appear today, and will be pleased to answer your questions.

CHAPTER 36

The *Lester Crown* Case: Its Implications and Applications

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SYNOPSIS

§ 36.01 THE LESTER CROWN CASE

The General Accounting Office and the Internal Revenue Service have been publicly discussing the problems caused by the so-called "underground economy," involving extensive failures to file tax returns and extensive tax fraud amounting to millions of tax returns and billions of dollars of unpaid tax. If the rules the government urged in the *Lester Crown* case were to become the law, it is my opinion that the underground economy would grow in scope and activity. The *Lester Crown* case involved the simple concept that interest free loans payable on demand are not gifts to the extent of the value of the use of the funds.[1] Also argued in the *Lester Crown* case was the fact that there would not be income imputed to the borrower by virtue of the interest free loan although it is the case of *J. Simpson Dean*,[2] discussed below, that is the leading case on the question of imputed interest income to the borrower. Essentially, the policy issue involved in litigation surrounding interest free loans is the question of whether the tax system in this area should be guided by the basic principle that administrative convenience is important or whether the tax system should be guided by the question of what is income or what is a gift carried to its full theoretical limits. It is hard to believe that anyone would argue that an interest free loan for indefinite duration is not a thing of value. Moreover, it is hard to believe that an interest free demand note among family members does not operate to transfer values to future generations in a manner which would

[1] *Lester Crown*, 67 T.C. 1060 (1977), *nonacq.*, *aff'd*, 585 F.2d 234 (7th Cir. 1978).

[2] *J. Simpson Dean*, 35 T.C. 1063 (1961) *nonacq.*, *aff'd*, 585 F.2d 234 (7th Cir 1978).

otherwise result in death tax. The key issue, however, is whether what is theoretically correct, that is the imposition of a gift tax or an income tax where there is an interest free demand loan, justifies the complexity of the law that will be required in order to require reporting of all economic benefits. The true nature of the issue is not whether the rather unique fact situation in the *Lester Crown* case should be subject to gift tax or income tax; the true issue is whether the millions of transactions among families and related persons including employer-employee relations, should be put into the requirements for reporting and taxation under a tax system which is presently overburdened by excessive complexity. This social issue will not be discussed at great length, but it is inherent in the decisions of the courts, both in the *Lester Crown* case and in the *J. Simpson Dean* case. The results in those two cases are decisions where the courts themselves were divided on what is the proper solution and where many of the judges looking at the issues felt there was something wrong with their decision. They knew, however, that their decision was correct because of the need for a settled doctrine of law that could be used by taxpayers as a guide for future conduct.

It is certainly true that the result in the *Lester Crown* case and in the *J. Simpson Dean* case is simple to administer. It is also true, as will be shown, that once the simplicity of those rules is eliminated, the administrative problems and the complexity of the income, estate, and gift tax law will be greatly multiplied. These problems arise when the cases are overruled or when legislation attempts to extend the income, estate, and gift tax to cover transfers of economic advantage among related persons beyond where it presently is.

[1] Income Defined

Gross income is defined in I.R.C. Section 61 as "... all income from whatever source derived ..." and Sections 71-83 of the Code describe additional items specifically includable in gross income and Sections 101-123 describe items specifically excluded from gross income. The items listed in the Code are not exhaustive of the receipts included in gross income.[3]

Income is "realized" when the receipt of economic advantage is a measurable and severable accession to wealth that is not a recovery of capital under circumstances where the transaction is closed.[4] For example, second mortgage notes received when property was sold were not income where the notes had no ascertainable fair market value when received, even though the notes were subsequently paid.[5] The Internal Revenue Service has announced that it will continue to require valuation of contracts or claims to receive ". . . indefinite amounts of income . . . except in rare and extraordinary cases."[6] Closing the transaction in many cases can present very difficult problems of valuation, but the usual method is to consider the transaction as if it were at arms length and to assign the same value to each party. See, however, *United States v. Davis*,[7] holding that the value of rights relinquished in a divorce were measured by the value of marketable securities transferred to the person who gave up the rights. Recovery of capital occurs when the wealth is returned to the taxpayer and not when there is a change in the bundle of rights. Receipt of payment for cancellation of the right to receive future rentals was not a return of capital despite the fact that the capital wealth of the taxpayer included the right to future rent receipts in *Horst v. Commissioner.*[8] In the situation where there is an interest free loan, it is clear that someone is going to be receiving income on the corpus of the loan. Fundamental to the problem of determining the proper tax treatment of such transactions is the question of who should pay income tax on the income from that corpus. Should the income go to the person who borrows the money or should the income be taxable to the person or entity who controls the person or entity

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[3] Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).

[4] Burnet v. Logan, 283 U.S. 404 (1931).

[5] Miller v. United States, 235 F.2d 553 (6th Cir. 1956).

[6] Rev. Rul. 58-402 (C.B. 1958-2, 15).

[7] United States v. Davis, 307 U.S. 65 (1962).

[8] Horst v. Comm'r, 313 U.S. 28 (1947).

receiving the income? An argument not discussed in the *Crown* case which seems obvious, is that with an interest free demand loan, the lender has control of the corpus since the lender has the absolute right to demand return of the corpus at any time. By virtue of that control, the lender should be taxable on the income even though the income is received by the borrower. Such concepts have not troubled the courts or the Service where there has been litigation involving corpus put into trusts. Why should there be a difference simply because there is no trust instrument?

[a] *Income is Taxable to the Person or Entity Who Controls the Person or Entity Receiving the Income*

The Internal Revenue Code has relatively little to say about whose income it is and most of the development of the law in this area looks to the litigation involving the area of the *Dean* case. Because one of the most advantageous tax planning devices is to shift income among related persons and entities so as to minimize the effective tax rate on the family or economic unit, whose income it is becomes increasingly important. The rules concerning taxation of income to a particular taxpayer have been well developed and the oft quoted lines of cases dealing with earned income from personal services and income earned from property have clearly spelled the evolution of rules with which we are familiar. See, for example, *Irwin v. Gavitt*, 268 U.S. 161 (1925) and *Lucas v. Earl*, 281 U.S. 111 (1930).

[2] Gift Defined

Again, in the area of interest-free demand loans, the transaction should be compared with the general law. Code Sections 2501(a) and 2512(b) are intended by Congress to use the term "gift" in its broadest and most comprehensive sense to permit an excise tax on the transfer of wealth where there is no statutory exclusion and where property is transferred for less than an adequate and full consideration in money or money's worth.[9] Inherent in the con-

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[9] Comm'r v. Wemyss, 324 U.S. 303 (1945).

cept of a gift is the fact that the transfer is a *present transfer* which *reduces* the *present wealth* of the transferor and not that the transfer increases the wealth of the transferee. The gift occurs when the transfer is accomplished whether or not the wealth is received, but a gift does not occur if the transfer is gross income to the recipient even though the gift tax and the income tax are not reciprocal.

[a] *Must the Tax Treatment of Transferor and Transferee be Reciprocal?*

Long established law has held that the income tax is not to be construed as though it were in *pari materia* with either the estate tax or the gift tax.[10] No genuine business transaction is intended to cause a transfer of property to be treated as a gift,[11] and every exchange that is not precisely equal does not involve a gift.[12] The tax treatment when we are analyzing whether or not a gift has occurred may turn upon the relationship of the parties. In that sense reciprocal treatment becomes relevant because intra-family transfers are subject to different standards of scrutiny than transfers among strangers. It is precisely this difference of treatment among family members that gave rise to the gift tax dispute in the *Lester Crown* case. In addition, it is this close relationship that gave rise to the income tax dispute in the *Dean* case. The basic problem, however, is that if rules are adopted to tax transactions like the loans of three brothers to their fifteen children in the *Lester Crown* case, or to tax as income the interest free loan from their controlled corporation to its stockholders, those same rules will apply to the millions of people in the United States who struggle to comply with the present complex income, estate and gift tax laws.

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[10] Farid-es-Sultaneh v. Comm'r, 160 F.2d 812 (2d Cir. 1947).

[11] Comm'r v. Wemyss, 324 U.S. 303 (1945); Reg. § 25.2512-8.

[12] United States v. Davis, 370 U.S. 65 (1962).

[3] The Dilemma of "Protecting the Revenue"

The Treasury Department is in the business of collecting revenue in accordance with vague statutes and changing policies. The Internal Revenue Service does, however, have extensive powers and procedural advantages which permit the Service to effectively go about the business of collecting revenue. The unfortunate thing is that occasionally the Treasury Department must adopt positions that are untenable or wrong in order to either create rules to fill legislative oversight or to force Congress to decide what policy should be followed. In the case of interest free loans, the Treasury Department has the dilemma that it must protect the revenues because if the rule in *Lester Crown* and in *Dean* is the law, then there is a rather substantial inroad in the tax base for both the gift and estate tax and the income tax. Interestingly, Congress may decide not to tax those transactions as a matter of public policy. Certainly from the standpoint of simplicity of the law and ease of administration, leaving the *Crown* and *Dean* cases undisturbed would be good public policy. Moreover, if the question is how to deter the major tax avoidance that will occur with wealthy persons as those taxpayers in the *Crown* and *Dean* cases, perhaps the answer is not to change the general rule, but to design some special rules that apply to special circumstances. For example, the *Dean* case involves interest free loans from a controlled corporation to a stockholder. It would seem to me that a substantial deterrent would occur if a regulation were written under Code Section 531 stating that an interest free loan is evidence of an unreasonable accumulation of surplus and that the tax on unreasonably accumulated surplus should be imposed at any time that there is an interest free loan of a duration of more than some reasonable period of time, such as six months. In addition, strictly from an income tax standpoint, it should be possible to protect the revenues by going back and re-examining the question of who controls the revenue when there is income earned on the funds borrowed on an interest free loan basis. Probably the taxation of such loans will be covered in the legislation which is presently being developed to deal with corporate fringe benefits since an interest free loan from an employer is simply another variation of the many untaxed fringe benefits that go to corporate employees under our present tax system.

[4] What Should be the Tax Base or Time for Taxation?

The present income tax base and time for taxation are workable, albeit immensely complicated. The present gift tax base and time for taxation are similarly workable and should not be changed. The basic issue behind the *Lester Crown* case is whether the Treasury Department will be permitted to impose tax to deter intra-family transfers of future economic advantage. *Crown* involves a written, non-interest-bearing demand promissory note, which is to be contrasted with a promissory note for a term at an interest rate that is less than the market. The Federal Estate Tax is a transfer tax imposed upon a transfer which results in the present reduction of the estate of the transferor. In the *Lester Crown* case, the present estate of the lender was not reduced by the interest free loan. Therefore, in strict theory, there is no transfer that should be subject to death tax or to gift tax. What the Service is attempting to do in this situation, however, is to impose a present gift tax on a transfer of a future benefit. The Service has, of course, attempted to get around that dilemma by measuring the present gift by hindsight and going forward to determine what the value would be if the gift were permitted to continue indefinitely, but the Service overlooks the fact that in many family situations loans may be made and repaid and made again and repaid again on numerous occasions and if each such transaction were to result in a gift, the taxpayers would not have the ability to pay such tax. The basic problem is that the transaction in *Lester Crown* should not be taxed because it is a transfer of future benefits. The basic dilemma is that such a rule points up the fact that under our death tax system the wealthy have a distinct advantage if they can transfer economic benefits. Thus, for example, a parent who spends extraordinary amounts of money on medical treatment and educational benefits for his or her children will not be taxed for having made those payments. This holds even if the children progress faster than the average and may enjoy a superior life style for their entire lives by virtue of their superior medical treatment and education. Those present expenditures are really the creation of future economic benefits. The transaction in the *Lester Crown* case is no different. What is being done is for a parent without reducing his or her present estate to provide benefits which will have future worth to the intended beneficiary. The *Lester Crown* case would seem to turn on the question of whether or not the value of the interest free demand note is less than the amount that was loaned. The Internal Revenue Service would impose a gift tax if there is a difference. What would the Service do if instead of making the $18,000,000 loan, the taxpayers in the *Lester Crown* case had simply put $18,000,000 on deposit at the bank and said to the trusts for their children, "Go out and borrow $18,000,000 and we will pledge our assets as security for that loan so that you will be able to borrow the money"? Would the pledge or guarantee of a child's note constitute a gift? Would the pledge or guarantee of a child's note be taxable income to the child? Would it be taxable income to the parent? The problem of protecting the revenues sometimes means that judgment must be exercised not to carry matters to a logical extreme. Moreover, it would seem that until a new tax system has been devised, that the *Lester Crown* case and the *Dean* case should be left undisturbed. Obviously, such a decision does not sit well with those who wish to attack wealth. The cases, however, do contribute to simplicity in the tax law and the administration thereof. *Lester Crown* and *Dean* will also assist in maintaining the integrity of the tax system. Some concern, perhaps should also be voiced for the tax system's integrity to prevent increasingly ruinous complexity and to discourage the underground economy.

§ 36.02 HISTORY OF INCOME TAX ASPECTS OF INTRA-FAMILY TRANSFERS OF ECONOMIC ADVANTAGE BY USE OF INTEREST-FREE LOANS

[1] Internal Revenue Service Policies

The history of Internal Revenue Service policies has largely been concerned with whether a benefit has been received, by whom, and when, under such circumstances that it is administratively feasible to declare that such receipts or benefits have the quality of income. Many receipts previously ignored are now subject to reexamination. For example, fringe benefits have been subject to taxation (unless statutorily excluded) pursuant to Regulations Section 1.61–2(d), but prior to 1975 the Service had not made a major effort to tax most fringe benefits. In September, 1975, proposed regulations to change past policies were issued. The storm of protest has led to delay in establishing new policies mandated by Congress until such time as new policies can be developed. The delay and the whole area of fringe benefits has been referred to and relied upon by the Tax Court in its recent extensive discussion in this area in *Greenspun* (72 T.C. No. 78 (1979)).

The policies relating to intra-family transfers with respect to the estate and gift tax may similarly be under reexamination by the Service in its attempts to put restraints on the transfer of future economic advantages.

[2] Statutory Policies

In the area of intra-family transfers of future economic advantage there has been no recent change in the statute as it relates to the free use of property or interest-free loans. Whatever developments we are seeing come as a result of attempts by the Internal Revenue Service to expand this scope of the tax from what has been settled law to develop new concepts of taxation. This expansion has been evolving as our inflationary economy has been expanding. Many transactions which were once considered too small for tax collection have, due to inflation, become significant and have led to the adoption of new rules or reexamination of old rules.

[3] Cases of Significance

The income tax treatment of interest-free loans has had one significant but little-noted change. Under early cases such as *Smith-Bridgman & Co.* (16 T.C. 787 (1951)), the courts did not permit the Service to create income by allocation of income among related entities through use of Code Section 482. However, after the *issuance of regulations specifically under authority granted by the statute itself,* the courts have now permitted the Service to impute interest on interest-free loans.[13] In this area see also *Commissioner v. Duberstein* (363 U.S. 278 (1960)). In analyzing what is a gift for income tax purposes, the Supreme Court said:

> We are of the opinion that the governing principles are necessarily general and have already been spelled out in opinions of this Court, and that the problem is one which, under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases. (363 U.S. 278, 284-285)

In a very real sense, the Tax Court is saying the same thing to the Internal Revenue Service in *Lester Crown, Dean,* and the subsequent litigation which is discussed below. An issue not before the *Lester Crown* court but discussed in the argument is whether interest-free loans give rise to constructive income.

[4] Interest-Free Loans

Many cases dealing with interest-free loans say that there is no income to the *borrower.* The leading case is *J. Simpson Dean* (35 T.C. 1083 (1961) *nonacq. aff'd,* 585 F.2d 234 (7th Cir. 1978)). The *Dean* case involved an interest free loan from a controlled corporation in the amount of $2,000,000 to its shareholders. The *Dean* case held that the interest free loan did not result in income to the

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[13] B. Forman Co. v. Comm'r, 453 F.2d 1144 (2d Cir. 1972) and *Latham Park Manor, Inc.,* 69 T.C. 199 (1977).

borrower. The case was reviewed by the Court and was a decision of the court with four dissents. In the development of the whole area of whether or not an interest free loan is income to the borrower there have been many variations. For example, it has been held that an interest free loan to employees is not compensation,[14] and that interest free use of funds is not a dividend.[15] In Letter Ruling 7845004 it was held that forgiveness of interest on a debt does not result in taxable income to the released debtor unless the tax benefit rule applies.[16]

There has been a rash of cases recently involving the principle of the *Dean* case because the Service has been attempting to persuade the Tax Court to overrule its decision in the *Dean* case. The attack on the *Dean* case should be contrasted with cases which had previously held that the *Dean* case did not apply.[17] Those cases holding that the *Dean* case does not apply are obviously cases where there is a factual distinction which justifies a different decision. The *Dean* case, however, is now settled law as far as the Tax Court is concerned. In *Albert Suttle* (37 T.C.M. 393 (1978)), the Tax Court reaffirmed *Dean* where the president and majority shareholder of an auto sales agency each borrowed interest-free from their company.

The most significant decision in the recent flurry of activity is *Greenspun* (72 T.C. No. 78 (1979)), another case involving Tax Court review by the entire court in which the court held that the taxpayer received no taxable income from the receipt of loan

[14] Saunders v. United States, 294 F.Supp. 1276, 1282 (D. Hawaii 1968), *rev'd on other issues*, 450 F. 2d 1047 (9th Cir. 1971).

[15] Joseph Lupowitz Sons, Inc. v. Comm'r, 497 F.2d 862 (3d Cir. 1974) and *Lisle*, 35 T.C.M. 140 (1976).

[16] For a case applying the tax benefit rule, see Helvering v. Jane Holding Corp., 109 F.2d 933 (8th Cir. 1940) *rev'g* 33 B.T.A. 960 (1939); and see Rev. Rul. 67-200 (C.B. 1967-1, 15).

[17] *Robert G. Contra Shannon*, 35 T.C.M. 304 (1976), finding a constructive dividend when there were cash advances to a stockholder the court determined were not bona fide loans. *Victor Shahen*, 21 T.C. 785 (1954) and *C.F. Williams*, 37 T.C.M. 306 (1978) are additional cases where on the facts the court held there was no bona fide loan and interest-free loans were taxed as disguised dividends.

proceeds where the taxpayer had borrowed $4,000,000 at 3 percent interest for an eight-year term when the market rate of interest was 6 percent. The interesting thing about the *Greenspun* case is that two judges did not participate in the decision and there were two concurring opinions and one dissent with one judge simply concurring in the result. The *Greenspun* case shows that the court is reluctant to legislate and ignore the *Dean* case in view of its history. Most members of the court, however, can see distinctions which would give rise to different results even in the noninterest loan situation. Significantly, the court discussed the *Dean* case. There, the rationale had seemed to be that there was no taxable income on the interest-free loan because interest paid by the borrower would have offset interest income. That rationale which has been questioned is now not seemingly the present opinion of the court. The court refers to the fact that had the taxpayer used the proceeds of the interest free loan to invest in municipal bonds, the result would have been different. The *Greenspun* case was decided August 28, 1979, and shortly thereafter two more cases were decided by the Tax Court. September 5, 1979, *Zager* (72 T.C. No. 82 (1979)) reaffirmed the *Dean* case and held that an interest free loan from a corporation to the dominant shareholder-officer was not taxable income in express reliance upon *Dean* and following the principle of *stare decisis* as had been discussed at length in the *Greenspun* case. On September 25, 1979, the *Creel* case was decided. *Creel* (72 T.C. No. 97 (1979)) had one of the new developments which has been adverted to in earlier litigation but is now clearly a danger signal to many persons who seek to utilize interest-free loans as tax avoidance devices. The Tax Court again held that an open account interest-free loan from its wholly owned corporation to the stockholders was not taxable income. In one case, however, it was held that to the extent that the corporation making the loan had borrowed money and paid interest, the loan and interest were respectively borrowed and paid on behalf of the taxpayer and the petitioners were deemed to have realized income and were deemed to have paid interest by virtue of that transaction. This decision that the corporation is acting as an agent for the stockholder-employee is one which has been discussed widely as one of the problem areas. There is reason to believe that that doctrine will create a whole new rash of litigation. Any time that a taxpayer making an interest-free loan has or changes loans he or it may raise questions of whether the lender is merely acting as the borrower's agent and whether the loan is really to the borrower or of the nominal lender from some outside person. Take the simple case of a parent who borrows money at the bank and pays bank interest rates. If the parent should later lend a child money without interest to go to school, is the doctrine now going to be that the loan to the child is really a loan by the child because of the fact that the parent has borrowed money at the bank whether or not that bank loan is directly connected with the loan to the child? It may be that a distinction can be made between an attempt by the child to borrow money, unsuccessfully, followed by the parent borrowing the exact same sum the child sought and lending to the child interest free. That, of course, is a question which will have to be decided by future ligitation.

