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I. INTRODUCTION

Paulina du Pont, born August 18, 1903, was the great-great-granddaughter of the legendary Pierre Samuel du Pont de Nemours (1739-1817), forbearer of one of America's wealthiest families.[1] One hundred and one years before her birth, Paulina's great-grandfather, Eleuthère Irénée du Pont, founded what would become E.I. du Pont de Nemours and Company,[2] currently one of the world's largest chemical companies[3] and one of thirty companies composing the Dow Jones Industrial Average.[4]

Before her marriage to collegiate golf champion Junius Simpson Dean in 1923,[5] Paulina had purchased a home for over $200,000[6] and continued after her marriage to spend large sums on its upkeep and improvement.[7] Soon after their marriage, Paulina and Junius organized a personal holding company named, appropriately, the Nemours Corporation. Paulina was

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1 *Our Family History*, Pedigree Chart for Paulina du Pont, http://gentree.usgenfiles.com/pedigreetext.php?personID=I15642&tree=primary&parentset=0&display=&generations=6 (last visited April 14, 2010).

2 Encyclopedia Britannica, du Pont Family, http://www.britannica.com/EBchecked/topic/172546/du-Pont-family (last visited April 14, 2010).

3 Fortune 500, CNN Money, http://money.cnn.com/magazines/fortune/fortune500/2008/industries/7/index.html (last visited April 14, 2010).

4 Dow Jones Indexes, http://www.djindexes.com/ (Dow Jones Averages/Current Component Report) (last visited April 14, 2010).

5 Milestones: May 12, 1923, Paulina du Pont, http://www.time.com/time/magazine/article/0,9171,846048,00.html (last visited April 14, 2010); *see supra* note 1.

6 When the first housing census was taken about twenty years later the average price of a home in the United States was under $3,000. Census of Housing, http://www.census.gov/hhes/www/housing/census/historic/values.html.

7 *Dean v. Comm'r*, 9 T.C. 256 at 263 (1947), *aff'd* 187 F.2d 1019 at 1019 (3d Cir. 1951); *Dean v. Comm'r*, 187 F.2d 1019 at 1019-20 (3d Cir. 1951). Hereinafter the decision by the Tax Court will be referred to as "*Dean I*, T.C.," the Third Circuit's decision will be referred to as "*Dean I, 3d* Cir.," and *Dean I*, T.C. and *Dean I, 3d* Cir. will be referred to collectively as "*Dean I*."

vice president of the company and owned eighty percent of the stock. Junius was president and owned the remaining twenty percent.[8]

Paulina Dupont Dean, Junius Simpson Dean, the Nemours Corporation, and Paulina's house were destined to play critical roles in the development of the law of income taxation.

In 1931, Nemours owed $600,000 to the Chase National Bank, which was concerned over the corporation's relatively thin capitalization. It demanded that Paulina transfer the home in which she and her husband lived to the corporation. She did so. Following the transfer the family continued to live in the house as before.[9]

In auditing the returns of Paulina and Junius for the 1939 tax year, the Commissioner noted that they were using what was now corporate property without paying the corporation any rent. He determined, therefore, that the use value of that property was taxable income. As this was before the era of joint returns, he allocated the income in accordance with the couple's shareholdings: eighty percent to Paulina and twenty percent to Junius.[10]

The Tax Court, to which the couple filed a petition, upheld the Commissioner's determination that the personal use of corporate property constituted taxable income but disagreed with the Commissioner's allocation of that income. The court ruled that Junius, who bore the responsibility of providing a home for his family, had received use of the property in his capacity as president of the corporation and that the use value of the property was properly taxable to him as compensation.[11] The Court of Appeals for the Third Circuit affirmed.[12]

The reluctance of the Tax Court to view the benefit as deriving from shareholding and its preference, instead, to consider it compensation for services was tested in other cases, where corporate property was used rent-free by shareholders who had provided no services to the corporation. In these situations, the use of the property could not be classified as compensation. For a while, the courts dabbled with the idea that where the shareholder did not provide any services to the corporation, the free use of corporate property should be considered a tax-free gift to the shareholders.[13]

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8 *Dean I*, T.C at 257-58; *Dean I, 3d* Cir. at 1019.

9 *Dean I*, T.C at 263; *Dean I, 3d* Cir. at 1019-20.

10 *Dean I*, T.C at 263-64; *Dean I, 3d* Cir. at 1020.

11 *Dean I*, T.C at 267-68. (despite the fact that Paulina was vice president of the company, the Tax Court held that "Paulina duPont Dean rendered no services to the corporation").