It would appear that the Tax Court is attempting to force the Internal Revenue Service to go to Congress to get the rule changed in the *Dean* case. Certainly, that is the tenor of all of the opinions in the *Greenspun* case. Moreover, the Court has made it clear that in the interest-free loan by a corporate employer to an employee, the court views the interest-free loan as simply one facet of the whole fringe benefits problem. Accordingly, the court has suggested that the solution to the interest-free loan by an employer will be found in the legislation to be written dealing with fringe benefits. Certainly, if new legislation should come out dealing with the fringe benefit area and there is nothing in it dealing with interest-free loans, it would be safe to assume that the Court is going to adhere to the *Dean* doctrine.

In connection with the question of whether interest-free loans give rise to constructive income, there has been some litigation involving the question of whether the loan gives rise to income to the *lender.* It has been held, however, that a corporation that lends money interest free to its shareholders does not itself receive interest income.[18] And expanding upon that concept, it has been held that imputed interest accrues to a lender only if a right to interest actually comes into existence and when there is not intention to create a liability for interest.[19] It would seem, however, that the area of interest-free loans is a mine field through which taxpayers must tread with caution. There is a clear line that can be followed which is the expressly similar facts of the *Dean* case. But anything that departs from that is done at one's own risk. In addition, in light of the fact that it is necessary to be clear when one is dealing with the question of imputed income, it would also be necessary to keep accurate records and to clearly document exactly what the transaction is.

The *Greenspun* case was interesting because it indicated that despite the fact that the parties did not document their cases strictly in accordance with the facts but attempted to disguise the transaction, the Court nevertheless held that the bargain interest element received by the borrower was not income under the *Dean* case. It is interesting to speculate, however, whether the same standards have been applied to the taxpayer in *Greenspun*, as might be applied in other situations where it appears the taxpayers have attempted to backdate documents or to otherwise hide the true transaction. In any event, even though *Greenspun* seemed to condone conduct which was questionable, it would be inadvisable for anyone dealing with the question of interest-free loans not to do his planning in advance and to avoid the pitfalls which would surround backdating documents.

[5] Planning Opportunities

The noninterest demand loan is an economic advantage which conveys to the borrower future benefits, whether those benefits are the ability to use the funds or the income from the funds. The non-interest-bearing loan also has benefits to the lender in that the

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[18] *Combs Lumber Co.*, 41 B.T.A. 339 (1940); *Brandtjen & Kluge, Inc.*, 34 T.C. 416 (1960) (A., C.B. 1960–2, 4).

[19] Ross v. Comm'r, 169 F.2d 483 (1st Cir. 1948).

lender can effectively reduce his or her estate in an individual estate planning situation since the loan immediately puts a limit on future growth in value of assets. In addition, the non-interest-bearing loan has a degree of advantages as a bargaining tool between employee and employer in the whole area of fringe benefits. A distinction should be made, however, between those opportunities for planning where there is less-than-arms-length bargaining such as a loan between a parent and child, and those transactions where the loan may be the product of arms length bargaining. Five of the judges in *Greenspun* expressly stated that they did not agree with the original rationale of *Dean* in saying that the loan was not resulting in taxable income because if you imputed interest income, you would also impute an interest deduction which would be a wash. These five Tax Court judges said that the issue should turn on application of the bargain purchase doctrine and whether or not the interest free loan in an employer-employee situation results in income should be determined by the bargain purchase doctrine, or by the application of statute and regulations if there is more clarity than presently provided by the law.

The *Greenspun* case did not deal with an employer-employee situation. In *Greenspun*, the lender was a wealthy individual and the borrower a newspaper owner. The purpose of the loan was for the lender to receive a favorable press from the borrower, which was the result. Both parties were benefited by virtue of a loan at 3 percent interest when the rate of interest in the marketplace was 6 percent and certainly the case could be made for the proposition that neither party earned income as a result of that transaction because it was bargained for exchange and the borrower simply obtained a bargain purchase. On the facts, however, if I were deciding the case, I would have decided that the taxpayer received income in the absence of the *Dean* case because it seemed apparent that the low interest loan was compensation for favorable editorial or other activities by the borrower on behalf of the lender. The court seemed influenced, however, by the fact that there was a sufficient uncertainty about the whole transaction, that it was not clear why the bargain interest rate was given because while it can be argued that the borrower rendered services in the case, the borrower argued and the facts certainly suggested that the borrower was getting a low-interest loan because the borrower had given to the lender an option to purchase certain real estate in the future.

There are many planning opportunities that one can speculate about, but very few in which there is certainty as to the tax results other than one that falls directly within the facts of the *Dean* case. It is possible to ask what happens if an employer corporation lends $100,000 interest free to a shareholder who turns around and invests the money in tax free municipals. Until the discussion in the *Greenspun* case, one might argue that such a transaction would permit the corporation to reduce its income (because it no longer has the income on the $100,000) and for the shareholder of the corporation to generate tax free income. Now, under the dicta in *Greenspun*, it is arguable that if the employer corporation makes an interest free loan to the shareholder who invests in tax free municipals, the shareholder will have received income.

Perhaps it is even wise to point out that it may well be that the economics are such that an interest-free loan is not in the best interests of the parties. Is the shareholder better off paying interest to his corporation, interest that is income to the corporation at 16 percent and deductible by the shareholder at 50 percent? Certainly it can be argued that at any time that the corporation has a lower tax bracket than the individual, if the individual owns the corporation, it may be better for the individual to pay interest on the loan (assuming, of course, that the interest does not cause the corporation to be a personal holding company or otherwise cause tax problems).

If the Service were successful in imputing interest to the lender, does that also entitle the borrower to an imputed interest deduction? If it does, then one might ask whether there is any risk to the borrower in an interest free loan. The imputation of interest income to the borrower would, of course, affect such limitations as the medical expense deduction and the charitable contributions deduction limitation. It would also raise the question of whether the interest is a constructive dividend and therefore not compensation eligible for the maxi-tax. If the imputed interest is also considered a dividend, then does it reduce the earnings and profits of the corporation? Obviously, the complexities caused by creation of imputed interest without legislative guidance is something that justifies the decision of the court to leave the *Dean* case alone.

Another troublesome question in the corporate situation where an interest-free loan is made to the stockholder, is the question of whether such a loan is not conclusive proof of a corporation unreasonably accumulating earnings so as to be subject to the penalty tax under Code Section 531. The $150,000 limit before that tax applies is probably some protection against the problem, but in the leading cases involving interest-free loans, that would not have been an answer and there have apparently been no cases dealing with the interest free loan as indicia of an unreasonable accumulation. However, it would seem pretty clear that under the case law, if there is cash accumulated in a corporation that has accumulated earnings and the corporation lends the funds to a stockholder, the corporation cannot argue that it has reasonable needs in the business.

§ 36.03 HISTORY OF ESTATE AND GIFT TAX ASPECTS OF INTRA-FAMILY TRANSFERS BY INTEREST-FREE LOANS

[1] Internal Revenue Service Policies

The first case dealing with the problem of estate and gift tax aspects of interest-free loans was *Johnson v. United States.*[20] In that case, the taxpayers made interest-free loans to their children; the court held there was no gift since there was ". . . no legal requirement, express or implied, to charge them interest on money advanced to them. . . ." The court relied in part upon the fact that the children of wealthy parents had used the loans to earn money

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[20] Johnson v. United States, 254 F.Supp. 73 (N.D.Tex. 1966).

and repaid almost the entire amount loaned during their father's lifetime.

Revenue Ruling 73-61 (C.B. 1973-1, 408) sets forth the Service's view of the gift tax treatment of intra-family, interest-free loans. When the loan is for a specific term, there is an immediate gift of the actuarial value of foregone interest; and when the note is a demand note, there is a gift in each quarter for the interest forgiven that quarter.

Those views that were set forth in Revenue Ruling 73-61 were the ones litigated in the *Crown* case.

[2] Statutory Developments

There has been no significant change in the last 50 years in the statutes relating to estate and gift tax as it relates to transfers of economic advantage by interest-free loans. The gift tax continues to be an excise tax on transfers. Presumably, if there is no transfer subject to gift tax, the 1976 Tax Reform Act changes concerning transfer taxation, generation-skipping tax, and contemplation of death transfers, and other changes are not relevant.

[3] Cases of Significance

There are many cases that deal with various aspects of transfers of economic advantage between parent and child. For example, a mother's sale of assets to the children for a note of less value than the assets results in a gift.[21] A father who loaned $110,000 to his son at 2 percent interest made a gift when he later forgave the interest.[22] A mother made taxable gifts to her son by letting the statute of limitation run on loans previously made to him.[23] Parents who exchange stock for an annuity from their children made a gift where the annuity was worth less than the stock.[24] A mother

[21] *Gertrude H. Blackburn*, 20 T.C. 204 (1953).

[22] Republic Petroleum Corp. v. United States, 397 F.Supp. 900 (E.D. La. 1975).

[23] *Estate of Lang*, 64 T.C. 404 (1975).

[24] *Estate of Lloyd Bell*, 60 T.C. 469 (1973).

makes a taxable gift when she transfers a partnership interest to her son where what she receives is worth less than the partnership interest.[25] And, transfers by a guardian from the ward's estate to relatives are taxable gifts.[26]

Not all transfers between related parties where there are differences in economic advantage between the transferor and the transferee result in gifts, however. For example, a transfer and settlement of a family dispute is not a gift.[27] A transfer in settlement of a will contest is not a gift.[28] A transfer in settlement of a dispute by retracting a prior gift is not a gift.[29] And, there is no taxable gift where a father's *good faith* sale to his son at $10 per share of stock was below the value of $13 per share.[30] Nor was there a taxable gift at the time of sale where the mother sold assets on the installment basis with the intent to forgive payment of installments in the future.[31] And, there was no taxable gift where there is a a sale on the installment basis and the father forgives his son's notes without payment as they come due.[32] Finally, there is no gift where there is a sale by the grantor to children's trusts of stock worth $16 a share at a price of $1.25 per share under a written contract, saying if the fair market value of the stock is increased by the I.R.S., the sale price will be increased.[33]

[4] Effect of Integrated Transfer Tax

The 1976 Tax Reform Act did not specifically deal with gifts caused by an intra-family transfer of future benefits pursuant to an interest-free loan. It is possible to argue that because the estate and gift tax were extensively reviewed for purposes of the 1976

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[25] *Estate of Campbell*, 59 T.C. 133 (1972).

[26] Rev. Rul. 73–612(C.B.1973–2), Rev. Rul. 57–280, (C.B. 1967–2 349).

[27] *Estate of Gertrude Friedman*, 40 T.C. 714 (1963).

[28] Righter v. United States, 258 F.Supp. 763 (W.D. Mo. 1966), *rev'd on other issues* 400 F.2d. 344 (8th Cir. 1968).

[29] *Catherine Beveridge*, 10 T.C. 915 (1948).

[30] *Morris M. Messing*, 48 T.C. 502 (1967).

[31] *Selsor Haygood*, 42 T.C. 936 (1964).

[32] *Estate of J. N. Kelly*, 63 T.C. 321 (1974).

[33] King v. United States, 545 F.2d 700 (10th Cir. 1976).

Tax Reform Act and that Revenue Ruling 73–61 had covered the questions, the reenactment of the law (when the 1976 Tax Reform Act was enacted) would constitute an endorsement of the position of the Internal Revenue Service. However, the *Crown* case was decided after enactment of the 1976 Tax Reform Act and the court did not draw any significance to the issue from the enactment of the 1976 Tax Reform Act.

§ 36.04 THE *CASE OF CROWN v. COMMISSIONER*[34]

[1] Characteristics of the *Crown* Case

The *Crown* case dealt with non-interest-bearing demand promissory notes written and delivered in a situation where the records were adequate to construct exactly what happened. The issue was clearly set forth by reference to the policy adopted by the Service in Revenue Ruling 73–61 and the court in an opinion reviewed by the court with four dissents expressly held that Revenue Ruling 73–61 was incorrect and held that the non-interest-bearing demand promissory note did not result in a taxable gift. The court placed great stress on the fact that there was no value different from the face and stressed that the Service failed to produce any evidence that demand notes traded for less than face value. Thus, the court adopted the relatively clear concept that since the non-interest-bearing promissory note did not in any way reduce the estate of the lender, there was no taxable transfer.

[2] Estate Planning Implications

Many ideas can occur to you when you stop to think that a transfer of economic advantage in the form of a demand non-interest-bearing promissory note does not result in a gift. For example, the children's interest-free loan to their father to pay gift tax on a gift of stock of the business relieves the father of need to liquidate assets to pay gift tax. The loan is in turn treated as a debt

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[34] Crown v. Comm'r, 67 T.C. 1060 (1977), *nonacq.*, *aff'd* 585 F.2d 234 (7th Cir. 1978) (decided 11-4 by the Tax Court; decided 2-1 by the Seventh Circuit).

of father's estate even though the loan is not in writing.[35] In this case, there is ample evidence of the fact that the interest free loan to the father is intended as a loan because it is carried on the books of the father as a debt and on the books of the children as an asset.

Certainly with the *Crown* doctrine, it is arguable that instead of giving outright to parents, one should make a demand interest-free loan. This would give the parents the lifetime use of the money and income from the investment. The lender will not be subject to tax on the income and the lender will be repaid from the estate without tax since the estate will simply be paying a debt of the decedent. While this scenario seems beneficial, whether it is beneficial would require separate analysis in each estate.

The use of interest-free loans in lieu of a short-term trust under Code Section 673 appears to permit elimination of gift tax usually incurred on the value of the income interest when the trust is created.[36] Thus, if the *Crown* doctrine holds up, it is arguable that it is always better to make a demand interest-free loan than it is to use a short term trust.

In planning situations, a transfer of money in a close family situation is presumed to be a gift.[37] Therefore, a written promissory note and proper bookkeeping by both parties is recommended. The presumption that such a transfer is a gift arises from the fact that it literally falls within the statute and case law. Unless it can be established that there was in fact an intent to repay, as evidenced by proper record keeping, the Service clearly has the presumption of correctness in its favor in any dispute.

In dealing with the use of non-interest-bearing loans, it is important that the note expressly state it is without interest to eliminate those situations where local law may impute interest. In other words, while not in all states, some states provide that there is imputed interest by local law and if that were the state doctrine, then the Service would correctly argue that what purports to be

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[35] Estate of Elkins v. United States, 457 F.Supp. 870 (S.D. Tex. 1978).

[36] Reg. § 25.2511-1(h), example 7.

[37] *Estate of Ames*, 5 T.C.M. 73 (1946); *Jacob Grossman*, 9 B.T.A. 643 (1927);

a non-interest-bearing loan is in fact interest-bearing because of local law.

The greatest planning opportunity with respect to non-interest-bearing loans is exemplified by the *Crown* case where parents in high tax brackets can lend money to children in low tax brackets and the children use the money to earn income. Thus, there is a very easy device for transferring income to lower tax brackets. The planning opportunities surrounding such transfers between family members is obvious. In fact, "transfers of income" by interest-free loans can be used to support parents, to provide support for children in school or to purchase a home or business. Any place where property might be transferred by gift, the alternative of an interest-free loan should be considered. The danger, of course, is if the lender has borrowed at interest the funds to make an interest-free loan, the two transactions should not be closely related. Otherwise, one runs the risk that the interest-free borrower is considered the true borrower from the commercial lender, and the intermediate lender has, by assuming the interest expense, made a taxable gift. In the *Creel* case discussed above, dealing with the income tax aspects, the court readily adopted the imputed interest argument and treated the lender as agent of the borrower where the lender made a commercial loan and then turned around and made an interest-free loan to the borrower.

[3] Economics of Interest-Free Loans

In *Crown,* three brothers caused their business to lend $18,000,000 to fifteen children. At 6 percent interest, the value of the gift was $1,086,408 by calculating daily interest on the loan balance. Thus, it is obvious that interest free loans can involve the transfer of substantial amounts of economic wealth. In *J. Simpson Dean,* the shareholders borrowed $2,000,000 interest free from their corporation. Small transactions with interest of $3,000 to $6,000 per year will probably be ignored for gift tax purposes because of the annual exclusion and split-gift or community property effectively eliminating gift tax liability. Therefore, the real question from an economic standpoint is whether as in the *Crown* case, there is sufficient transfer of economic wealth that it is worth litigating the question or whether smaller transactions are justified if it is known that the policy of the Service is as set forth in Revenue Ruling 73–61. In other words, the economics of interest-free loans have to be determined on the basis of the cost of litigation.

[4] The Case of *Estate of Meyer B. Berkman* (T.C.M. 1979–46)

Where the rate of interest and length of maturity must be considered in determining the full market value of a loan, there is a gift if the note is on terms less than those required in the market place.[38] In *Estate of Berkman*, loans of $275,000 were made over four years evidenced by five 20-year unsecured promissory notes bearing 6 percent interest (when a bank loan was available at 7 percent). The bargain interest element was a taxable gift even though the lender was to receive more interest income from his children than the lender had been earning. The court held the loan was valid, but was less than arm's length under Regulations Section 25.2512–8. Other factors relied upon were that the lender was age 75 when he began making the loans due in 20 years; that the notes were unsecured and required no principal payment until maturity; that the borrowers were the lender's children, and that his daughter was bequeathed one-half of the notes on which she was debtor.

Letter Ruling 7905090 recently ruled that a note at 6 percent interest when the market rate was 9 percent resulted in a gift of the present value of the difference. The ruling stated that in addition to interest rate and term, the Service would look at the adequacy of security and the financial responsibility of the maker.

[5] Estate Planning Implications

A transaction which can be construed to be anything other than an unsecured demand non-interest-bearing promissory note will probably have a market comparison that will result in gift tax. If

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[38] *Gertrude H. Blackburn*, 20 T.C. 204 (1953).

the taxpayer makes a term loan at market and later the loan turns out to be advantageous, will the Service seek to tax? Should there be an escape clause? The answer to such questions lies in the economics of litigation. If the transactions are large enough and the loan becomes clearly advantageous, or if the loan is made at a market rate to a person who would not otherwise qualify as a lender from a commercial borrower, then we again get into the gray area of whether there is a taxable gift. The problem is no different from the question of whether the guarantee by a parent of a child's loan at the bank is a gift. Say the child borrows the money at low market rates based upon the security of the parents guarantee when the child alone would pay higher interest. This is clearly a transfer of an economic advantage and can lead to the child realizing substantial income and an economic situation not unlike a non-interest-bearing demand note. Here, however, you get into the question again of whether a guarantee is a transfer of assets of the guarantor. It would seem clear on its face that the guarantor has not reduced his or her estate by virtue of the guarantee and no transfer has occurred. Clearly, in the guarantee situation, the parent has transferred nothing. If the gift tax is truly a transfer tax, then it would seem that there has been no gift and the taxpayer should simply use the guarantee route wherever there is concern about the use of a non-interest-bearing note.