12 *Dean I, 3d* Cir. at 1020. Similar results were reached in *Reynard Corp. v. Comm'r*, 30 B.T.A. 451 (1934); *Frueauff v. Comm'r*, 30 B.T.A. 449 (1934); *Levy v. Comm'r*, T.C. Memo 1984-306, 48 T.C.M. (CCH) 293 (1984). In *Motel Co. v. Comm'r*, 340 F.2d 445 at 448-49 (2nd Cir. 1965), use of a corporation's property by its president and CEO was ruled a gift. For current statutory treatment of "gifts" to employees, *see* I.R.C. § 102(c)(1) (2009).

13 Hillman v. Comm'r, 71 F.2d 688 (3rd Cir. 1934); Richards v. Comm'r, 111 F.2d 376 (5th Cir. 1940); Peacock v. Comm'r, 256 F.2d 160 at 162 (5th Cir. 1958) ("[W]here the owners of the stock of a corporation occupy a residence owned by it and there is no evidence that the rental value was to be

However, they eventually decided that the rent-free use of corporate property by shareholders is properly classified as a constructive dividend.[14]

A parallel question concerns the tax consequences to the corporation itself. Does allowing its shareholders to use its property without paying rent constitute a realization of taxable gain for the corporation?[15] Although the courts did not address this question directly, a negative answer is clearly indicated. Income tax is imposed on "all income from whatever source derived."[16] As the corporation receives no rent for the use of its property (nor is it contractually entitled to receive any rent), there is no income on which it can be taxed.[17]

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received as compensation for services, such rental value is a gift from the corporation to the stockholders and is not to be treated as taxable income.").

14 Chandler v. Comm'r, 119 F.2d 623 at 627 (3d Cir. 1941) ("Reasoning such as that advanced in the Hillman case that a gift is presumed because of the family relationship between the parties overlooks, we think, the fact that a corporation is not 'related' to its stockholders, directors and officers. That purely artificial modern concept, the stock company, does not form a segment in the oldest of all human relationships, the family circle. The corporate "person" may be deemed by a fiction of the law to have abilities normally ascribed to man but that fiction cannot be indulged to the extent of endowing the corporation with feelings of love and affection for its stockholders, officers and directors. It is only because of the love and affection which a normal human donor feels for members of his family that it is presumed by the law that a transfer of property by him to them is a gift. The basis for such a presumption is entirely absent when the donor is a corporation."); Campbell .v Comm'r, T.C. Memo 1961-166, T.C.M. (CCH) 825 (1961); Challenge Mfg. Co. v. Comm'r, 37 T.C. 650 (1962); United Aniline Co. v. Comm'r, 316 F.2d 701 (1st Cir. 1963); Comm'r v. Riss, 374 F.2d 161 at 169 (1967); Ashby v. Comm'r, 50 T.C. 409 (1968); Int'l Artists, Ltd. v. Comm'r, 55 T.C. 94 at 107 (1970); Whipple Chrysler-Plymouth v. Comm'r, T.C. Memo 1972-55, 31 T.C.M. (CCH) 230 (1972); Nicholls, North, Buse Co. v. Comm'r, 56 T.C. 1225 at 1238 (1971); Crosby v. United States, 496 F.2d 1384 (1974); Loftin & Woodard, Inc. v. United States, 577 F.2d 1206 at 1214 (1978) ("When a corporation confers an economic benefit upon a shareholder, in his capacity as such, without an expectation of reimbursement, that economic benefit becomes a constructive dividend, taxable to the respective shareholder."); Finney v. Comm'r, T.C. Memo 1980-23, 39 T.C.M. (CCH) 938 (1980); Uranga v. Comm'r, T.C. Memo 1983-373, 46 T.C.M. (CCH) 567 (1983); Tanner v. Comm'r, T.C. Memo 1983-230, 45 T.C.M. (CCH) 1419 (1983); Cirelli v. Comm'r, 82 T.C. 335 (1984); Royce C. McDougal, M.D., Inc. v. Comm'r, 49 T.C.M. (CCH) 731; Melvin v. Comm'r, 88 T.C. 63 (1987); Stan Frisbie, Inc. v. Comm'r, T.C. Memo 1190-419, 60 T.C.M. (CCH) 440 (1990); Gil v. Comm'r, T.C. Memo 1994-92, 67 T.C.M. (CCH) 2311 (1994); Smith v. Comm'r, T.C. Memo 1995-410, 70 T.C.M. 502 (1995); Yarbrough Oldsmobile Cadillac v. Comm'r, T.C. Memo 1995-538, 70 T.C.M. (CCH) 1282 (1995); Roy v. Comm'r, T.C. Memo 1997-562, 74 T. C.M. (CCH) 1428 (1997).

15 Because the recipient of the benefit is a shareholder and not, for example, an employee or other service provider, no question arises as to whether the corporation may deduct the expense. However, we will need to consider the effect of allowing shareholder rent-free use of corporate property on the earnings and profits of the corporation. See *infra* note 130 and the surrounding text.

16 I.R.C. § 61 (2009) (adopting almost verbatim the language of the sixteenth amendment to the Constitution).

17 In *Helvering v. Indep. Life Ins. Co*., 292 U.S. 371 (1934), the Supreme Court ruled unconstitutional a Congressional attempt to impose tax on the rental value of owner-occupied property. The same principle would bar Congress from imposing tax on the rent value of property occupied rent-free by shareholders: in the absence of actual income, the imposition of tax would constitute a tax on property not apportioned among the states.

Several decisions of the Tax Court, and its predecessor the Board of Tax Appeals, imply that a corporation derives no taxable gain from allowing shareholders to use its property rent-free. In *Reynard*, Thus, the law with regard to the rent-free use of corporate property by shareholders appears to be relatively straightforward. The corporation need not report any income, and the shareholder must report the use value of the property as a dividend.[18] Nevertheless, a deeper analysis will show that the situation is anything but simple. Indeed, it turns out that the issues that arise with regard to this seemingly straightforward transaction are fundamental to the whole concept of income taxation in general and the corporate tax regime in particular.

The tax consequences of rent-free use of corporate property by shareholders have received little attention from the courts since the 1950s and even less from commentators. The Code and regulations do not provide any specific guidance, but instead rely on general principles of income tax. Perhaps the reason is that it just seems too simple. Nonetheless, an ostensi-

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the Board of Tax Appeals determined that the rent-free use of corporate property by an individual who was both the sole shareholder and president of the corporation was compensation (*supra* note 12). It further held that the corporation had no gross income. The two determinations appear contradictory. If the use of property was consideration for services, it necessarily follows that that in return for the use of its property, the corporation received services. Those services would constitute realized income.

Nonetheless, despite, or perhaps because of, this internal inconsistency, *Reynard* supports the contention that a corporation allowing its shareholders rent-free use of property experiences no gross income. The court ignored the services that the corporation received and held that allowing its property to be used rent-free does not generate gross income for the corporation. This rule would apply, *a fortiori*, when the corporation allowed shareholders to use its property and received, in fact, nothing in return.

See Melvin v. Comm'r, 88 T.C. 63 at 83 (1987) ("[A] corporation is not entitled to deduct the costs of owning corporate property that are attributable to the personal use of the property by its shareholders."). Unstated but implicit in the court's reasoning is that allowing shareholders to use its property produces no gross income for the corporation; otherwise, the expenses would clearly be deductible as necessary for generating that income.). *See also* Hal E. Roach Studios v. Comm'r, 20 B.T.A. 917; Challenge Manufacturing Co. v. Comm'r, 37 T.C. 650 (1962); Levy v. Comm'r, T.C. Memo 1984-306, 48 T.C.M. (CCH) 293 (1984).

In *Combs Lumber*, *infra* note 20, and *Society Brand Clothes*, *infra* note 21, the Board of Tax Appeals and the Tax Court held that a corporation does not have gross income by lending money to shareholders interest free. The same principle would apparently apply in the case of rent-free use of property.

[18] Where the shareholder is itself a corporation, § 482 of the Code might be applicable. This section provides that:

> In any case of two or more organizations, trades, or businesses…owned or controlled directly or indirectly by the same interests, the Secretary may…allocate gross income…if he determines that such…allocation…is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

At one time, the courts held that gross income could not be allocated under § 482 unless there was actually income to allocate. Thus, in *Tennessee-Arkansas Gravel Co. v. Comm'r*, 112 F.2d 508 (6th Cir. 1940), the Sixth Circuit refused to allow the Commissioner to impute income to a corporation that allowed a sister corporation to use its property rent-free, holding that "[§ 482] did not authorize the Commissioner to set up income where none existed." However, today it is clear that the Commissioner has that authority. In the specific case of rent-free use of tangible property, Treas. Reg. 1.482-2(c) provides that the Commissioner may make appropriate allocations to reflect an arm's length rental charge.

The focus of this article is on shareholders who are individuals and whose use of corporate property is not within the framework of a trade or business, thus obviating the application of § 482.

bly similar type of transaction has received a tremendous amount of attention by courts, commentators and Congress. For a generation the courts struggled to come to grips with the taxation of interest-free loans from corporations to their shareholders until Congress finally had to step in and provide a comprehensive legislative solution.