[6] Economics of Term Loans and Valuation Problems

Term loans that are made in an intra-family transaction will be compared with commercial loans for valuation purposes by the Internal Revenue Service. The cases are silent on what notes are truly comparable for valuation purposes. It may be that the size of the gift can be reduced by techniques that will maximize the value of the note given by the family donee. The use of experts for valuation at the time of any substantial term loan is recommended.

Valuation problems may also be minimized by having the maker of the note find available lenders outside the family group such as credit unions or other agencies which will make less expensive loans available to the borrower to reduce the value of the gift.

§ 36.05 INTRA-FAMILY TRANSACTIONS OTHER THAN LOANS

[1] Installment Sales of Assets Without Interest

The sale of assets on credit without interest is treated under the *Berkman* doctrine, discussed above, rather than the *Crown* case. But in light of *Crown*, it may be helpful to restructure transactions so that the buyer of high basis assets pays a small down payment and delivers an unsecured, demand non-interest-bearing promissory note instead of a secured, fixed-term installment note. If the buyer gives an installment note without interest, Code Section 483 will create imputed interest income for the seller. Whereas, if the buyer simply delivers an unsecured demand non-interest-bearing promissory note, it would seem under the *Crown* case that there is no imputed interest.

H.B. 3899, 96th Congress, 1st Sess. (1979), would now apply special tax treatment to intra-family installment sales and deny the seller the right to an installment election under Code 456. Therefore, under this pending legislation, it is arguable that any tax benefits to be realized from installment sales of assets among family members may be barred.

[2] Transactions Involving Business Relations

The tax results continue to be uncertain where there is a bona fide business transaction between family members because of the problems of proof. The Service seems to always assume that transactions among family members are done for the purpose of avoidance of tax and therefore, wherever there are transactions which involve non-interest-bearing loans or transfers of future economic advantage, it is always prudent to document the transactions carefully.

§ 36.06 CONCLUSION

The interest-free loan is an advantage that will be abused and it is reasonable to expect the Service will propose gift tax regulations to impose a tax. In the *Crown* decision in the Seventh Circuit, the court expressly noted that the result of the *Crown* decision might be different if there were gift tax regulations. The court stated that it was not passing on whether such regulations would be valid.

The characteristics that are required for *Crown* type treatment include:

(1) A bona fide debt (preferably in writing) and on the books of account of the parties if they maintain books;

(2) A demand obligation;

(3) Expressly precluding interest.

The attempt to tax intra-family transfers of economic advantage can lead to poor tax administration and to a poor tax system where there is a "cost basis income tax system" and a gift tax based upon the transfer of the fair market value of the asset at the time of transfer. The virtue of the *Crown* case and *Dean* doctrine is that there is relative certainty of result and administration of the tax laws is easier. The argument that *Crown* is a loophole is misplaced because all families make free loans and free use of assets and a tax system that attempted to tax such transactions selectively would be inequitable and would create an administrative morass.

STATEMENT OF

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BEFORE THE

SUBCOMMITTEES ON ESTATE AND GIFT TAXATION

AND TAXATION AND DEBT MANAGEMENT

OF THE

SENATE FINANCE COMMITTEE

ON PROPOSED LEGISLATION REGARDING

PROSPECTIVE APPLICATION OF

DICKMAN V. COMMISSIONER

April 12, 1984

SUMMARY OF POINTS

1. A retroactive application of Dickman is unfair. Application of the Dickman ruling to pre-1984 loans of property, on an interest-free or below-market rate of interest basis, is unfair to taxpayers who either (i) failed to realize they were making gifts, or (ii) planned their gifts in reliance on pre-Dickman law.

2. Dickman changes the law. The Dickman ruling is a change in the law which should be given prospective application only.

3. Lending taxpayer worse off than if he had made cash gift. A taxpayer who made an interest-free loan in reliance upon pre-Dickman authority is in a worse position now than if he had not made the loan or had made a gift of cash instead.

4. A retroactive application of Dickman will erode taxpayer respect for the way our tax laws are administered.

   (a) Retroactive application of Dickman erodes confidence in the predictability of the administration of the tax laws;

   (b) Retroactive application of Dickman will necessarily be selective, which will erode confidence in the equitable application of the tax laws;

   (c) The very small increase in revenues expected from the retroactive application of Dickman is far outweighed by the erosion of taxpayer confidence in the equitable and predictable administration of the tax laws. This is particularly important at this time when the merits of our self-assessing tax system are being questioned ever more severely by increasing numbers of taxpayers.

My name is H. Randolph Williams. I am an estate planning attorney with the Chicago office of the firm of Baker & McKenzie. I serve on the Section Council of the Estate Planning, Probate, and Trust Law Section of the Illinois State Bar Association, but I hasten to add that I am not authorized to, nor do I purport to, speak on behalf of that group today.

Prior to 1978, I was a partner in a Topeka, Kansas, firm where I was engaged in an estate and tax planning practice and taught Agricultural Law and Tax Planning for Agriculture at Kansas State University. I mention this personal history to indicate that my remarks are necessarily based upon experience as an advisor on estate and gift tax matters in both an urban practice and a practice including a fair number of farmers and other closely-held business owners.

Introduction

On February 22 of this year, the Supreme Court held that a loan of valuable property, repayable on demand, may result in a taxable gift having been made by the lender (Dickman v. Commissioner, 52 U.S.L.W. 4222). That taxable gift is made, according to the Supreme Court, on a continuing basis as the lender chooses neither to (i) retrieve the loaned property for his own use, nor (ii) make an appropriate charge to the borrower for the use of that property. This one judicial decision now gives the Internal Revenue Service the vast and disruptive power to review transactions made over fifty years ago (back to the very inception of the gift tax) and to find that taxable gifts had been made during all those ensuing years. Furthermore, such power creates continuing uncertainty in a taxpayer's obligation to report future gift and estate tax liabilities.

Thus, the fundamental reason for not applying Dickman retroactively is that the United States government should play fair with its taxpayers (a very important consideration in view of the fact that our government at the present time is crying out, and rightly so, that too many of its taxpayers are not playing fair with the government).* For many years court decisions have consistently held as a matter of law that an interest-free loan does not give rise to a taxable gift. Finally, in 1984, the Supreme Court decided to the contrary, reaching its decision by making, as explained more fully below, a new interpretation of the law.

Certainly it runs counter to the traditional concepts of fairness in administering, enforcing and legislating our Federal tax laws to make the impact of such a basic change in the law retroactive in effect. It is only human nature to resent having the rules of the game changed after the game has been played. Conversely, a change in the law which says you can keep what you have won or deserved under the prior law--but as to the future you have to change your tune and pay up is basically acceptable. While such newly imposed tax obligation may not

* Murray, Cheating Uncle Sam: IRS Is Losing Battle Against Tax Evaders Despite Its New Gear, Wall St. J., Apr. 10, 1984, at 1, col. 6.

be assumed with relish it simply does not engender the same smoldering and long lasting resentment which attaches to "retroactive revenue grabs." And, from the government's point of view, since so little revenue is involved in the present matter, its retroactive reach cannot be justified on revenue grounds. When the minor loss of revenue is measured against the large amount of taxpayer ire and resentment against retroactive changes of the type envisioned, it is clear that wisdom militates against retroactivity.

One other point regarding the basic unfairness of applying Dickman retroactively deserves mention. This has been the exacerbation of the situation by the lethargic manner in which the Internal Revenue Service has sought to obtain a judicial declaration that supported its interpretation of the law. It seems readily apparent that the fairer approach under such circumstances is not to require the taxpayer to pay for this style of administration by settling accounts retroactively back to the beginning of gift tax time, but rather to clean the slate for everyone by applying the finally and newly defined gift tax theory on a prospective basis.

Other speakers at these hearings have made some of the foregoing fairness arguments in greater depth and I will say no more about them--except to stress their underlying if not overwhelming importance to a proper disposition of the non-retroactiveness of Dickman.

In addressing the concerns of the Subcommittees outlined in the March 29, 1984 press release, however, I would like the Subcommittees to consider the following two fallacies that emerged during the earlier phase of these hearings: (1) The Dickman decision is not a change in the law and should have been expected by any well-advised taxpayer, and (2) A taxpayer who planned a transaction in reliance on pre-Dickman law is in no worse position by the retroactive application of the case than if he or she had given cash instead.

Fallacy No. 1--Dickman Does Not Involve a Change in the Law

The basic problem with which the courts have concerned themselves has been whether an interest-free loan was a transfer of value of the type intended to be encompassed by § 2501(a) of the Internal Revenue Code, namely the "transfer of property by gift." The answer to this legal question in Crown* was an unequivocable "no."

> To characterize the mere use of property as a transfer of a property right implies a broader concept of what constitutes a property right under the gift tax laws than has heretofore been recognized. (Crown v. Commissioner, 585 F.2d at 240, emphasis added.)

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

Moreover, before Dickman, reasonable minds were not in accord that Crown would inevitably be overturned. The Crown and Johnson* results had, indeed, been critized as being contrary to economic reality and improper as a matter of tax policy. In fact, both of those opinions recognized that a gratuitous transfer of economic value occurs in an interest-free demand loan. However, reviewing the legislative history of the gift tax law, the Court in Crown concluded that a taxable "property interest" must be one which is "protected by law" and has "exchangeable value." The Court found no existing legal authority to even suggest that the recipient of a loan payable on demand has a legally protectible interest vis-a-vis the lender, nor that the borrower's interest under such a loan has an exchangeable value.

The Supreme Court abandoned such a traditional analysis of property rights in favor of an economic analysis that the gift tax law is broad enough in scope to include such a "plainly valuable right" within taxable transfers of property. While the result may well be proper as a matter of policy and economic theory, the dissenting opinion, in which Justices Powell and Rehnquist joined, call it a "new reading of the statute" which should have been made by Congress. (Emphasis added)

It is curious that the Treasury ignored the calls for legislative action made by the Crown and Johnson courts. In the course of

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* Johnson v. U.S., 254 F. Supp. 73 (N.D. Tex. 1966).

these hearings, it has been suggested that that is because Treasury did not feel the statute needed amendment simply because the courts were misinterpreting the law. Why, then, is a comprehensive income tax treatment of interest-free or low-interest loans necessary, such as the one proposed in §176 of the Deficit Reduction Tax Bill of 1984 simply because a number of circuit courts have ruled in favor of the taxpayer on this issue?

It is to this day impossible to accurately advise a client of the current law, even with the benefit of Dickman. For example, the important matter of valuing the gift resulting from an interest-free demand loan is still undecided. Over the history of the litigation, at least three distinct valuation methods have been suggested. The end result of the holding in Dickman is to remand the case for such a determination. Furthermore, the Dickman opinion indicated that the Internal Revenue Service would be expected to apply its holding in a reasonable manner, an aspect of the opinion with which the dissent took great issue. As a result of that admonition, these Subcommittees have been advised that the Internal Revenue Service intends to formulate a de minimis rule for the application of these principles to prior gifts. Both the undetermined value issue and the administrative de minimis rule have important effects upon the current and future gift and estate tax reporting obligations of taxpayers, some of which reports must be made within the next week.

It is respectfully submitted that the Congress must recognize, for reasons of underlying fairness as well as for the rational administration of our Federal tax system, that Dickman involves a fundamental change in the law governing these transactions. The case represents more than the settlement of a long-standing controversy. If respect for our self-assessment system of taxation is not to be further undermined, then taxpayers who planned their affairs in reliance on the state of the law as it existed prior to the Dickman change should be protected just as they would have been had the change been made legislatively.

Fallacy No. 2--A Taxpayer Relying on Crown Has Nothing to Lose

It has been asserted that a taxpayer making an interest-free loan prior to Dickman is in no worse position than if the loan had not been made and cash had been given. It is suggested that (i) he was able to shift the income to the donee-borrower; (ii) the payment of gift tax has been deferred; and (iii) interest payable on the the gift tax liability is merely compensation for the use of those funds the taxpayer has enjoyed in the meantime.

This analysis, of course, ignores penalties that may be applicable to the taxpayers under Chapter 68 of the Internal Revenue Code for failure to file a tax return or to pay a tax. Even more significant is the fact that this analysis assumes that any income earned by the funds loaned would equal or surpass whatever discount rate is finally used to value the loan for gift tax purposes. Thus, the taxable gift will not exceed the amount by which the estate would have increased had the loan not been made. For example, if the statutory interest rates under §6621 were used as a basis for calculating the value of the gift, the donee-borrower of the funds should have earned income of 19.33% on the borrowed funds in 1982. Otherwise, the taxable gift would be proportionately greater than the estate tax base eliminated by the loan. While such a return on the funds might be expected if the funds were invested in money market instruments, such would probably not be the case with other loans, particularly loans of property. For example, Illinois farm property could be expected to return income at the rate of only 2% to 3% of its value annually. It is difficult to see how such a taxpayer could be considered to be in no worse position than if he had not made the loan.

Recapitulation of Policy Considerations--Respect For Our Self-Assessing Tax System will be Lowered if Dickman is Applied Retroactively

The policy implications of the retroactive application of the Dickman decision, other than the unfairness inherent in its application to a taxpayer who relied on the prior state of the law in his or her planning, cannot be overemphasized. Hence, this recapitulation of some of the thoughts expressed above.

A great strength of the United States tax system has always been its self-enforcement nature. This depends upon the honesty of the taxpayers which, in turn, depends upon each taxpayer's confidence in the predictability and fairness of the administration of that tax law. The fact that many taxpayers will be caught unaware by the Dickman ruling, and that many others will consider themselves to be trapped by a change in the law, will serve to erode taxpayer confidence in both the predictability and the fairness of the administration of the tax laws.

Furthermore, because the enforcement of gift tax liability on pre-Dickman interest-free demand loans will admittedly be sparing, even beyond any de minimis rule prescribed by the IRS, taxpayers will be encouraged to report such prior transactions selectively. There will be those, obviously, who seek competent advice and follow it in the completion of subsequent gift and estate tax returns, and those persons will be at a disadvantage vis-a-vis others who choose either not to seek advice, or to disregard the law. All of these factors tend to add to an unfortunate notion of inequitable administration of the tax laws.

At no time during these hearings has the revenue effect of the retroactive application of Dickman been estimated. In fact, it has generally being conceded by witnesses for both points of view that the total revenue increase will not be great. If so, it is again respectfully submitted that the Treasury has much more to lose by eroding taxpayer confidence in the equitable and predictable administration of the tax laws than it has to gain in additional revenue from the selective and retroactive enforcement of Dickman.

HRW/ckw

Chamber of Commerce of the United States of America

Washington

STATEMENT
on
UNITED STATES SUPREME COURT DECISION
DICKMAN v. COMMISSIONER AND
INTEREST-FREE LOANS
for submission to the
SUBCOMMITTEES ON TAXATION AND DEBT MANAGEMENT
AND ON ESTATE AND GIFT TAXATION
of the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
David B. Franasiak
April 5, 1984

The Chamber of Commerce of the United States welcomes the opportunity to submit testimony on the situation created by the U.S. Supreme Court Decision of Dickman v. Commissioner and the recently proposed codification of this decision, Section 176 Deficit Reduction Act of 1984.

The use of low-interest or interest-free loans is a regular business practice, but touching our small business community particularly. The impediment of their use would remove a means of smoothing out cash flow problems, providing financing, compensating deserving employees and attracting new employees.

RETROACTIVITY OF THE DICKMAN DECISION

The U.S. Chamber of Commerce urges that legislation be enacted to prevent the Internal Revenue Services (IRS) from applying the rule established in the Dickman case to loans that were made before the date of the Court's decision.

Until the Supreme Court handed down its decision in Dickman on February 22, 1984, taxpayers had reasonably believed that below-market loans did not have gift tax consequences. This was IRS's position for over thirty years (c.f. Rev. Rul. 55-713, 1955-2, C.B. 23) and when IRS first tried to impose gift tax on below-market demand loans in 1966, in the Johnson case, the court sided with the taxpayer. When IRS tried again in the Lester Crown case over ten years later, first the Tax Court, then the 7th Circuit, sided with the taxpayer. The government did not seek Supreme Court review.

Reasonably relying first on IRS's own actions, then on the courts, taxpayers have made low or no-interest demand loans to their children to purchase their first homes, to contiue their education, to acquire family farms and businesses, and for other purposes, without reporting these transactions on gift tax returns.

IRS now expects taxpayers to go back and determine the gift tax on all these loans. Taxpayers who filed a gift tax return for the year in which a loan was made are protected by the statue of limitations. However, there is no statute of limitations if no return was filed. Thus, many taxpayers are exposed to gift tax liability all the way back to 1932 when the gift tax was enacted. Wealthier taxpayers may have made gifts of cash, stock or other property in the year a loan was made and filed a return reporting these gifts. However, less fortunate taxpayers may not have been in the position to make other gifts and, therefore, would not have filed a gift tax return. Thus, the compliance burden that would be imposed by retroactive application of Dickman may fall most heavily on middle-class taxpayers, exacerbating the inherent unfairness of applying the rule retroactively.

TERM LOANS

We further urge that reconsideration be given to the treatment of low or no-interest term loans provided in section 176 of the bill.

Under the bill, a below-market loan would be treated as two transactions: A loan at a statuory interest rate and a payment by the lender to the borrower to pay the interest. This payment would be treated as a gift to the borrower in the case of a loan to a family member, a dividend in the case of a shareholder and wages in the case of an employee. The parties would be treated as if the payment were transferred back to the lender as interest, with the interest payments includible in the lender's income and deductible by the borrower in accordance with the usual rules governing the treatment of interest.

In the case of a demand loan, income and the total amount of deductions resulting from a below-market loan is determined on an annual basis. For each taxable year in which the loan is outstanding, the difference between the interest the borrower would have paid on a loan at the Federal short-term rate and the amount of interest actually paid is treated as if it were paid to the borrower and paid back to the lender as interest on the last day of the taxable year. Income attributable to the loan for the taxable year would be directly offset by deductions in many cases. To take a simplified example, if a $100 no-interest demand loan to an employee remains outstanding for two full years, and a simple 10% rate applies during the entire period, the employee would realize $10 compensation income per year. Assuming no restrictions on the deductibility of interest and the employee itemizes his deductions, the employee would have an offsetting $10 interest deduction per year. Similarly, an employer would have $10 interest income per year and an offsetting $10 compensation deduction.

In contrast, the proposed rules governing below-market term loans may result in serious and inequitable mismatching of income and expenses. Under the bill, the borrower would be treated as receiving at the time the loan is made the cash equivalent of all the interest he would have been required to pay over the life of the loan if the loan were interest bearing (discounted to present value and minus any interest actually required to be paid). In the case of a loan to a shareholder or employee, this deemed cash payment would be subject to immediate taxation as a dividend or compensation. However, interest would be imputed at a constant rate over the life of the loan as if the loan had original issue discount. Thus, the full amount of dividend income or wages attributable to a below-market loan to a shareholder or employee would be includible in income in the taxable year in which the loan is made, but the borrower would be required to spread interest deductions over the life of the loan.

The Senate Report states that this treatment of term loans "is consistent with the treatment of deferred compensation under section 83 which taxes transfers of property in connection with the performance of services when there is no substantial risk of forfeiture", p. 478. However, the treatment of term loans is proper by analogy to section 83 only if it is assumed that employers would otherwise make loans only if there were a front-end cash payment of a market rate of interest. However, it is just as reasonable to assume that payments of interest on a market-rate loan would be made ratably over the period of the loan.

This mismatch of interest income and deductions on below-market term loans may put such loans out of reach of many individuals, particularly employees. For example, many employers offer no/or low-interest housing loans as part of a standard compensation package or as an inducement for a prospective employee to relocate. Some employees may be unable to secure financing at the current mortgage interest rates. Others may have purchased their homes at a time when interest rates were substantially lower than now, and may be unwilling to assume a greater financial burden. A workable solution has been for the employer to provide long-term financing at a rate the employee can afford.