As we shall see, the courts for the most part rejected the analogy between rent-free use of property and interest-free use of money and refused to apply to the latter the principles that had guided them in dealing with the former. When the path they chose proved impassable, Congress provided a legislative solution for the taxation of interest-free loans.

This article will analyze the tax consequences of rent-free use of corporate property by shareholders.[19] It will demonstrate that, despite the apparent similarities between rent-free use of property and interest-free use of money, there is an important difference, which can complicate analogizing from one to the other: what are purportedly loan proceeds can be bifurcated and recharacterized whereas rent-free use of property cannot. Interestingly, this difference played no part in the development of the case law. The supposed difference, upon which the courts relied when refusing to apply to interest-free loans the case law as it had developed with regard to rent-free use of property, is illusory.

In framing its legislative solution, Congress focused, advertently or not, on that particular aspect of interest-free loans that distinguishes them conceptually from rent-free use of property. This difference, more than any express words in the Code, makes the legislative solution to the problem of taxing interest-free loans inapplicable to situations involving the rent-free use of property and necessitates an independent analysis of the tax consequences of rent-free use of corporate property by shareholders.

For the purpose of our discussion, it is crucial to distinguish between rent-free use of corporate property by shareholders (or any other uncompensated service provided by a corporation to its shareholders), on the one hand, and barter transactions, on the other. When goods or services are exchanged, each party to the transaction receives actual, non-cash income. As the word "income," as used both in the Constitution and in the Code, is clearly not restricted to cash but rather includes also money's worth, the goods or services received clearly constitute income. For example, where an employee is allowed personal use of the employer's property there is a barter transaction: use of property in exchange for services. In fact, it is

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19 For the sake of convenience, this article will not refer to use of corporate property for below-market rent. Nevertheless, any reference to rent-free use should be read as also including use for which rent is paid at below-market rates. Similarly, interest-free loans include loans at below market interest. *See, e.g.*, Comm'r v. Greenspun, 670 F.2d 123 (9th Cir. 1982) (loan at 3 percent interest when market rate was 6 percent).

inaccurate to refer to the employee's use of the property as "rent-free." The employee actually pays rent and the employer actually receives rent, although instead of paying for the use of the property in cash, the employee pays in kind. Analyzing the tax consequences of barter transactions involves adapting rules fashioned primarily for cash income and cash expenditures to situations in which the income or the expense is not in the form of cash.

With regard to rent-free use of corporate property by shareholders, the use actually is rent-free. The corporation receives no goods or services in exchange for allowing its shareholders to use its property. In tax terminology, allowing its shareholders to use its property rent-free does not generate any gross income for the corporation. The focus of this article will be on the consequences, both to the corporation and to the shareholders, of the fact that the shareholders' use of corporate property is in fact rent-free.

Part II traces the development of the case law regarding the taxation of interest free loans from 1940 through 1984 and the legislative solution eventually provided by Congress with the addition of § 7872 to the Code. It analyzes the issues faced by the courts and explains why the courts were unable to mold a satisfactory solution to the issues raised by such loans. It then explores the structure of § 7872 and argues that Congress did not break from traditional tax principles but rather imposed a construction that the courts could and probably should have adopted on their own.

Part III shows that the legislative solution to the problem of interest-free loans is inapplicable to rent-free use of property. By its language, § 7872 applies only to interest-free loans. More importantly, the underlying principles, which the courts could have adopted on their own with regard to interest-free loans, are unavailable in the case of rent-free use of property because § 7872 relies on that particular feature of interest-free use of money (namely, that the loan proceed can be bifurcated and recharacterized) that distinguishes it from rent-free use of property.

Part IV analyzes the taxation of rent-free use of corporate property in light of the issues that caused the courts such difficulties when they confronted the problem of interest-free loans. It shows how the courts could have overcome the dilemmas they faced and how those solutions are applicable to the case of rent-free use of property. It also challenges the case law's determination that the economic benefit enjoyed by shareholders who use corporate property rent-free is properly classified as a dividend.

Part V compares the tax consequences of rent-free use of corporate property with those of an economically equivalent transaction in which the corporation rents property to its shareholders and then distributes as a dividend the rent received and will contend with the argument that the relatively light taxation of the former indicates a flaw in the analysis. The explanation for such a discrepancy is inherent in the corporate tax structure itself: non-integrated and partially integrated systems impose different burdens of taxation on distributed corporate earnings and on income derived directly by individuals. To demonstrate that the source of the horizontal inequity is the corporate tax structure and not any flaw in the analysis, the taxation of the two transactions is compared under various models of corporate taxation involving full integration.

Part VI summarizes the findings.