An employee who would otherwise retain a below-market conventional mortgage may be no better off than he was before. Under the bill, however, the employee would be treated as if he had received in cash the full amount of the "bargain" element of the employer-provided term loan in the year the loan is made. Thus, the employee may have a substantial increase in his taxable income and neither cash with which to pay the tax, nor offsetting interest deductions. The only alternative would be to take a demand loan, but then the employee would be at constant risk of foreclosure. Thus, the effect of the proposed treatment of term loans may be to force employees to choose between an onerous tax burden and the risk that the loan will be called. At the same time, the employer would have an immediate compensation deduction, but would be permitted to defer recognition of interest income.

To correct the unfair mismatching of income and expenses resulting from the proposed treatment of term loans, a deduction equal to the amount includible in income should be allowed to the borrower, or the imputed interest income should be spread over the period of the loan.

Finally, new rules governing the treatment of below-market loans would be effective as of the date of enactment with respect to all loans except term loans. The proposed exception for term loans would be effective with respect to loans made on or before February 1, 1984. The proposed treatment of below-market term loans would subject many taxpayers to unanticipated and onerous tax liability. While the Administration had published the general framework of proposals in this area, the details of the new rules were not publicly available until the House Report was published March 5. Moreover, it was only on April 4, 1984 that the Senate counterpart of the House bill was released. In view of this, it cannot be said that taxpayers have been on notice of the consequences of below-market loans and thus it would be patently unfair to apply this legislation retroactively.

CONCLUSION

We commend the Subcommittees on their interest in resolving the situation created by the Dickman decision and the proposed codification of this decision. We feel that the retroactive application of Dickman is an unfair burden to place on the taxpayer. Section 176 of the bill goes even beyond the Dickman decision and threatens the use of an important business tool, the interest-free term loan.

CITIBANK

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Stewart B. Clifford

April 16, 1984

Mr. Roderick DeArment, Chief Counsel
Senate Finance Committee
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

RE: Gift taxation of interest-free loans to family members

Dear Mr. DeArment:

As head of Citibank's Private Banking & Investment Group, I am writing to submit for the record our comments in support of gift tax legislative proposals providing relief from the recent Supreme Court's Dickman v. Commission decision in the case of interest-free demand loans between family members. As you know, the Senate Finance Committee's Deficit Reduction Act of 1984 includes a provision to apply the Supreme Court ruling prospectively. However, there are also efforts by legislators who support the Treasury Department's efforts to apply Dickman retroactively to which we are opposed for the following reasons:

- Although the IRS first litigated this issue in 1966, until the Supreme Court decided in its favor in 1984, the only other court ever to agree with the I.R.S. on the issue that the making of an interest-free demand loan was a gift for gift tax purposes was the 11th Circuit Court of Appeals, in 1982 (Dickman v.Comm. 690 F.2d 812 (CA 11 1982)). During that time, the I.R.S. lost in Federal District Court in Texas in Johnson v. U.S , 254 F. Supp. 73(N.D. Tex, 1966), the United States Tax Court in Crown v. Comm., 67 T.C. 1060 (1977), and the 7th Circuit Court of Appeals when it affirmed the Tax Court's Crown decision in Crown v. Comm., 585 F.2d 234(1978). The most recent decision against the I.R.S. on this issue was by the Tax Court in 1980, when it issued its original holding in Dickman, 41 T.C.M. 620.

- As Justice Powell noted in his dissent to the Dickman opinion, the gift tax provisions of the Internal Revenue Code were amended eight times in the period from 1966 to 1982, and no attempt was made to change the statute to provide specifically that interest-free demand loans should be treated as gifts.

- Retroactive relief has been provided by Congress in many similar situations in which there was a substantial area of uncertainty in the tax law which was resolved by a subsequent Supreme Court decision. For example, recently Congress granted retroactive relief to police officers as a result of the Supreme Court's decision in Comm. v. Kowalski, 434 U.S. 77, 1977, which held that meal allowances paid in cash to state troopers could not be excluded from the troopers' income because meals purchased with meal allowance funds were not "in kind" meals provided by the State.

- Depending upon the uses to which the borrowed funds have been put, there may be hardship or "forced sale" situations imposed upon borrowers whose loans are called. This will adversly affect middle income taxpayers especially, as the demand loan may have been used to start a business or to pay for a college or professional education, etc.

- Also, not granting retroactive relief will result in the imposition of a gift tax liability in situations in which a gift tax liability was completely avoidable, had taxpayers and their advisors not acted in good faith reliance on the decisions noted above. For instance, where the medical or tuition expenses of another are paid directly to the provider of these services, no gift tax liability results for donating funds for these purposes for tax years beginning after 12/31/81.

- The Treasury Department's proposal on the issue of retroactivity recognizes the myriad of administrative problems the attempt to apply Dickman retroactively raises, and deals with them primarily by providing de minimus rules of $100,000 and $50,000 for such loans made by married couples and single individuals, respectively. In effect, the IRS is seeking to enforce Dickman retroactively only where such enforcement will generate the greatest amount of revenue. Such selective enforcement of our tax laws is unseemly at best, and, at worst, simply provides an even greater incentive for those not otherwise wiling to come forward voluntarily to play "audit lottery."

For these reasons, we would favor legislation which, at the very least, would provide for a "grace" or "transition" period in which no, or low, interest rate loans could be called and/or restructured, and only such loans as are in existence as of a future date(e.g. 7/1/84), or which are made after that date, would be subject to these provisions.

Yours very truly,

Stewart B. Clifford

cc: The Honorable Daniel Patrick Moynihan

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April 6, 1984

Mr. Roderick A. DeArment, Chief Counsel
Committee on Finance, Room SD-219
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Sir:

CCH reports that you are interested in testimony with respect to certain interest free demand loans. Something certainly should be done concerning this situation. I have been concerned for quite sometime about the interference of tax laws with family affairs.

Let us suppose that a husband and wife have an only child who is a son. The son has an opportunity to buy a small business and everyone agrees that it is a rare opportunity. The difficulty is that the son does not have $40,000.00 to buy the business and does not have the collateral to secure a loan. In addition, interest rates are about 18%. The parents make to the son an interest free demand loan of the $40,000.00 and give the amount of the loan to their son over the next years as permitted by the Gift Tax Law. There is no way to enforce tax collection on the imputed interest simply because it is wrong and any fair-minded person knows that it is wrong.

However, the above situation is considerably different to establishing 18 trusts for grandchildren and loaning $1,000,000.00 to each trust interest free. Some sort of a ceiling on interest free demand loans would be appropriate, but Congress had better keep its hands off of the small family type operations such as mentioned above.

Cordially yours,

Fred L. Conner

FLC/ag

SUMMARY OF PRINCIPAL POINTS IN
STATEMENT OF
EDWIN S. COHEN
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
AND THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
CONCERNING GIFT TAX RELIEF LEGISLATION

April 12, 1984

1. In considering gift tax relief with respect to interest-free loans, Congress should also consider the gift tax status of payments of tuition and medical care, which Congress in 1981 legislation specifically provided should not be subject to gift tax if made after January 1, 1982.

2. The Service has taken the position that the 1981 legislation indicates a Congressional intention to impose gift tax on such payments made before 1982, if the donor is nôt under a state law obligation to support the individual for whose benefit the payments are made.

3. Since parents generally are not obligated under state law to support children over the age of 18 (or 21), payments of tuition or medical care of more than $3,000 ($6,000 in some cases) made by one relative for another before 1982, would frequently be subject to gift tax under this view of the law. If, as is likely in most cases, no gift tax return was filed, no statute of limitations will ever run and the gift tax could be asserted, with interest, at any time in the future.

4. Either the Treasury and the Service should take action administratively, or the Congress should provide by statute, that pre-1982 payments of tuition and medical care expense are not intended to be subject to gift tax, at least if the student or patient has no financial capacity to defray the expense.

STATEMENT OF EDWIN S. COHEN
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
AND THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
CONCERNING GIFT TAX RELIEF LEGISLATION

April 12, 1984

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling, of Washington, D.C.

The principal focus of these hearings has concerned gift tax liability with respect to interest-free loans made prior to the recent Supreme Court decision in the Dickman case. The tax bills now pending in the House and Senate provide rules for future periods, and the issue in these hearings concerns the rule to be applied for past years.

I call to the attention of the Committee that similar issue with respect to the effective date of gift tax rules exists with respect to tuition and medical expenses paid by one individual for another prior to January 1, 1982. That issue can affect hundreds of thousands of persons and will involve serious problems of administration and litigation unless it is resolved by administrative or legislative action.

Prior to the enactment of the Economic Recovery Tax act of 1981 ("ERTA"), the gift tax law exempted gifts of $3,000 from one individual to another, but contained no specific provision as to whether or not payments of tuition or medical care by one individual for another constituted taxable gifts. The 1981 Act provided that, effective January 1, 1982, the gift tax exemption was raised from $3,000 to $10,000, and in addition it specifically provided (§2503(e)) that, effective January 1, 1982, a payment of tuition or medical care should not be considered a gift for gift tax purposes.

This provision was inserted in the 1981 Act in the House of Representatives and accepted in conference. The House Ways and Means Committee bill stated in explanation:

> "In providing an unlimited exclusion for certain medical expenses and tuition, the committee does not intend to change the law that there is no gift if the person paying the medical expenses or tuition is under an obligation under local law to provide such items to the recipient." (Rpt. 97-201, p. 194)

The Internal Revenue Service is apparently relying upon this statement in the committee report and the fact that the 1981 legislation is effective January 1, 1982, to conclude that the Congress intended to impose gift tax liability for years prior to 1982 upon persons providing tuition or medical care for relatives if they are not under a state law obligation to support the relatives. Because the obligation of support has traditionally ceased when a child reaches age 21, and in many states, such as in my native state of Virginia, now ceases at age 18, parents who have paid tuition expenses are now faced with the possibility that for years prior to 1982 those tuition expenditures paid for children over the age of 18 (or 21) constituted taxable gifts, and if -- as is likely --

they filed no gift tax returns for earlier years, the gift tax liability will be open to assertion by the Service without any statute of limitations. Tuition costs, especially for graduate schools, will often have exceeded \$3,000, a year, and in any event must be combined with other transfers to the child in determining whether the \$3,000 exemption */ has been exceeded. Moreover, if the tuition payments in years before 1982 were gifts, they will ultimately increase the estate tax liability when the parent dies.

So far as I am aware, as an administrative matter, the Service has never heretofore asserted that the tuition payments for adult children are subject to gift tax, and no ccurt decision so holds.

A similar problem exists with respect to medical care payments made prior to 1982. My law firm is of counsel to the estate of a taxpayer who prior to 1982 made payments for medical care for his indigent mother-in-law who is now over 100 years of age, bedridden and helpless, with around-the-clock nursing and medical care in a nursing home. Because the 1981 legislation is by its terms effective January 1, 1982, and because the Service has asserted that the decedent was under no state law obligation to support his

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*/ The exemption would have been \$6,000 for married donors if their spouse had timely consented to treat the payments as having been made one-half by each.

mother-in-law, it has asserted that these payments for medical care represented taxable gifts, despite the fact that she had no financial capacity to make the payments herself.

I find it difficult to believe that the Congress ever intended to impose a gift tax upon a person who provides essential medical care to maintain the life of another person who has no financial means to provide the care for herself. Those payments do not represent a transfer of wealth from one person to another for which a gift or estate tax should be imposed. They represent simply an act of private charity, without which the patient would die or become a public charge.*/

Accordingly, I respectfully suggest that, as the Committee considers gift tax relief legislation, it give attention also to the problems which exist with respect to tuition and medical care expenditures made prior to 1982. The rules with respect to these payments prior to 1982 should be no harsher than those with respect to payments made thereafter. Otherwise, we will have hundreds of thousands of delinquent gift tax returns due from persons who prior to 1982 made payments for tuition or medical care on behalf of family members to whom under state law they owed no legal obligation of support.

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*/ No court decision holds that medical payments represent taxable gifts. A Service ruling in 1954 took the position that such payments were subject to gift tax (Rev. Rul. 54-343, 1954-2 C.B. 318), but the ruling does not state whether or not the patient had sufficient funds to pay for the medical care.

Perhaps, as Secretary Chapoton suggested before the Committee on April 4, 1984, with respect to interest-free loans, the Treasury and the Service might as an administrative matter announce that they will not pursue gift tax liability for tuition or medical care payments made prior to 1982, at least where the student or patient is indigent and unable to provide the payments out of his or her own funds. But unless some such relief is provided by administrative action, Congress should make clear that it did not in 1981 intend that the tax be imposed on such payments for years prior to 1982 any more than for future years.

UNITED STATES SENATE

COMMITTEE ON FINANCE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARING ON GIFT TAX RELIEF LEGISLATION

STATEMENT OF LARRY C. RABUN

DELOITTE HASKINS & SELLS

APRIL 12, 1984

My name is Larry C. Rabun, I am a partner in the Philadelphia office of the international accounting firm of Deloitte Haskins & Sells and am my Firm's partner-in-charge of the technical aspects of our estate and gift tax practice. I appreciate the opportunity to testify on behalf of my firm before you today.

We urge you to apply the U.S. Supreme Court decision in Dickman v. Comm'r prospectivly, because it is our belief that retroactive application of this decision will impose a substantial burden on many taxpayers and will not be in the best interest of our self-assessment system.

I summarize on the following pages my views on each of the questions raised in your press release.

QUESTION 1

What actual amounts of gift tax liability would be forgiven if the scope of the Dickman case were to be retroactively limited?

We are not in a position to provide you with an accurate estimate of the amount of gift tax liability involved in these cases. While the amount of tax obviously could, in some cases, be substantial, I am not aware of any data which could serve as the basis for a reasonable estimate of the total amount involved. However, given the fact that estate and gift taxes account for only a small percentage of total taxes collected by the U.S. Government, it would not seem that the total tax in question would have a major revenue impact.

QUESTION 2

What types of transactions would be provided relief by such legislation? Specifically, would the legislation largely apply to transactions entered into intentionally to avoid estate and gift taxes, or would it largely affect taxpayers who structured transactions as interest-free demand loans for non-tax purposes?

We strongly urge that legislation be passed to limit the application of Dickman to interest-free loans made after the date of the Supreme Court's decision, or at least to loans made after the 11th Circuit Court of Appeals decision in the Dickman case in the fall of 1982.

It has been our experience that most interest-free loans were made by taxpayers to help support their children or other relatives or to help them obtain an education, acquire a home or start a business. Surely, many taxpayers had to realize that the use of the interest-free loans might result in savings of some gift taxes inasmuch as this was the prevailing view of the U.S. courts until the Eleventh Circuit Court of Appeals' decision in Dickman. Nonetheless, most taxpayers entered into these transactions primarily for the economic benefits to be derived, not for the savings in gift taxes.

QUESTION 3 A.

What legal advice was typically given to taxpayers making interest-free demand loans? Specifically, were taxpayers advised of the IRS interpretation that interest-free loans were subject to gift taxes?

We assume taxpayers generally were advised by professional advisors of the Service's position after it announced its non-acquiescence in Johnson v. U.S., 254 F. Supp. 73 (N.D. Tex., 1966) in 1973. However, we further assume that taxpayers were advised that the Service had never won a case dealing with the gift tax consequences of interest-free demand loans. In fact, until the Eleventh Circuit Court of Appeals' decision in the fall of 1982, the Service lost every case which it litigated. For this reason, tax advisors and taxpayers had very strong grounds for believing that the Service's position was fundamentally incorrect.

QUESTION 3 B.

If so, were taxpayers advised not to file gift tax returns disclosing their transactions? Or, were taxpayers advised to consider filing gift tax returns in order to take advantage of the three-year statute of limitations or the six-year statute of limitations applicable where a return significantly understates taxable gifts?

As I indicated above, tax advisors and taxpayers had significant grounds for believing that there were no gift tax consequences to interest-free loans. This being the case, in all cases of which I have personal knowledge, tax advisors advised their clients that the filing of a gift tax return was not required for an interest-free loan. We believe that in most cases taxpayers were not advised to file gift tax returns unless there were other gifts involved in the years in question. Therefore, one could conclude that it is not the wealthy taxpayers who were otherwise required to file gift tax returns who will suffer from the retroactive application of Dickman, but rather the middle income taxpayer group who, not having filed returns, face possible tax assessments by the IRS on all open years.

Thus, it is worthy of note that taxpayers who have never filed gift tax returns are subject to examination by the IRS for all years since 1932. Such a possibility puts an enormous strain on the taxpayer compliance system upon which our tax structure is based. It is doubtful, for example, that sufficient records are still in existence to permit the proper determination of (1) whether any interest-free loans were made, and (2) if they were, the amounts loaned and the amount of gift involved.

QUESTION 3 C.

What is likely to be the effect of the Dickman decision, in the absence of legislation, on attorneys or tax advisors who counseled clients to make interest-free loans?

It is our opinion that taxpayers and their advisors had significant authority upon which to conclude that an interest-free loan did not result in gift tax consequences. Thus, we do not anticipate there would be any significant adverse effect on professionals who counseled their clients to make interest-free loans.

However, I should note that those individuals who seek help in complying with Dickman, if it is applied retroactively, will incur significant fees in determining what gift tax returns in fact are required and what their gift tax liability, if any, might be.

QUESTION 4 A.

What is the likely effect of retroactive legislation relief on the administration of the tax laws generally?

As you are well aware, the U.S. tax system is a self-assessment system. While income tax returns are generally required to be filed by the majority of taxpayers every year, this is not the case with gift tax returns.

In the income tax area, there are numerous reporting requirements to help insure taxpayer compliance, including information returns dealing with interest and dividends, K-1's from partnerships, W-2's indicating salaries from employers, etc. There are no such information returns dealing with gifts. Therefore, the Service has very little in the way of independent information to put it on notice as to the making of a gift. For that reason, the gift tax is even more dependent on voluntary compliance than the income tax.

To require taxpayers to file gift tax returns potentially as far back as 1932 is an overwhelming burden. It is difficult, if not impossible, to estimate how many taxpayers will voluntarily comply with such a directive. We believe that any requirement which results in taxpayes failing to comply, undermines the effectiveness of the entire voluntary compliance system.

QUESTION 4 B.

Is such legislation likely to increase the tax compliance problems caused by aggressive tax shelters, and taxpayers playing the audit lottery?

From 1932 until the Eleventh Circuit Court decision in the fall of 1982, taxpayers had significant reasons for believing that interest-free loans did not result in taxable gifts. There were no decisions to the contrary. Thus, while taxpayers were put on notice in 1973 with the Service's disagreement with the tax-free nature of interest-free loans, there was still sufficient authority to treat these transactions as gift-tax free.

We do not believe there is a correlation between (1) abusive tax shelters or taxpayers playing the audit lottery and (2) interest-free loans.

QUESTION 5

What administrative problems are likely to be faced by taxpayers, estate administrators, and the IRS, if the Dickman decision is not limited?

We believe that each of the parties named above will face severe administrative problems.

Taxpayers desiring to file whatever gift tax returns might be required as a result of the retroactive application of Dickman must now examine their records for the last fifty-two years to determine if any interest-free loans were made, when they were made, and when they were repaid. It is likely that many of these records have long since been destroyed. Thus, the taxpayer who wishes to comply may not be able to comply because of a lack of records.

Furthermore, the Supreme Court did not decide how the value of the gift is to be computed. While the Service has indicated that it believes that the value of the gift should be computed using the prevailing rate on deficiencies, there is no specific authority to indicate that the Service is correct in this belief. In fact, the Service has used several different approaches in the various cases it has litigated. Moreover, the Eleventh Circuit in the Crown decision indicated that it would be very difficult to compute the value of the interest element on the demand loan due to the fact that a demand loan could be called at any time. Thus, even if a taxpayer can locate the records, the procedure he should use in valuing the gift is anything but clear.

Estate administrators will also face major problems for the foreseeable future. Take, for example, the executor of a large estate but not one worth millions of dollars. It is entirely possible that at some time during the decedent's life he or she may have made an interest-free loan. The Supreme Court has held that such a loan would result in a taxable gift. How is the executor supposed to determine if, in fact, such a loan had been made? How does he fulfill his responsibility to establish prior taxable gifts of the decedent in order to properly compute the estate tax of that decedent? Such a situation clearly puts an undue burden on executors in the discharge of their fiduciary responsibilities.

Finally, it does not appear that the IRS is in a position to effectively administer the Dickman decision on a retroactive basis. Few, if any, gift tax returns are currently examined.

The Service does not have enough manpower according to its own officials to examine all of the income tax returns it wishes to examine. How can we now burden it with the responsibility to try to determine whether a given taxpayer should have filed a gift tax return at any time during the last fifty-two year period?

SUMMARY

It is our view that the retroactive application of the Supreme Court decision in Dickman will result in an undue hardship to taxpayers and the Government alike.

I appreciate the opportunity to testify before you today. I will be pleased to answer any questions you may have.

36-195 O—84——18

UNITED STATES SENATE

COMMITTEE ON FINANCE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARING ON GIFT TAX RELIEF LEGISLATION

STATEMENT OF THOMAS F. KELLER

DEAN, FUQUA SCHOOL OF BUSINESS

DUKE UNIVERSITY

April 12, 1984

SUMMARY

1. Applying Dickman retroactively is unfair.

2. The courts ruled for sixteen years that an interest free loan was not a gift.

3. The penalties of retroactivity are unfair.

4. Valuation of past transactions is impossible and an exercise in revisionism.

5. No one can plan, anticipate or act in legal matters if they cannot rely on the decisions by the courts which are not challenged for years.

6. Retroactivity in tax ruling will create disrespect and chaos.

MY NAME IS THOMAS F. KELLER. I AM DEAN OF DUKE UNIVERSITY'S FUQUA SCHOOL OF BUSINESS. I AM A CPA HAVING PRACTICED WITH BOTH PEAT, MARWICK & MITCHELL AND PRICE WATERHOUSE. I HAVE TAUGHT ACCOUNTING FOR OVER 22 YEARS AND AUTHORED SOME 29 BOOKS AND ARTICLES.

I WANT TO ADDRESS THE ISSUES OF FAIRNESS AND THE CITIZENS' CONFIDENCE IN OUR JUDICIAL AND TAX SYSTEM. BECAUSE THESE TWO POINTS SHOULD BE ULTIMATELY IMPORTANT, I STRONGLY URGE THAT THE U.S. SUPREME COURT'S DECISION IN DICKMAN vs. THE UNITED STATES NOT BE ALLOWED TO APPLY RETROACTIVELY FROM ITS ANNOUNCEMENT ON FEBRUARY 22, 1984. THE DICKMAN DECISION REVERSES THE LEGALITY OF COMMON PRACTICES AND ATTEMPTS TO REVISE THE "CORRECT" METHOD OF TAX CONSIDERATION DATING BACK TO 1932. THE BURDENS THIS WOULD CREATE FOR THE TAXPAYERS ARE NOT ONLY UNREASONABLE BUT ALSO UNFAIR.

UNTIL THIS DECISION, THERE HAS BEEN A LEGAL RATIONALE FOR A METHOD USED TO MINIMIZE TAXES WITHIN A FAMILY. THIS IS THAT INTEREST FREE LOANS BETWEEN FAMILY MEMBERS SHOULD NOT BE SUBJECT TO GIFT TAX. THIS METHOD HAS BEEN USED TO ACCOMPLISH SUCH GOALS AS SUPPORTING ELDERLY PARENTS AND PROVIDING FUNDS FOR EDUCATION. IMPORTANTLY, THE I.R.S. HAD TAKEN NO ACTION ON THIS METHOD FOR 34 YEARS, FROM 1932 UNTIL 1966, WHEN IN JOHNSON vs. THE UNITED STATES, THE COURT HELD

THAT SUCH A TRANSACTION WAS INDEED NOT SUBJECT TO A GIFT TAX. THE I.R.S. DID NOT APPEAL NOR ISSUE ANY RULINGS, REGULATIONS OR OPINIONS TO THE CONTRARY UNTIL 1973, IN THE CROWN CASE.

IN 1977 THE I.R.S. POSITION WAS REJECTED BY THE TAX COURT, RULING IN FAVOR OF CROWN. THE 7th CIRCUIT COURT OF APPEALS AFFIRMED THIS DECISION IN 1978. FROM 1978 TO 1982, THE CROWN DECISION WAS ACCEPTED AS LAW. THE I.R.S. MADE NO ATTEMPT TO APPEAL UNTIL NOVEMBER 1, 1982. THAT'S SIXTEEN YEARS OF COURT RULINGS IN FAVOR OF THE CROWN POSITION.

NOW, ALL OF A SUDDEN, FIFTY YEARS OF LEGAL TAX PROCEDURES ARE PRONOUNCED INVALID. THE DICKMAN DECISION TREATS AS TAXABLE MANY TRANSACTIONS WHICH WERE RECOMMENDED IN PROFESSIONAL TAX AND ESTATE PLANNING OF THE PAST. ALL WHO FOLLOWED SUCH PROCEDURE BY THE LETTER AND THE JUDGED ACCEPTED METHODS ARE TO BE PENALIZED.

LET'S LOOK AT THE PENALTIES. THE I.R.S. HAS ANNOUNCED THAT IT WILL APPLY THE DICKMAN DECISION RETROACTIVELY AND USE THE STATUTORY (CODE §6621) INTEREST RATES FOR TAX DEFICIENCIES (CURRENTLY 12% BUT RECENTLY AS HIGH AS 20% COMPOUNDED DAILY) TO VALUE THE GIFT. THE I.R.S. HAS USED VARIOUS RATES FOR VALUING THE INTEREST FREE USE OF LOAN FUNDS FROM 3½% IN THE JOHNSON CASE TO 31% IN LA ROSA, A CASE NOW PENDING IN TAX COURT.

THE FACT IS NO RATE IS FAIR. THERE IS NO WAY ANYONE CAN LIVE IN 1984 AND LOOK BACK AND MAKE FAIR AGREEABLE JUDGEMENT ABOUT A TIME THAT NO LONGER EXISTS.

TAXPAYERS WHO TRY TO MEET THE LETTER OF THE DECISION WILL BE CAUGHT IN A VALUATION ARGUMENT WITH THE I.R.S. ARE WE TO ASSUME THAT THOSE WHO IGNORE IT OR ARE NOT AWARE OF ITS EXISTENCE MAY GO UNBURDENED? THIS INEQUITABLE ADMINISTRATION OF THE LAW WILL RESULT IN DISDAIN FOR OUR TAX SYSTEM. OUR SYSTEM IS COMPLEX ENOUGH BUT TO BEGIN TO CHANGE THE GROUNDRULES ON PAST TRANSACTIONS WOULD BE AN INSULT TO OUR INSTITUTION.

THE I.R.S. CONTENDS THAT IT PUT THE TAXPAYER ON NOTICE WITH ITS 1973 REVENUE RULING. REVENUE RULINGS, HOWEVER, ONLY STATE THE I.R.S.'S POSITION. THERE IS NO LEGITIMATE COMPARISON OF SUCH A RULING TO DECISIONS OF A TAX COURT, OR THE FEDERAL DISTRICT AND CIRCUIT COURTS. FURTHERMORE, BASED ON THE TESTIMONY OF JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY IN THE TREASURY DEPARTMENT, THE I.R.S. WOULD LIKE TO MAKE THE DECISION RETROACTIVE TO 1932. THIS IS SIMPLY NOT FAIR. THE INNOCENT WILL BE PENALIZED FOR MISTAKES THEY DIDN'T MAKE AT THE TIME. CAN A CITIZEN NOT RELY ON THE JUDGEMENT OF THE COURT OR WILL LATER DECISIONS WITH RETROACTIVE APPLICATION CREATE DISTRUST OR CONTEMPT FOR AN INSECURE SYSTEM OF JUSTICE?

I AGREE WITH JUSTICES POWELL AND REHNQUIST WHO CORRECTLY POINT OUT IN A DISSENTING VIEW, "THERE CAN BE LITTLE

DOUBT THAT THE COURTS ARE NOT THE BEST FORUM FOR CONSIDERATION OF THE RAMIFICATIONS OF THE GIFT TAXATION OF INTEREST-FREE LOANS. CONGRESS IS THE BODY THAT IS BEST EQUIPPED TO DETERMINE THE RULES THAT SHOULD GOVERN."

CONGRESS SHOULD MAKE THE LAWS, BUT LAWS THAT GOVERN OUR FUTURE. WE CANNOT BE REVISIONIST AND PENALIZE THE GRAND-CHILDREN FOR THE GRANDPARENTS ACTIONS.

I AM NOT HERE TO SAY THAT THE DICKMAN RULING WAS UNFAIR. BUT IT IS UNFAIR TO SAY THAT THAT WHICH WAS DEEMED LEGAL BEFORE IT HAPPENED IS NOW ILLEGAL AND SHOULD BE PENALIZED INTO THE PAST. I BELIEVE THAT THE APPLICATION OF DICKMAN RETROACTIVELY WILL CREATE SEVERE INEQUITIES AND CHAOS IN THE APPLICATION AND UNDERSTANDING OF WHAT OUR SYSTEM EXPECTS FROM US.

AS CITIZENS OF THE UNITED STATES OF AMERICA, IT IS AN ABSOLUTE NECESSITY THAT WE HAVE CONFIDENCE IN THE LEGAL SYSTEM. WE MUST TRUST AND RELY ON THE VERDICTS THE COURTS RENDER AS VALID AND SOUND. HOW CAN YOU ACT, PLAN OR ANTICIPATE IF YOU CAN'T TRUST THE COURT ROOM, THE JUDGEMENTS OR THE SYSTEM. REMEMBER, FROM 1966 to 1982 THERE WAS NO INDICATION THAT WHAT WE HEARD AND READ MIGHT BE CONTESTED OR OVERTURNED. TO RULE THAT THE DICKMAN DECISION IS RETROACTIVE INTRODUCES UNCERTAINTY AND DISTRUST INTO THE SYSTEM.

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MAX M. KAMPELMAN, P.C.
202-342-3520

April 3, 1984

The Honorable Robert J. Dole
United States Senate
Room 141
Hart Senate Office Building
Washington, DC 20510

Dear Senator Dole:

I am writing to you to express my support for legislation being considered by the Committee on Finance which would cause the gift tax treatment of interest-free demand loans mandated by the Supreme Court's opinion in the Dickman case to have only prospective effect.

I believe that any other application of the holding of that case will arbitrarily discriminate against taxpayers who made interest-free loans in the period since the 1978 decision in the Crown case.

Until the recent Dickman case the courts twice held, in Johnson and Crown, that interest-free demand loans did not give rise to taxable gifts. Moreover, in other related areas, such as loans to employees and shareholders, the courts had repeatedly refused to "impute" interest unless specific statutory or regulatory authority supported imputation. The government itself had been almost lackadaisical, not litigating a case in this area between the 1966 Johnson case and the Crown case.

Thus, many taxpayers were advised to make such loans and did not file gift tax returns. Others filed protective gift tax returns which did not disclose these loans.

Thus, if Dickman is given retroactive effect a few taxpayers will be subjected to gift tax on a lottery like basis. Many will incur significant interest and penalities. The vast bulk of such transactions will go untaxed and those persons who are taxed will consider themselves unfairly discriminated against.

There is repeated precedent in the estate and gift tax area for not giving retroactive effect to judicial reversals of prior judge-made law. I believe it would be fair and appropriate to follow a similar course here, and give the Dickman case only prospective effect.

I should mention that my firm has clients who would be favorably affected by such legislation although I want to emphasize that we have not been retained to represent any interest in this matter and this letter is, therefore, not written on behalf of any client.

Sincerely yours,

Max M. Kampelman

Max M. Kampelman, P.C.

MMK/rmc

HAND-DELIVERED

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April 2, 1984

Senator Robert Packwood, Chairman
Subcommittee on Taxation and
Debt Management
Senate Finance Committee
Dirksen Senate Office Building
Washington, D.C. 20510

Senator Steven Symms, Chairman
Subcommittee on Estate and
Gift Taxation
Senate Finance Committee
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senators Packwood and Symms:

The Supreme Court decided in 1984 in the case of Dickman v. Commissioner that the value of interest not charged on an interest-free demand loan constitutes a gift for tax purposes. Since this decision interpreted existing law, its consequences are retroactive. Unless Congress takes action to limit the decision to prospective situations, significant inequity and substantial administrative burdens will result.

Prior to the Dickman case, no court had ever held that an interest-free demand loan could result in a gift for tax purposes. In fact, a federal district court in 1966, the Tax Court in 1977, and the Court of Appeals for the Seventh Circuit in 1978 had held to the contrary. Prior to these cases, the IRS had never even asserted that such a loan could constitute a gift, even though the gift tax statute has remained generally unchanged since its adoption in 1932. Many taxpayers relied on the long-standing silence of the IRS and the decisions of the district court, Tax Court, and Seventh Circuit in making plans for their finances and families. The reasonable expectation of these taxpayers should not be dashed retroactively. To the contrary, Congress should insure that the tax laws continue to be enforced only after clear notice and based on specific legislative authorization.

In addition to the issue of fundamental fairness, substantial administrative burdens will result unless Congress acts to make Dickman prospective. Because taxpayers generally did not know until Dickman that interest-free loans were subject to gift tax, they did not file gift tax returns. In the absence of a gift tax return, the statute of limitations does not apply. This means that all years back to 1932, the year the gift tax was adopted, may be open. Since the gift and estate taxes were unified in 1976, all estates since 1976 may be questioned as well. This is so because the unified credit used to offset estate taxes should have been applied to offset gift taxes -- on gifts the taxpayer did not know he was making at the time.

These past gift and estate matters will not be resolved quickly, because there are many questions to be resolved. (1) There is no agreed method of valuing the gifts the Dickman case says were made. The IRS itself has used a different method in each case it has pursued. Separate valuations will have to be made on a quarterly basis, perhaps on a monthly basis. Many administrative hearings, litigation and delay will be inevitable. (2) The effects of applying Dickman retroactively will spill over into the future. Taxpayers have to determine, for example, how to value and report "prior gifts" in completing future returns. (3) Nor will the Treasury be correct if it argues that these past problems are covered by the annual exclusion or the old exemption or current credit. In handling family and financial matters, many taxpayers make gifts each year in the amount of the annual exclusion, so that the first dollar loaned thereafter results in a gift. (4) Moreover, to the extent that a gift is covered by the exemption or credit, subsequent use of the exemption or credit will have to be disallowed.

Thus, despite the existence of the annual exclusion and exemption or credit, the result of the Dickman decision is that gift tax returns for all past years are probably due, often unexpected gift taxes are probably due, exemptions and credits have probably been misclaimed, subsequent returns may have to be recalculated and refiled, and future returns may have to be recalculated and refiled after an agreed method of valuation emerges. The prospect is, in short, an administrative nightmare. These problems are not resolvable by action which is appropriate for the executive branch. The Dickman case clarifies a situation which was clearly doubtful and uncertain before. The transition to the new result which it prescribes should be one which is fair and administratively workable. This should be determined by Congress.

I filed an amicus brief in the Dickman case arguing that legislation -- prospective and unambiguous -- was the equitable and efficient means of resolving the gift tax questions presented by interest-free loans. I still believe this to be true, and ask that my comments be made part of the Subcommittee's record.

Very truly yours,

Erwin N. Griswold

Erwin N. Griswold

cc: Senator Robert Dole
Senator Russell Long
Senator Spark Matsunaga
Senator David Boren

WRITTEN STATEMENT OF

ADDIS E. HULL

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

AND THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON PROPOSED LEGISLATION REGARDING

PROSPECTIVE APPLICATION OF

DICKMAN v. COMMISSIONER

April 18, 1984

My name is Addis Hull. I am a senior partner in the Chicago law firm of Jenner & Block. Since 1949, I have headed our firm's estate planning and probate department, a role which has given me the opportunity to counsel hundreds of individuals, families, and small business owners concerning their income, estate, and gift tax planning. I have, in addition, lectured widely before bar groups, authored dozens of articles on estate planning, and now also serve as an adjunct professor at the Chicago Kent College of Law.

Today I write to urge your committee to support the amendment by Senator Heinz which would make prospective only the application of the recent Supreme Court case Dickman v. Commissioner. I so urge for two reasons:

1. Fairness to taxpayers demands it; and

2. Retrospective application would be an administrative nightmare.

I now wish to particularize both of these reasons by responding to the five specific questions in which Senators Symms and Packwood have indicated special interest.

<u>1) What types of transactions would be provided relief by such legislation? Specifically, would the legislation largely apply to transactions entered into intentionally to avoid estate and gift taxes, or would it largely affect taxpayers who structured transactions as interest-free demand loans for non-tax purposes?</u>

I am acquainted with many family farmers and other small business owners in which, fifteen or twenty years ago, a parent lent his or her child, without interest, the money to buy a farm or go into business. When this was done the family received legal advice, sound at the time, that the arrangement had no tax consequences.

Now, the IRS proposes to seek and collect gift taxes over this entire period. For most of these families, the IRS can collect over the entire 15 or 20-year period because these parents of moderate means could not and did not make any outright gifts to their children, and therefore did not file gift tax returns. And even those who did file have now "red flagged" their returns for IRS audit.

2) What legal advice was typically given to taxpayers making interest-free demand loans? Specifically, were taxpayers advised of the IRS interpretation that interest-free loans were subject to gift taxes? If so, were taxpayers advised not to file gift tax returns disclosing their transactions? Or were taxpayers advised to consider filing gift tax returns in order to take advantage of the 3-year statute of limitations, or the 6-year statute of limitations applicable where a return significantly understates taxable gifts? What is likely to be the effect of the Dickman decision, in the absence of legislation, on attorneys or tax advisers who counseled clients to make interest-free loans?

I live and practice in an area subject to the jurisdiction of the Seventh Circuit Court of Appeals, where 20 million other Midwesterners live, work, and pay taxes. Up until a month ago, the ruling of the highest court in our jurisdiction was that interest-free demand loans are not subject to gift tax. Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978). For 36 of my 38 years in law practice, there have been no reported decisions to the contrary and I, along with most other responsible tax practitioners, so advised our clients. Our advice during this period was, in addition, also to point out the significant non-tax advantages of loans. Vis-a-vis trusts or outright gifts, for example, an interest-free demand loan requires a minimum of documentation, does not require the creation of a new tax entity with its attendant filing requirements, and retains for the client of modest means the ability to at any time recover the loaned assets. In short, I advised many clients to make interest-free loans for non-tax reasons.

As to the filing of gift tax returns, during this pre-Dickman period, just to disclose these interest-free loans, we justifiably advised our clients not to do so. If, under Crown, the loan was not a gift, it should not have been reported as such. Filing a return in my opinion, would have: 1) impeached the then perfectly legitimate position that loans were not gifts; 2) exposed clients to a needless "red flag"; 3) demanded consideration of serious valuation questions that were not then and still have not been resolved; and 4) subjected clients to needless time and expense.

In 1982 the 11th Circuit's decision in Dickman caused our advice to soften somewhat, but Crown still remained the law in our jurisdiction. In any event, the IRS now seeks to go back not only to 1982, but as far back as 1932, and it would now be fundamentally unfair to punish all taxpayers, particularly those who reside in the 7th Circuit, for the pre-1982 failure of all of us to be omniscient.

3) What actual amounts of gift tax liability would be forgiven if the scope of the Dickman case were to be retroactively limited?

In his April 4 testimony before your subcommittees, Assistant Treasury Secretary John E. Chapoton stated that, in the interest-free loan area the IRS is now seeking back gift taxes "involving an aggregate potential gift tax liability of approximately $5.5 million." While this may seem large, it is only 2 1/2 cents per American citizen, vs. the $4,000 or so per citizen that we pay in federal taxes each year.

Further, this 2 1/2 cents is the maximum amount being sought by the IRS and, pending litigation over the valuation of the gifts and collection problems, much of it will probably not be collected. Whatever is collected will be reduced by the costs of collection.

Assuming that this 2 1/2 cents per citizen back gift tax now being sought extends over the normal 3-year gift tax statute of limitations, and given that we have paid approximately $12,000 in federal taxes per citizen during this period, the revenue loss from the Heinz amendment would seem to be only 1 part in 480,000, a small amount indeed. There might even be a revenue gain if all Internal Revenue Service personnel now involved in these cases were freed up for other purposes.

36-195 O—84——19

4) What aministrative problems are likely to be faced by taxpayers, estate administrators, and the IRS, if the Dickman decision is not limited?

In my opinion there would be three aspects of this administrative nightmare, First, any retrospective application of Dickman will force the honest taxpayer to become a financial detective and go back 10 or 20 years -- perhaps all the way back to 1932 -- to search out all documentation behind any loans he can now only dimly remember. Even with the best of initial intentions, such documentation probably will not now be available or, if it is, be only a cancelled check in an unsorted shoebox or an unannotated deposit slip. Under the Internal Revenue Code, this failure to keep proper records may itself create liability.

This problem will be particularly acute for estate administrators, many of whom I counsel. They are required to file an accurate federal estate tax return within nine months after the death of a decedent. To prepare each such return, they must determine the amount of all prior gifts made by the decedent, and perhaps his spouse. In most cases, any gifts will be outside the personal knowledge of the administrator, who now won't even be able to rely on any gift tax returns (or on the absence of such returns) filed by the decedent. The estate administrator will be compelled, under threat of personal liability, to reconstruct records that may not exist. This problem has no solution. Honest estate administators will try to unearth records, but they may be unable to do so, and even if records are found and sorted, the process will largely benefit lawyers and accountants.

Finally, even in the few cases where the retrospective gift tax liability can be computed with reasonable certainty, the collection process will be fraught with difficulty. Where the loan has been outstanding for more than a few years, the back gift tax may exceed the amount of the loan. And, even if the loan covers the tax, the funds, in my experience, will either have been exhausted in paying for a child's higher education, or perhaps still be tied up in an illiquid family farm or business. Selling such an asset cannot be the result now intended, particularly where the family sought and received legal advice, sound at the time, that their arrangement would have no tax consequences.

5) What is the likely effect of retroactive legislative relief on the administration of the tax laws generally? Is such legislation likely to increase the tax compliance problems caused by aggressive tax shelters, and taxpayers playing the "audit lottery"?

Our gift tax system is one of the best examples of our overall tax philosophy of voluntary compliance. Unlike income taxes, our gift tax system features no withholding, W-2's, 1099's or other third-party documents which prod taxpayers to file their returns. Thus, gift taxation is particularly sensitive to those aspects of our governmental environment which encourage voluntary compliance. These are, in my opinion: 1) Overall taxpayer perception that the system is fair; and 2) Clear and timely communication to taxpayers of their filing requirements.

Both of these buttresses would be weakened, in my opinion, by a now retrospective application of Dickman. As to taxpayer perceptions of fairness, any retrospective application of Dickman will necessarily be arbitrary and capricious; the IRS itself has in fact stated that it intends to pursue only some taxpayers. As I discussed earlier, those who filed gift tax returns will be able to now hide behind the accompanying statute of limitations, while those of more modest means, who make no outright gifts and therefore did not file, will have their entire financial lives now open to scrutiny by gift tax agents. This can only strengthen the recently-expressed perception that the tax deck is stacked in favor of the wealthy.

As to timely communicating to taxpayers what their filing responsibilities are, the valuation of interest-free loans by taxpayers in future years might prove a tolerable burden, but to now tell honest taxpayers that they have to go back five, ten, or twenty years and engage in the bookkeeping archeology necessary (if it is still possible at all) to value their loans would, in my opinion, cause many to throw up their hands in dismay. Many might joint the ranks of the so-called "tax dropouts" and still others might seek out less responsible tax counsel who offer the placebo of not worrying about it. Senator Dole's prediction would indeed come true: Bad tax advice would drive out good. Let us also not let bad tax administation drive out good.

For the reasons above stated I again urge the adoption of Senator Heinz' amendment. Thank you again for the opportunity to submit this statement.

WRITTEN STATEMENT OF LATHAM, WATKINS & HILLS

Senate Committee on Finance

Subcommittee on Estate and Gift Taxation

Subcommittee on Taxation and Debt Management

Joint Hearing on Gift Tax Relief Legislation

April 4 and 12, 1984

This testimony is submitted on behalf of the law firm of Latham, Watkins & Hills, 1333 New Hampshire Ave, N.W., Suite 1200, Washington, D.C. 20036. We represent families who will be adversely affected by the retroactive application of the Supreme Court's recent decision in Dickman v. Commissioner, 52 U.S.L.W. 4222 (Feb. 28, 1984).

We commend the Committee for conducting these hearings on this important issue of equity. Retroactive application of the Dickman decision would be exceedingly unfair to taxpayers who reasonably relied on the law established in the federal courts prior to the appellate decisions in Dickman itself. We urge your support for legislation preventing the Internal Revenue Service (IRS) from applying the Dickman decision to any loan made prior to February 22, 1984.

The basic unfairness of applying the gift tax to preexisting interest-free loans stems from the almost complete lack of support for the IRS' position prior to Dickman. Not until 1966 -- 34 years after enactment of the gift tax provisions -- did the IRS even assert that an interest-free loan amounts to a gift equal to the value of the use of the loaned funds. This theory was rejected in Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966). The IRS did not appeal that decision. In 1973, after waiting seven years, the IRS announced that it would not follow Johnson. Rev. Rul. 73-61, 1973-1 C. B. 408. A few years later, however, the IRS' position was again rejected, this time by both the Tax Court and the Court of Appeals for the Seventh Circuit. Crown v. Commissioner, 67 T.C. 1060 (1977), aff'd, 585 F.2d 234 (7th Cir. 1978). The IRS did not seek review in the Supreme Court. Not until 1982, when the Court of Appeals for the Eleventh Circuit decided against the taxpayers in Dickman, did any federal court agree with the IRS' position.

This brief history demonstrates that taxpayers making interest-free loans before 1982 quite reasonably followed the uniform law established in the federal courts that the gift tax did not apply. This history also makes clear that the IRS' handling of this issue has left much to be desired. It did not arrive at its statutory construction until more than three decades after the gift tax statute was enacted; did not appeal the Johnson decision to the court of appeals and waited seven years even to state that it would not follow Johnson; and did not seek review of the Crown decision in the Supreme Court. Moreover, the IRS made no effort to resolve the issue more definitively: it did not attempt to adopt prospective regulations embodying its position, despite being invited to do so by the Seventh Circuit in Crown, see 585 F.2d at 241, and it did not seek congressional action to overturn the unfavorable federal court decisions.

In light of this background of federal court rulings and IRS delay and inaction, it would be grossly unfair to permit Dickman to be applied retroactively. In many circumstances, the taxpayers who made interest-free loans long ago are now elderly and may have great difficulty paying years of back taxes and penalties. More generally, if Dickman had clearly been the law, families might well have structured the loans differently, or indeed might have preferred to pay the interest, rather than make a gift of the value of the use of the funds. If Dickman is applied retroactively, taxpayers who followed the rules as established by the federal courts would be severely penalized for doing so.

Enactment of tax laws is the responsibility of Congress, not the IRS, and Congress bears a share of responsibility for the present situation. Although the position of the IRS was rejected by all federal courts that considered the matter from 1966 to 1982, no legislative action was taken. After being content to permit the IRS' position to be rejected for almost two decades, Congress should not now stand by idly while taxpayers who followed the existing law are subjected to enormous taxes and penalties.

The tax bills pending in both the House and the Senate expressly provide that interest-free loans are subject to the gift tax. We express no view on these proposals, but note that they properly would apply only to future loans. Families will therefore be able to plan with full understanding of the applicable law. Now that the law finally will be clarified, Congress should not permit a second set of rules, developed solely by the IRS, to be applied to loans made in prior years. We therefore respectfully urge the Committee to propose and support legislation that would prohibit retroactive application of Dickman.

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April 4, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance, Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Gift Tax Relief Legislation
April 4, 1984

Dear Mr. DeArment:

The one thing that concerns me about Dickman vs. Commissioner of Internal Revenue is the impact it will have on loans made by parent to child where the child has used the money borrowed for the down payment on their personal residence.

The result of such a transaction is that the child has 100% financing for the purchase of the personal residence. Because the child has 100% financing which they could not have otherwise obtained the value of that loan to the children is substantial because a borrower is generally willing to pay a higher rate of interest on secondary sources of financing and the lender making such a loan would demand a higher rate of interest because of the substantial risks involved.

The application of Dickman to this transaction results in the parent being penalized for having assisted their child in purchasing their residence.

I request, that as a minimum, relief be granted in this and similar situations.

Very truly yours,

Robert K. Maize, Jr.

RKM:smm

BEFORE

THE SENATE COMMITTEE ON FINANCE

APRIL 12, 1984

TESTIMONY

ROBERT A. WARDEN

on behalf of

McDermott, Will & Emery

SUMMARY OF PRINCIPAL POINTS

1. We urge the Committee to support an amendment to apply the Supreme Court decision in the Dickman case to taxpayers only on a prospective basis. Prior to the holding in Dickman, lower Courts had consistently held that an interest--free loan between family members was not a taxable gift.

2. There are many legitimate non-tax reasons why family members might make interest-free loans to one another, including the purchase of a house, the start-up of a new business, needs brought about by natural disaster or illness, or, in certain parts of the country, rent-free use of a farm and equipment provided to younger family members.

3. While the Internal Revenue Service has taken the position since 1973 that an interest-free loan does constitute a gift, it does not follow the taxpayers would necessarily have been on notice that there was a risk of adverse tax consequences in making an interest-free loan. Many people might have entered such transactions without consulting their tax advisors because loans are traditionally thought of as transactions which are substantially different than gifts. Taxpayers who did consult tax advisors would have been informed prior to the Dickman case that Courts had unanimously held that interest-free loans were not gifts.

4. Substantial administrative problems will result if an amendment applying Dickman prospectively is not adopted. These problems cannot be fully alleviated by a de minimus rule.

TESTIMONY OF ROBERT WARDEN

My name is Robert Warden. I am a member in the law firm of McDermott, Will & Emery and I am appearing today on behalf of that firm. McDermott, Will & Emery has over twenty-five attorneys who work full time in the area of estate planning and probate.

I appear today in support of an amendment which would provide that the recent decision of the United States Supreme Court in the Dickman case would be applied to taxpayers only on a prospective basis. The Court held in that case that the value of an interest-free loan between members of the same family is to be treated as a gift and is subject to Federal gift tax. Prior to that ruling there had been several lower court opinions which had held to the contrary, that is, that such an interest-free loan is not a gift and that there are no Federal tax consequences to such a transaction.

There are many reasons why members of a family might lend money to one another which have nothing to do with tax avoidance. For example, parents might lend money to their children to purchase a house, or start up a business. Or the parents might lend money for purposes of furthering the education of their children or grandchildren. In some cases, the loan might be to help their children overcome some catastrophic loss caused by a flood or other natural disaster. Or the loan might be made because a family member had contracted a serious illness.

Some loans, particularly in farming communities, might be in the form of property rather than cash. For example, the family might allow their children to use certain farm land, a farm house, or farm equipment, such as tractors and combines, on a rent free basis.

One of the arguments which has been advanced against an amendment to make the Dickman case prospective is that taxpayers should have been on notice, at least after 1973 when the Internal Revenue Service announced its position on this issue, that such loans might be taxable. Presumably those individuals making the loans would have consulted with their tax advisors who would have informed them of the IRS position. However, this is not necessarily the case. Many of these loans were made without consultation because the loans were not tax motivated and because most people are not used to thinking of a loan as a gift. Even well advised taxpayers making such loans would probably have concluded that the law was in their favor because of the lower court opinions which unanimously held that a loan was not a gift.

Another argument that is sometimes made against the amendment is that the Federal gift tax exclusion of $10,000 is large enough to cover the value of most interest free loans, except for very large loans. But except for the last several years, the Federal gift tax exclusion has only been $3,000. Even the higher $10,000 limit might have been used up by gifts of cash or property made by parents to their children in the honest belief that the interest free loan was not a gift. Moreover, interest rates in recent years have been at historic all time highs. Thus loans for comparatively modest sums of money might result in taxable gifts, even though this would not have been the case if interest rates had been at more normal levels.

Failure to enact a prospective amendment will also result in very onerous administrative problems. Since no gift returns were filed in connection with most of those loans, because people did not believe that a gift had been made, every year will be open, going back to the enactment of the estate and gift taxes. In many cases the records needed to file an accurate gift tax return will not be available. Moreover, since the estate and gift tax systems are now unified, the gift value of the loans must be taken into account in filing a decedent's estate tax return. But there is no assurance that the executor of the estate will necessarily have adequate information about the gifts. In some cases the beneficiaries of the loans, and the beneficiaries of the estate (who will lose unified estate and gift tax credits because of the loans) will not be the same persons, thus distorting the estate plan of the decedent made in reliance on the law as then in effect.

There is also the troublesome question of what interest rate to impose in valuing the gift. Some have suggested using the Federal interest rate imposed on income tax deficiencies But a more equitable measure would be the lowest rate available in an arms-length transaction. It is even possible that the Federal rate would, from time to time, be usurous in certain states, if the parents had actually charged that rate for a loan to their children. Whatever standard is used for determining the inputed interest rate will doubtless result in a rate that fluctuates from time to time, thus further complicating the administrative problems.

For all of these reasons, we urge the committee to adopt an amendment which applies the rule of the Dickman case only on a prospective basis.

36-195 O—84——20

NATIONAL
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STATEMENT

of the

NATIONAL CATTLEMEN'S ASSOCIATION

to the

Subcommittee on Estate and Gift Taxation

of the

Committee on Finance
United States Senate

Relative to Proposed Legislation Concerning
Taxation of Interest-Free or Low Interest Rate Loans

Submitted by

James L. Powell, Chairman
Tax Committee

April 9, 1984

The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry--including cattle breeders, producers, and feeders. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 18 affiliated national breed organizations.

STATEMENT
ON

PROPOSED LEGISLATION CONCERNING TAXATION OF INTEREST-FREE OR LOW INTEREST RATE LOANS

Although the National Cattlemen's Association ("NCA") does not oppose proposed legislation concerning the taxation of interest-free or low interest rate loans, it feels that such legislation should not apply to past loans nor to any installment sale of property in which interest is not imputed to the seller under Section 483 of the Internal Revenue Code.

Taxpayers Should not be Penalized for Relying on Past Court Decisons Permitting Interest-free Loans

On February 22, 1984, the United States Supreme Court ruled in Dickman v. Commissioner of Internal Revenue that interest-free demand loans resulted in taxable gifts of the reasonable value of the use of the money loaned, affirming a 1982 decision of the Eleventh Circuit Court of Appeals. Prior to this decision, the United States Tax Court and all Circuit Courts of Appeal presented with this issue had consistently held that no taxable gifts resulted from such loans. Not until the decision by the Eleventh Circuit in 1982 in the Dickman case reversing the Tax Court was there any contrary court ruling. Relying on the only body of court law prior to 1982 which sanctioned such transactions, taxpayers made interest-free demand loans and did not regard or report these as taxable gifts. Even after the Eleventh Circuit's decision in 1982 holding these loans to be subject to the gift tax laws, all other court decisions held that these loans were not gifts.

NCA believes that taxpayers who relied on the law prior to the Supreme Court's Dickman decision in 1984 and made interest-free loans should not have these loans deemed subject to the gift tax laws. Legislation which would retroactively apply to and subject such loans to gift taxation would be inequitable. Taxpayers based their decisions and took actions on the laws as they existed at a particular point in time. To subject these taxpayers to tax liability on these past transactions would be unfair. Faith and confidence in our tax system would be eroded if a tax on such loans were retroactively imposed.

Additionally, compliance with a retroactive application of such tax would pose monumental problems. Since gift tax returns were not filed with respect to such loans, imposition of the requirement for filing returns and paying gift tax on interest-free loans could go back to 1932 when the gift tax was first enacted. This could result in amending all gift tax returns which were filed on other gift transactions by persons who made such loans. Since the gift tax is cumulative in nature, a retroactive tax on such loans would make it virtually impossible to file a correct gift tax return on present or future gifts. Saddling taxpayers as well as the IRS with straightening out gift transfers for all years back to 1932 would at best be next to impossible and at the least be an exercise in the macabre.

In the farm and ranch context, loans on an interest-free basis have been made in the past by parents to children to buy agricultural land or livestock. This has frequently been done since children who wanted to start their own farm or ranch operations are often unable to borrow from or pay the high interest rates of a commercial lender. To treat the unpaid interest on such loans as being subject to gift tax liability or artifically to force the children to pay such loans in order for the parents to avoid future gift tax liability would work an undue hardship. Enforcement problems would result since those who can afford and had experienced tax counsel would be able to take proper remedial action whereas other persons would not be aware of the future gift tax impact of such past loans. As a consequence, there would be an uneven application of the law based upon the presence or absence of knowledgeable tax advisors. This could all be avoided if legislation taxing such loans did not apply to interest-free loans made prior to 1984.

In the past, when the United States Supreme Court has ruled on a tax matter, such as in the case involving taxation of meals of state police officers, legislation has been passed addressing the matter which was not retroactive in application. The same should occur with regard to the taxation of interest-free loans.

Installment Sales Transactions Which Do Not Involve Imputed Interest Should Not Be Treated as Gifts

NCA's position is that the proposed legislation to tax interest-free or low interest rate loans should not apply to installment sales of property where no interest is imputed to the seller under section 483 of the Internal Revenue Code.

With respect to installment sales of property made in past years, such sales should not be subject to gift taxation where interest charged on such sales was in a sufficient amount to avoid the imputed interest rule of section 483. The statutory language of section 483 would seem to dictate this conclusion since it states that section 483 applies to all of Title 26 which encompasses the gift tax law. Moreover, for the reasons enumerated under the preceeding heading, it would be inequitable as well as an administration and compliance nightmare to treat such installment sales as subject to gift tax when the rate of interest charged was less than that imposed for tax deficiencies. The interest rate on tax deficiencies has ranged from a high of 20% to the present level of 11%. The present rule applied under section 483 on installment sales is that, unless interest is charged at a rate per annum of 9%, interest will be imputed at 10%, compounded semiannually. The wide and disparate fluctuations of these two interest rates could fashion a cruel trap for the unsuspecting in installment sales if the proposed legislation imposed gift taxes in situations in which the interest rate on installment sales was less than that established for tax deficiencies.

Farmers and ranchers have a special problem since, under section 483, certain installment sales of land between related parties may be at 6% without causing interest to be imputed. Many installment sales of farm and ranch land have been made relying on this provision. To impose a gift tax on such installment sales because the interest rate is less than the present tax deficiency rate of 11% would be harsh and unusual punishment. Furthermore, it would be denying the benefits which Congress specifically provided in 1981 for such installment sales.

For the reasons set forth, installment sales of property which do not involve the imputation of interest under section 483 should not be treated as gifts and subject to gift taxation.

PEAT
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April 16, 1984

The Honorable Robert Packwood
U.S. Senate
Chairman, Subcommittee on Taxation
and Debt Management
259 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

Prospective Application of
Dickman v. Comm'r.

We appreciate the opportunity to submit written testimony and share Peat Marwick's views with the subcommittees. This testimony is not submitted on behalf of any client, but rather sets forth our opinion on the proposed legislation as tax practitioners actively involved in advising clients on estate and gift tax matters and preparing estate and gift tax returns.

On February 22, 1984, the United States Supreme Court decided that the value of an interest-free loan was a transfer of property by gift. Dickman v. Comm'r., 84-1 USTC ¶9240 (U.S. S. Ct. 1984). Thus, interest-free loans should, in certain cases, be reported on annual gift tax returns. Although the statute on which the decision is based was enacted in 1932, the controversial question of whether or not interest-free loans were subject to gift tax had never been completely resolved until this Supreme Court decision. Even though most courts previously decided that such amounts were not taxable transfers, the Supreme Court's decision is retroactive and applies to all gifts for which the statute of limitations for the filing of gift tax returns is still open.

Senator Heinz has introduced proposed legislation which would overrule the Supreme Court's decision in Dickman with respect to certain interest-free demand loans outstanding before February 22, 1984. It is this proposed legislation which is the subject of this testimony.

We strongly support the legislation and feel it is appropriate for the following reasons:

(1) Prior to the Eleventh Circuit Court of Appeals' decision in Dickman in 1982, all judicial decisions regarding whether or not interest-free loans resulted in taxable gifts supported the taxpayer's position.

(2) The Internal Revenue Service's and Congress' action and inaction encouraged interest-free loans by seeming to approve the courts' decisions.

(3) The potentially far-reaching scope of the Dickman decision results in an application which will be highly selective, resulting in inequitable treatment among taxpayers.

(4) Retroactive application of the decision, when combined with the cumulative nature of the unified transfer tax, would result in immeasurable administrative and compliance confusion.

(5) Congressional action is necessary to legislate an equitable solution.

Prior Judicial Decision

The potential for a taxable gift in an interest-free demand loan was first raised by the Internal Revenue Service (IRS) in Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966). In Johnson, the taxpayers loaned significant sums of money to their children without interest. The facts were clear that the loans were valid and the debtors had agreed to repay the principal on demand. The court, acknowledging that this was a case of first impression, ruled that: "The taxpayer did not make gifts within the meaning of Section 2501" and went on to say "There is nothing about this tranaction that defeats the purpose of the gift tax laws."

In 1977, the IRS raised the same issue before the U.S. Tax Court in Crown v. Comm'r., 67 T.C. 1060 (1977). The petitioner, Lester Crown, had made substantial non-interest bearing demand loans to various trusts established for the benefit of his relatives. The Tax Court, relying on the rationale of the Johnson decision, held that there was no taxable gift involved. The IRS subsequently appealed the decision to the U.S. Court of Appeals for the Seventh Circuit (585 F.2d 234, 7th Cir. 1978), where the Tax Court's decision was upheld.

The next significant case dealing with the issue was Dickman v. Comm'r., T.C. Memo 1980-575 (U.S. Tax Court 1980) which was decided in favor of the taxpayer. The IRS appealed this decision also and, in 1982, the Eleventh Circuit Court of Appeals (690 F.2d 812, 11th Cir. 1982) decided in favor of the IRS. The difference in the two circuits was resolved when the Supreme Court upheld the Eleventh Circuit Court's decision in Dickman.

Thus, for fourteen years, lower courts had addressed the issue of whether interest-free loans resulted in a taxable transfer. The IRS position was continually rejected when all of these courts decided that an interest-free demand loan did not result in gift tax. Taxpayers making such loans could reasonably believe that they would be upheld by the courts. However, the Dickman decision renders these decisions meaningless. Taxpayers who had relied on these cases before entering into certain transactions can no longer believe that they will be upheld in court. However, for prior years, there is no possible way to undo or correct the transaction. Such a result seems particularly inequitable when the extent of prior judicial decisions in the taxpayer's favor is taken into account.

Internal Revenue Service And Congressional Action

The inequity of applying Dickman retroactively is highlighted by the Service's approach to the issue over the last 50 years. Retroactive application would theoretically extend back to 1932 when the gift tax was enacted by Congress. This outcome is absurd in light of the fact that the IRS never even raised the issue until 1966, after almost 35 years of inaction.

Even after the IRS raised the issue in Johnson, it did not pursue the issue forcefully. The IRS chose not to appeal Johnson, which clearly contributed to the belief that interest-free loans did not result in gift tax. In fact, the Commissioner inexplicably delayed seven years until announcing that it would not follow the Johnson decision and that it would apply the gift tax to interest-free demand loans in each calendar quarter during which the demand loan was outstanding (Rev. Rul. 73-61, 1973-1 C.B. 408). Although the IRS did announce its non-acquiescence to Crown somewhat more promptly (1978-2 C.B. 3), it again decided not to appeal the decision after failing to prevail in the Seventh Circuit Court of Appeals.

Congress, itself, had numerous opportunities to address the issue during the period since the Johnson decision. On eight separate occasions since 1966, Congress amended the gift and estate laws without altering the gift tax consequences of interest-free loans. In fact, the Treasury Department apparently never even requested such a change until 1984. Congress' decision not to amend the gift tax statutes contributed to the position that interest-free demand loans were not subject to gift tax.

In summary, in the 50 years following enactment of the gift tax, the IRS raised the issue in only two court cases, both of which were decided in the taxpayer's favor and neither of which was appealed by the IRS to the highest court available, although such an action would have been possible. In addition, the IRS issued one revenue ruling which was merely a reiteration of their position in the Johnson decision which had been rejected by the court. During this time, Congress never addressed the issue (until 1984) even though the gift tax rules were amended numerous times. By Congress' refusal to change existing law and the unsuccessful attempts by the IRS, a knowledgeable taxpayer would have reasonably concluded that the "correct" interpretation was that the transfer was nontaxable.

Selective Application

The Supreme Court's decision in Dickman will have exceptionally broad application. In addition to causing taxable gifts on interest-free loans, it could also create taxable gifts on loans with a stated interest rate below what the Service deems appropriate, on many installment sales and even the lending of other property, such as a house or car. Interest-free loans have been used extensively to provide funds for college education, to assist children in purchasing homes, to support elderly parents, and to transfer ownership in a family business. Many of these non-tax motivated transactions will be impacted by this decision. In fact, many of these socially desirable transactions probably would not have occurred other than through the use of interest-free loans.

The multitude of interest-free or below market interest rate loans that would be taxable if Dickman is effective retroactively will result in an extremely selective application of the decision. The IRS simply cannot assess taxes in all situations which Dickman would deem taxable. The result will likely be assessments related to loans of certain high visibility taxpayers and other loans various IRS agents become aware of. Knowledgeable taxpayers and those relying on tax counsel will report their loans by filing or amending gift tax returns, while other taxpayers will undoubtedly be unaware of their obligation to pay such taxes. Even if individuals are aware of their responsibility to file gift tax returns, many transactions were not properly recorded and may not be remembered. It is ironic that it would be the less wealthy taxpayers who will have significantly more exposure. Wealthy individuals traditionally make annual gifts which, by filing an annual gift tax return, has the effect of starting the period of limitations for assessment of tax. Individuals who have filed gift tax returns annually would generally only have to amend three years' returns (or in cases where the value of the interest-free loan exceeded 25 percent of the annual gifts, 6 years' returns). A less wealthy individual who did not file annual gift tax returns could have many years for which returns are due.

The net result will be markedly different application of the law among taxpayers. While some taxpayers will want to comply, many loans could go unknowingly unreported. Assessments by the IRS will center only on very wealthy indviduals. Finally, the knowledgeable taxpayer who has not filed annual returns will be the most burdened by virtue of the fact that gift tax returns for all prior years could be due. The only equitable solution is prospective application where all taxpayers will be treated equally and will be fully aware of the expected tax treatment.

Cumulative Nature Of Unified Transfer Tax

Since lifetime gifts and the taxable portion of a decedent's estate are subject to a single unified tax schedule and unified credit, each taxable transfer impacts every subsequent taxable transfer. Accordingly, the retroactive adjustment of a prior years' gift tax liability will impact all intervening years as well as all future years. If the Dickman decision were to be applied retroactively, any individual that had an interest-free or below market rate loan outstanding during any period since 1932 would conceivably have to amend that year's return and every gift tax return due subsequent to that period. It is virtually impossible to imagine all, or even most, taxpayers correctly complying with this requirement. In fact, the resulting potential for noncompliance by taxpayers outweighs the minimal amount of revenue that would be generated by unlimited retroactive application of the Dickman decision. If the decision is applied prospectively, the large majority of taxpayers will be willing and able to comply with the law.

Congressional Action Is Necessary

When Congress has, for so long, acted so as to imply that the court decisions were correct, it should be Congress, not the courts, that change this position for all prior transactions. The court's decisions created judicial support; the IRS's inaction and repeated failures to appeal, indicated administrative

36-195 O--84----21

acceptance; and Congress, with its approval by silence, created legislative support for the taxpayer's position. The abrupt reversal in Dickman should be made prospective through legislative action.

Many of the courts which addressed the issue of whether interest-free loans were taxable gifts discussed whether any change in the tax treatment of these transactions should be judicial or legislative. The court in Johnson stated:

> Passage of a law providing for a tax like the one here contended for should be sought through Congress instead of the Courts. There the people would have a chance to be heard in committee meetings. It would well be that many substantial persons would there express the hope that there might still be some better sources for raising taxes. Laws passed by Congress would necessarily be prospective, rather than ex post facto, in application; and people affected would thereby have an opportunity to govern their conduct according to such laws.

In affirming the Crown decision, the Seventh Circuit echoed this sentiment:

> In conclusion, although we are sympathetic to the Commissioner's desire to fill in what may be a significant loophole in the gift tax laws, a number of theoretical and practical problems make it undesirable to do so by judicial construction. Accord, Note, 9 Camden L. J. 579, 586 (1978). We express no view here as to whether a propsective regulation making such loans taxable would be valid or whether, on the other hand, the problem would best be left to Congress.

Even the Supreme Court, in the dissenting opinion, indicated this matter should properly be under Congress' purview, not the courts:

> The Court's decision today rejects a longstanding principle of taxation, and creates in its stead a new and anomalous rule of law. Such action is best left to Congress.

In a remarkably similar situation, Congress has chosen this path. In 1982, the Supreme Court held in Diedrich v. Comm'r., 457 U.S. 191 (1982) that the donee's payment of the donor's gift tax liability results in income to the donor to the extent this discharge of liability exceeds the donor's basis in the gifted property. H.R. 4170, which was passed last week by the House of Representatives, precludes application of this decision prior to the date of the lower Court's decision that the donor recognized income.

Therefore, it is clear that many courts and, in fact Congress itself in a similar situation, believe adoption of a new tax policy should be left to Congress. The gift tax treatment of interest-free loans is such a policy and should be legislative rather than judicial. Although the Supreme Court believed that it should not distinguish an interpretation of the statute and regulations by making it effective only prospectively, the opportunity to do so, thereby treating all taxpayers equivalently, is now before Congress. To adopt a position which is fair to all taxpayers, we believe Congress should enact legislation making the Dickman decision prospective.

With this understanding of why we feel the Dickman decision should be applied prospectively only, we would now like to address the specific questions set forth in the notice announcing hearings on the proposed legislation.

QUESTION 1

> What actual amounts of gift tax liability would be forgiven if the scope of the Dickman case were to be retroactively limited?

No accurate determination of the actual amounts of gift tax liability that would be forgiven if the Dickman decision is prospective can be reasonably made. Our experience indicates that the amount would not be substantial.

It is difficult to determine the amount of gift tax liability that would be forgiven for a number of reasons. The use of interest-free loans as a tax planning tool received widespread publicity in the financial press. Therefore, many persons, including our clients, may have entered into these transactions without consulting us or any other adviser. In fact, the breadth of the Dickman decision makes it likely that many of these transactions could have been entered into without any outside counsel. Assuming the principal amount of interest-free or below market interest rate loans can be determined accurately, the interest rate for valuing gifts attributable to these loans is uncertain. The IRS itself has assessed a wide range of rates in its assessments of tax associated with these transactions.

The method of taxing gifts makes an estimate of the potential liability difficult. Gifts are potentially taxable only after the total gifts made to an individual during a year exceed an annual exclusion. This exclusion, currently $10,000, $3,000 for years before 1982, is doubled for married taxpayers who elect to treat the gift as one-half from each spouse. In addition, a gift tax liability is a cumulative calculation, the tax liability for one gift being dependent on other gifts made by the taxpayer during the year and in prior years. Records for all of these transactions are most likely no longer available. Because of the cumulative nature of gift taxes, incomplete records will result in incorrect gift tax liabilities for the taxable year of the gift and all succeeding years.

The Honorable Robert Packwood
Prospective Application of
Dickman v. Comm'r.
April 16, 1984
16

Even if the total gift tax liabilities associated with interest-free demand loans could be calculated, it is difficult to estimate the number of taxayers who would comply with the decision by filing or amending returns. Assuming non-compliance, it is also unclear the extent of gift tax assessments the IRS would make. Given the resources for assessing such taxes, it seems likely that the amounts will not be significant.

Because of the potential scope of the Dickman decision; the uncertainty of appropriate interest rates to be used in the valuing gifts; the lack of adequate records related to these transactions; the cumulative nature of the gift tax and the fact that many prior years could be involved, a meaningful estimate of the total gift tax liability is impossible to project. However, it is clear that only a portion of that amount would be collected. Thus, it seems only fair and reasonable that the decision should be applied prospectively so that administration of the law can be equitable rather than selective.

QUESTION 2

> What types of transactions would be provided relief by such legislation? Specifically, would

the legislation largely apply to transactions entered into intentionally to avoid estate and gift taxes, or would it largely affect taxpayers who structured transactions as interest-free demand loans for nontax purposes?

Interest-free loans were entered into for many reasons, often as the only practical means of consummating a transaction. Interest-free loans are commonly used to transfer a family business or farm to a younger generation. This technique is also used to provide funds for college education, to support elderly parents, and to assist children in purchasing a first home. There is no accurate way to determine the purpose of the majority of the loans, because there is no way to determine what loans exist or existed. Without an accurate assessment of the purpose of the loans, it is impossible to know whether the proposed legislation will apply largely to transactions entered into intentionally to minimize estate and gift tax or whether it would largely affect taxpayers who structured transactions as interest-free demand loans for nontax purposes. Without the legislation, the decision impacts both types of transactions. Understanding that all court decisions concerning interest-free or below market interest rate loans were favorable for the taxpayer until 1982, it is likely that many transactions were entered into with no consideration of gift taxes.

QUESTION 3

> What legal advice was typically given to taxpayers making interest-free demand loans? Specifically, were taxpayers advised of the IRS interpretation that interest-free loans were subject to gift taxes? If so, were taxpayers advised not to file gift tax returns disclosing their transactions? Or were taxpayers advised to consider filing gift tax returns in order to take advantage of the three-year statute of limitations, or the six-year statute of limitations applicable where a return significantly understates taxable gifts? What is likely to be the effect of the Dickman decision, in the absence of legislation, on attorneys or tax advisers who counseled clients to make interest-free loans?

The Honorable Robert Packwood
Prospective Application of
Dickman v. Comm'r.
April 16, 1984
19

It is our policy to advise clients of the potential tax risk for any proposed transaction. We believe most taxpayers who sought counsel were advised of the IRS's position in Rev. Rul. 73-61 and their non-acquiescence in the judicial decisions. Taxpayers would also have been advised that the IRS position was continually, until 1982, rejected by the courts who addressed the question. Analyzing the judicial support for the position that interest-free loans were not taxable gifts, most clients would have been advised that such transactions were not taxable gifts and gift tax returns would not have been filed.

Having advised our clients of the apparent IRS position concerning interest-free or below market interest rate loans, quantifying the tax risk of not reporting such a transaction includes an analysis of filing requirements and the statute of limitations. The idea that a gift tax return was filed only to begin the statute of limitations, is to place an unjustified emphasis on the tax effect and risk of a transaction. Gifts are made for donative purposes and not to enable a taxpayer to file a gift tax return. Most taxpayers, not responsible for filing a gift tax return, would not have done so. On the other hand, most wealthy taxpayers make annual gifts and thus would have filed returns which would begin the statutory period of limitations.

In the event the proposed legislation is not enacted, attorneys and tax advisers will be required to advise their clients to file or amend previously filed gift tax returns. In general, this will only increase the taxpayer's compliance requirements and any professional fees he normally incurs to meet these requirements.

QUESTION 4

> What is the likely effect of retroactive legislative relief on the administration of the tax laws generally? Is such legislation likely to increase the tax compliance problems caused by aggressive tax shelters, and taxpayers playing the "audit lottery?"

The likely effect of retroactive legislative relief for the application of the Dickman decision will be a more fair and equitable administration of the tax laws. As previously discussed, the complexity of computing gift tax liabilities for all prior years that have not been closed by an expiration of the assessment period, the difficulties in determining the taxable gift when an interest-free or below market rate of interest loan is made, and the unavailability of records for reporting the transactions, makes administration of this decision inequitable.

Given the IRS limited resources for assessing gift taxes, the audit procedure will probably be to single out large taxpayers and determine whether an assessment can be made. In addition, taxpayers filing gift tax returns reporting loans draw attention to the method of computing the taxable gift, and invite IRS audit and possible assessment. The breadth of this decision coupled with the limited IRS resources for assessment invite selective application of the law.

Comparison of this proposed legislation with tax compliance problems caused by aggressive tax shelters and the "audit lottery" is unwarranted. This legislation concerning gift taxes should not be compared with compliance with the income tax laws. Non-filing of gift tax returns or not reporting interest-free or below market rate interest rate loans was based on judicial decisions in the taxpayer's favor. Aggressive tax shelters, by virtue of their classification as "aggressive," are based on much less solid legal grounds.

Enactment of this legislation will most likely decrease taxpayers playing the "audit lottery" since it will enable all taxpayers to comply with the new judicial position. Retroactive application will suggest to many taxpayers that they should take their chances on not being audited by not going back and reporting all their potentially taxable gifts relating to interest-free or below market interest rate loans.

If the proposed legislation is not enacted, noncompliance, due to the administrative complexity and audit risk associated with complying, will probably be extensive. So that we can properly and accurately advise taxpayers, we support the legislation as a means of significantly decreasing administrative problems associated with decision and increasing compliance.

QUESTION 5

What administrative problems are likely to be faced by taxpayers, their advisers, estate administrators, and the IRS, if the Dickman decision is not limited?

Taxpayers, their advisers, estate administrators, and the IRS would face significant administrative problems if the proposed legislation is not enacted. These problems center around the problem of determining the existence of and valuing the gifts.

Taxpayers, their advisers, and the IRS will have difficulty in obtaining or reconstructing records to determine taxable loan transactions. Having determined that a taxable loan transaction exists, the next step is valuing the amount of the taxable gift. The proper method of determining a reasonable interest rate is unclear, and in fact, probably varies based on the facts and circumstances of each loan. The IRS itself has assessed a variety of rates, ranging from the rate specified in regulations for valuing annuities, life estates, terms for years, remainders and reversions (Johnson v. Comm'r., 254 F. Supp. 73) to a reasonable rate (Crown v. Comm'r., 67 T.C. 1060) to a separate monthly rate as provided by an expert who relied on estimated fair market interest rates considering the credit worthiness of the borrowers (LaRosa v. Comm'r., No. 29632-82). Determination of the appropriate rate will undoubtedly cause additional disagreements between the IRS and taxpayers.

The Dickman decision implies that virtually all property transferred without consideration could be a gift. This would include the use of automobiles and real property. Where non-cash transfers are made, the complexity of valuing the gift increases.

Taxable gifts must be included in calculating future gift and estate taxes. Therefore, not to report these amounts renders all future returns inaccurate. This puts an unreasonable burden on executors as they will often be unaware that interest-free or below market interest rate loans were made. However, they are responsible for the payment of estate taxes and other unpaid liabilities, including gift tax liabilities.

In general, the administrative complexities associated with retroactively restating gift tax liabilities are significant for the IRS, taxpayers, executors, and tax advisers. The decisions which will necessarily have to be made to retroactively apply the Dickman case could easily become a source of disagreement between the IRS and the taxpayer. This will likely promote further court battles. For this reason we feel prospective application, as the proposed legislation intends, is fair and equitable.

The Honorable Robert Packwood
Prospective Application of
Dickman v. Comm'r.
April 16, 1984
25

We feel there is a compelling case to limit the application of *Dickman* to loans outstanding after February 22, 1984. To allow retroactive application of *Dickman* invites noncompliance and selective application of the law. Enactment of the legislation will do much to simplify the administrative complexities arising because of this significant reversal in judicial opinion.

We would welcome the opportunity to discuss this with you further at your convenience.

Very truly yours,

Peter I Elinsky

Peter I. Elinsky, Partner

Deborah Walker

Deborah Walker, Senior Manager

PIE/DB:APR

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April 11, 1984

Senator Robert Packwood, Chairman
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Senate Finance Committee
Dirksen Senate Office Building
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Senator Steven Symms, Chairman
Subcommittee on Estate and
Gift Taxation
Senate Finance Committee
Dirksen Senate Office Building
Washington, D. C. 20510

Re: Hearings on Dickman v. Commissioner,
April 4, 1984

Dear Senators Packwood and Symms:

I am an attorney who has practiced law in the District of Columbia for about 35 years, specializing in Federal income, estate and gift tax matters. I am writing this letter in response to the invitation in your press release dated March 29, 1984, urging interested parties to comment on proposed legislation to overrule the Supreme Court's decision in Dickman v. Commissioner insofar as it applies retroactively. I request that this statement be included in the printed record of the hearings on this subject.

In my opinion, the decision of the Supreme Court in Dickman is, conceptually, a correct interpretation of the law. Nevertheless, because retroactive application of that decision will result in unforeseen, inequitable and uneven treatment of many taxpayers, and will involve serious administrative problems, I believe Congress should make the decision inapplicable to periods prior to February 22, 1984.

The testimony before, and the statements filed with, your committees on April 4, 1984, amply demonstrate, I believe, the administrative problems (which some have said will amount to a "nightmare") that would be presented by retroactive application of the Dickman decision. The Treasury Department, in its statement to your committees, apparently concedes the existence of such problems, but contends that they can be resolved in large part by administrative measures. I want to focus in this letter on two such measures.

One is a safe harbor valuation rule. The Treasury stated that the Internal Revenue Service will adopt a rule whereby the valuation of intra-family interest-free demand loans for the periods prior to the Dickman decision will be determined by reference to the lesser of the short-term T-bill rate or the applicable statutory rate under Section 6621. Treasury seems to believe that this will solve much of the complexity about valuation which many commentators have referred to. It is true that such an Internal Revenue Service rule will provide taxpayers with an interest rate that can be used without fear of challenge. It will not, however, avoid widespread disputes and litigation by taxpayers who believe that the value of the loans in their particular case is less than that produced by application of the Internal Revenue Service rate. These taxpayers will have the support of the Supreme Court itself, which stated in the Dickman opinion that the value of a demand loan, as opposed to a term loan, "may be reduced by virtue of its demand status". Moreover, under generally accepted tax principles, taxpayers will be entitled to take into account the credit-worthiness of the borrower and any other factors bearing upon the value of such a loan. The Internal Revenue Service itself so ruled in Revenue Ruling 73-61, 1973-1 C.B. 408, which indicated that the interest rate to be used in determining the value of an interest-free demand loan would depend on the actual circumstances pertaining to the transaction. For this reason, I believe that long and protracted litigation over value, much of it relating to years in the distant past, as to which records are unavailable or difficult to obtain, is inevitable.

The second administrative measure is an effort to exclude certain loans from the ambit of the Dickman decision. Many who testified before your committees pointed to the administrative difficulties attributable to the fact that loans that were reasonably small in amount and were not tax-motivated would, under the Dickman decision, give rise to taxable gifts in years going all the way back to 1932. The Supreme Court, in its opinion, indicated that many such gifts would be protected by the taxpayer's annual exclusion, with the result that such problems should be minimized. That is true in some cases, where the taxpayer has not otherwise used his annual exclusion; but in many cases that exclusion will have been absorbed by other gifts. The Treasury has told your committees that the Internal Revenue Service will solve the problems presented by such cases by assuming that the annual exclusion is available for use against the gift attributable to an interest-free loan and by disregarding such loans of $100,000 or less per recipient for any married couple ($50,000 for a single taxpayer) for the period prior to the Dickman decision. Treasury stated that the Service would also disregard such loans for purposes of computing the gift tax on future gifts and the estate tax on the taxpayer's estate. All of this is described in the Treasury statement as a "de minimis" rule.

I submit that this proposed solution to a serious administrative problem is a clear example of legislation by the executive branch. In effect the Treasury is saying, "We will solve the administrative problems by ignoring the law in a large number of cases."

Can anyone, absent legislative directive, seriously call a $100,000 loan "de minimis"? Can anyone, without legislation, justify ignoring a $100,000 loan while fully taxing each year the value of a $101,000 loan? How will the Service treat a loan of $200,000 that bears half the going rate of interest? Will it be the equivalent of a $100,000 loan bearing no interest? Can the Treasury make up whatever rules it deems appropriate?

By its own statement, the Treasury has demonstrated beyond doubt the existence of serious administrative problems arising from retroactive application of Dickman. Its proposed solution is, in my view, wholly inappropriate. The Congress, not the Treasury Department, should specify those instances in which the law should not be applied retroactively. Moreover, the proposed administrative rules presuppose distinctions between similarly situated taxpayers that cannot be justified in principle or even pragmatically. Such uneven application of the law is the antithesis of good tax administration.

Perhaps the Treasury's statement itself is the strongest argument for the proposition that Congress should step in and solve this serious problem by appropriate legislation. Such legislation should be uniform in its application. Any attempt to distinguish legislatively between tax-motivated loans and other loans (an approach suggested by some) would, in my view, be inappropriate. It is far better, I think, to let a few tax motivated donors avoid tax than to apply retroactively distinctions among taxpayers based upon factors, such as motive, that are irrelevant in determining whether there has been a transfer of property by gift.

Very truly yours,

Mac Asbill, Jr.

MAJ/ss

cc: Senator Robert J. Dole
Senator Russell B. Long
Hon. John E. Chapoton

Touche Ross & Co.

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARING ON GIFT TAX LEGISLATION

Statement By Gerald W. Padwe

National Director - Tax Practice

Touche Ross & Co.

April 12, 1984

Messrs. Chairmen, and Members of your distinguished subcommittees:

My name is Gerald W. Padwe, and I am the National Director - Tax Practice for the international public accounting firm of Touche Ross & Co. I appreciate the opportunity to present my firm's views on the retroactivity of the U.S. Supreme Court's decision in Dickman v. Commissioner, earlier this year. My statement is that of Touche Ross & Co., and is not made on behalf of any specific client or clients.

On March 2nd, less than two weeks after the opinion in Dickman was announced, I wrote to Chairman Dole, with copies to each member of the Finance Committee, because even at that short remove from the Supreme Court decision, we were beginning to see potentially serious administrative problems arising from it. While we would be happy to have that letter incorporated in your record, its thrust was to the effect that the Supreme Court's specific addressing and approving of retroactivity with regard to its decision would cause significant compliance, administrative, and equity questions. Subsequent developments on this issue - including Assistant Secretary Chapoton's

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statement to your subcommittees last week - has not changed our views.

In brief, as you are aware, the Dickman majority upheld the Commissioner's right to retroactivity, apparently without limit in the context of this issue. Further, no indication has been given - either by Treasury or the Internal Revenue Service - that any attempt would be made to limit the years to which the Dickman holding might be carried back.

However, although the gift tax entered our system in 1932, the question of interest on demand notes never rose to the level of a litigated issue until 1966 - 34 years later. At that time, the Service lost its first challenge, in a Texas district court. Thereafter, IRS waited seven years before it issued a revenue ruling announcing its decision not to follow that case.

In 1977 IRS again lost the issue, this time in the Tax Court in the famous Crown case. In 1978, there was another loss in Crown, in the Seventh Circuit. In 1980, the Tax Court held again against IRS in the first look at the Dickman facts.

\- Thus, not until 1982, when the Eleventh Circuit spoke in Dickman, did the Service win its first victory. In the context of tax practice standards adopted by this committee in its consideration of TEFRA penalties, before 1982 not only would the Service have been unable to secure a professional opinion that its view was "more likely than not" the proper one, it would have been hard pressed to argue it had "substantial authority" on its side.

Meanwhile, as pointed out by Justice Powell in his Dickman dissent, between 1966 and 1982 Congress had amended the gift tax statutes eight separate times - one of them (in 1976) a major

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integration of the gift and estate tax systems. In none of those instances, however, did Congress see fit to take the IRS' view of intrafamily demand notes as a gift. The doctrine of legislative reenactment, so often cited by IRS and Treasury against a taxpayer position, seems no less apt where it would support a taxpayer position - especially where, in the same time period, the government had been maintaining a zero batting average in the courts.

Thus, we would disagree with those who argue for open-ended retroactivity of Dickman on the grounds that the IRS position was well-known, or that it was "clear" the Service would eventually win the day. If the issue was so well known, why did it not surface for 34 years after the gift tax became part of our law? If it was so clear, why did it take seven years for IRS to announce its disagreement with the first case that had come to trial? If, indeed, it was so obvious that taxpayers had the incorrect view of the issue, why did a federal district court, a federal circuit court of appeals, and the U.S. Tax Court all hold for taxpayer, the first three times the opinions had to be written; and two justices of the U.S. Supreme Court feel it important that their dissent be memorialized in a written opinion?

We are sensitive to the questions raised on setting an improper policy precedent if retroactivity is limited by legislation. However, we believe the circumstances before you are unique, and the issues involved would not present the same open-endedness in an analogous income tax situation. Very few taxpayers file gift tax returns; thus, those who failed to file believing that Crown stated the law, are in the relatively unusual situation of not having

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started the statute of limitations running for the years involved. On the other hand, the filing of income tax returns is an annual occurrence for millions and millions of taxpayers, thus starting the statute of limitations. If we were looking to income tax issues, retroactivity would hardly be open-ended since the three-year statute of limitations (or even the six-year statute, where 25% of income is omitted) would put very practical limitations on how far back IRS could go.

Our concern is with the open-ended statute for taxpayers relying in good faith on the law before the Eleventh Circuit decision in Dickman. We believe, as discussed above, there is a strong argument to be made that retroactivity should not precede that Eleventh Circuit decision. We find no rational basis at all for permitting IRS to look back into years where even they had not made intrafamily demand loans a gift tax issue. And to those who would argue that the Service's view of the issue should allow retroactivity to, say, the issuance of its 1973 revenue ruling, we believe their approach misses the mark. Courts have recognized, on various occasions, that a revenue ruling does not rise to the level of a regulation, does not have to be approved by Treasury (as do regulations), and therefore falls far short of a binding interpretation of law. With several circuit courts, we would remind you a revenue ruling "represents the contention of one party to a case in court and is entitled to no greater weight" Estate of Lang v. Commissioner (9th Cir., 1980). Thus, the issuance of the 1973 ruling as an IRS position should not be determinative of a benchmark time for applying Dickman.

Open-ended retroactivity leads to further confusion given that, *Touche Ross & Co.*

prior to 1977, we operated under a different gift tax system involving lifetime exemptions (now integrated with the unified estate tax credit). Thus, for a taxpayer with Dickman-type gifts and no gift tax return filed for 1976, it is possible that retroactivity could result in the $30,000 lifetime exemption being utilized by or before 1976, with actual gift tax liability for that year -- and with interest going back, possibly, for decades. To add to this confusion, in 1976 gift tax returns were filed quarterly rather than annually, and it is not clear whether a return would have had to be filed for each quarter of the year to avoid the result of the prior sentence.

We urge Congress, therefore, to give certainty to this area via legislation. Silence by Treasury or IRS, with an unstated assumption that retroactivity to 1932 may be appropriate, is no answer - even given an intention to except loans of $50,000 or less. And, while we believe the arguments are more than merely equitable for using the Eleventh Circuit decision date in Dickman as the appropriate cut-off point, should your committee feel it necessary to go back to an earlier date, we would strongly urge that January 1, 1977 be the furthest retroactivity granted. This was the beginning of the new, unified gift/estate tax system, and limiting the Dickman holding to a period no earlier than that would, on practical grounds, be appropriate.

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April 13, 1984

Roderick A. DeArment, Esquire
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Interest-free Loans

Dear Mr. DeArment:

I am writing in response to the request from the Chairmen of the Subcommittees on Estate and Gift Taxation and Taxation and Debt Management of the Senate Finance Committee for input on the proposal to limit the effect of Dickman v. Commissioner, 52 U.S.L.W. 4222 with respect to certain interest-free demand loans outstanding on February 22, 1984.

If the Dickman decision were to be applied to demand loans outstanding prior to February 22, 1984, I would guess that our clients might have an aggregate potential gift tax liability of roughly $1,000,000. It was never our practice to recommend intrafamily interest-free demand loans to clients before the Seventh Circuit affirmed the Tax Court's finding of no gift tax liability in Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978). Even after the Crown decision, we informed our clients who were considering such loans that the Internal Revenue Service was unhappy with the courts' decisions in Crown and its predecessor, Johnson v. U.S., 254 F.Supp. 73 (N.D. Texas 1966), and that it would probably continue to press the gift tax question. Nevertheless, in view of the courts' unanimous rejection of the Service's position prior to the Eleventh Circuit's ruling in Dickman, 690 F.2d 812 (1982), we felt it appropriate to advise clients of the consistent judicial support for the taxpayer's position.

The fact that such a serious split could have developed between the Service's and the courts' interpretations of the gift tax status of such transactions illustrates a serious deficiency in the law in this area. The statute and the regulations are inadequate when they provide no clear guidance on the tax treatment of such transactions which are by no means always undertaken for tax purposes. The courts' reaction prior to Dickman reflects

Roderick A. DeArment, Esquire
April 13, 1984
Page Two

this inadequacy, and the current legislative proposals to codify the *Dickman* rule illustrate even the Treasury Department's acknowledgement that no hard and fast court developed rule can govern all such loans. Moreover, the Supreme Court itself, in remanding the *Dickman* case for consideration of the valuation question, acknowledged that taxpayers have been without consistent guidance on that crucial aspect of the gift tax question. In light of these factors, we believe that there is unusually strong justification for considering legislation which would limit or eliminate *Dickman*'s retroactive effect.

We are aware that serious objections have been raised against the practice of applying court decisions prospectively only, and we acknowledge the general validity of such objections. One argument suggests that if a policy is adopted of applying "loophole"-closing court decisions prospectively only, taxpayers will simply rush into abusive situations to beat the clock. Senator Dole has recently expressed the concern that such a precedent would be a signal to the Treasury Department that, upon losing a tax case in a lower court, it should immediately propose remedial legislation to Congress rather than pursuing the matter further in the judicial system. The Senator fears that this situation could place a heavy burden on Congress.

The underlying policy question is when a particular tax matter should be resolved by the courts and when it should be left to Congress. I submit that:

- Courts should deal with "loopholes" which are of a primarily technical nature, such as those which arise from legislative drafting in an area where the Congressional policy is clear.

- Courts should deal with tax issues that are primarily factual, such as whether a transaction is sham or not.

- Courts should deal with transactions that occur so rarely that general legislation is not justified.

- Courts can retroactively establish law with respect to transactions that are exclusively tax-motivated without unfairly burdening well-intentioned taxpayers who have acted in good faith.

We do not believe that the question of the gift taxability of intrafamily interest-free demand loans comes within any of those criteria. These transactions have arisen in the total absence of any clear legislative policy statements, under a statute and set of regulations which simply do not address the specific issue of whether they result in gifts and, if so, how such gifts are valued. This inadequacy is particularly serious because such loans are so often made without any tax-motivated purpose, or with such a purpose as merely a confirming rather than an originating factor.

For these reasons, we believe that the Dickman case represents an unusual instance in which Congress should consider a rule of non-retroactive effect.

We appreciate the opportunity to present our views on this matter.

Sincerely,

Frederic G. Corneel

Frederic G. Corneel

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April 13, 1984

Mr. Roderick A. DeArment
Chief Counsel, Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

Re: Senate Finance Subcommittee considering matter of legislation approving interest-free loans between relatives prior to the "Dickman" February 22, 1984 decision of the Supreme Court.

It is my understanding that a Senate Finance Subcommittee is giving consideration to legislation to overrule the Supreme Court "Dickman" decision relating to interest-free loans occurring prior to the Supreme Court decision on February 22, 1984.

It is believed that there are substantial equitable reasons to giving consideration to granting relief to pre "Dickman" interest-free loans for family members based upon the following:

a) Prior to the Supreme Court decision there were numerous federal court decisions, both district and appellate, supporting the "Crown" position, so that, except for one jurisdiction, any such loans were made in keeping with the then established and prevailing law.

b) In furnishing advice to clients with respect to such loans, it is certain that both legal counsel and tax practitioners relied on what appeared to be the overwhelming and prevailing law covering the subject matter.

c) It would be improper to allocate benefits to the donees of such loans based on interest rates comparable to that charged by the IRS for delinquencies, as such rates were not available to the holders of "demand" money.

d) The family member borrowers, in most instances, paid income taxes on any returns received by them from "demand" use made of the funds borrowed, so that the gift, if any, in most instances was not a total gift of the use of the money, but rather a net gift after payment of income taxes on the monies advanced.

It seems inequitable that attorneys and tax practitioners in this instance could not rely upon well established law in assisting their clients. There would be a considerable impracticability to limiting such reliance only on U.S. Supreme Court decisions, when prior to the decision there was a substantial favorable body of law recognized by both district and appellate level federal courts, not appealed by IRS. A more satisfactory and equitable disposition would appear to be to permit "Dickman" to govern all transactions following it, and to enact legislation overruling "Dickman" for any interest-free loans made in jurisdictions covered by the favorable nonappealed decisions prior to February 22, 1984.

Thank you for your consideration of the material in this letter.

Yours very truly,

SURPLICE & GOULD

By Richard C. Surplice

Richard C. Surplice

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April 10, 1984

Roderick A. DeArment, Esq.
Chief Counsel
Senate Finance Committee
SD 219
Washington, D.C. 20510

Dear Mr. DeArment:

This letter is written in regard to the recent U.S. Supreme Court decision in Dickman which holds that interest-free loans to family members will be subject to federal gift taxes.

As tax professionals, it has been our experience that prior to this decision, many people, in making such loans to their children and other family members, relied upon the Crown case and numerous other authorities which clearly stated that no gift tax would be assessed in such situations. The IRS has interpreted the Supreme Court decision in Dickman to the effect that it will be retroactively applied to all such loans in the absence of any Congressional action to the contrary. This result would unfairly damage many people who relied on established court precedent.

If no action is taken, the decision in Dickman will not only be applied unfairly, but will also impose an undue hardship on literally hundreds of thousands of unsuspecting taxpayers whose only mistake was to rely on laws existing when they made their loans.

We urge you to consider adding an amendment to the current Finance Committee Tax Legislation to make the Dickman case apply only to interest-free loans made after February 22, 1984, the date Dickman was decided by the Supreme Court.

Yours very truly

Byron F. White