II. THE TAXATION OF INTEREST-FREE LOANS FROM COMBS LUMBER TO SECTION 7872

A. Income for the Corporation?

The Board of Tax Appeals first confronted the issue of interest-free loans from a corporation to its shareholders in 1940.[20] Combs Lumber lent money to its shareholders and they, in return, signed notes promising to repay the loans along with interest at the rate of six percent. Notwithstanding the express provisions of the notes, the shareholders testified that at the time the notes were issued it had been understood by all parties concerned that the shareholders would not be charged interest by the corporation and, furthermore, that no interest had in fact ever been paid. In attempting to impose tax on the corporation for the stated interest, the Commissioner argued that the stated interest actually was owed, actually did accrue, and was, therefore, income in the hands of the corporation. Furthermore, he argued that oral evidence contradicting the content of the notes was barred by the parole evidence rule.

The court rejected both of the Commissioner's arguments. With regard to the procedural argument, it held that the parole evidence rule is not applicable in Tax Court. With regard to the factual argument, it accepted the shareholder's testimony and found that interest neither accrued nor was paid. It went on to conclude that a taxpayer who does not receive and who is not entitled to receive income does not experience any taxable gain. Twelve years later, in *Society Brand Clothes*,[21] the Tax Court encountered a similar fact pattern and reached similar conclusions.

The rule that corporations experience no taxable income when lending money to their shareholders interest-free, conforms to the rule we saw earlier whereby corporations do not experience any taxable income when they allow shareholders to use corporate property without paying rent. These rules are unremarkable. Barring a specific statutory provision, income tax is imposed on the actual income of a taxpayer, not the income a taxpayer could have earned by employing property or skills in the most productive

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20 Combs Lumber Co. v. Comm'r, 41 B.T.A. 339 (1940).

21 Soc'y Brand Clothes, Inc. v. Comm'r, 18 T.C. 304 (1952).

manor. A taxpayer who neither received nor is entitled to income need not report any.[22]

B. Deduction for the Shareholder?

Six years after *Combs Lumber*, the Tax Court had an opportunity to consider whether when shareholders borrow money interest free from a corporation they control, they are entitled to an interest deduction.[23] From 1930 to 1939 Howell Turpentine Company lent money to its controlling shareholder, Mr. D.F. Howell. During this time the corporation carried the obligation on its books without charging the shareholder any interest. In 1940 the corporation was liquidated, which resulted in a large gain for Mr. Howell. In consequence, he asked the auditor to compute the interest on the average yearly balances, paid that amount to the corporation, and claimed a deduction for the interest paid. The Tax Court found that the shareholder and the corporation had not contracted for interest to be paid and disallowed the deduction.[24]

In both *Combs Lumber* and *Howell Turpentine* the inquiry was primarily factual. The question the court faced was whether or not the loans bore interest. Once it determined, as a finding of fact, that the loans were interest free, the court immediately concluded that the corporation need not report interest income and that the shareholder is not entitled to an interest deduction.

Later, in *D. Loveman & Sons*, the Tax Court stated "the general rule – that interest may not be accrued where there is no obligation to pay interest."[25]

Then things started getting interesting.

C. Income for the Shareholder?

Nemours was a successful corporation and its shareholders, Junius and Paulina Dean, wanted to withdraw some of Nemours' cash. The problem was that taking out the cash as a dividend would have subjected them to tax at the rate of ninety-one percent.[26] Therefore, instead of withdrawing the cash as a dividend, they borrowed money from the corporation and in exchange delivered to the corporation non-interest bearing notes. By the end

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22 *See supra* note 17.

23 Howell Turpentine Co. v. Comm'r, 6 T.C. 364 (1946), *rev'd on other grounds,* 162 F.2d 316 (5th Cir. 1947).

24 The parties agreed, and the court so held, that under the circumstances the corporation need not report any interest income. 6 T.C. at 394.

25 D. Loveman & Sons Export Corp. v. Comm'r, 34 T.C. 776 at 805-06 (1960). The Board of Tax Appeals reached a similar result in a case not involving a corporation-shareholder relationship in *A. Brackus, Jr. & Sons v. Comm'r*, 6 B.T.A. 590 (1927).

26 Internal Revenue Code of 1954, Pub.L. 83-591, 68A Stat. 5, § 1 (1954).

of 1956, they owed upwards of two and a half million dollars (worth about twenty million present-day dollars), for which they neither paid nor were obliged to pay interest. As the withdrawal was a loan and not a dividend, they paid no tax on the money they received.[27]

The Commissioner did not argue that Nemours was obligated to pay tax on the interest it could have received had it lent the money at the market rate of interest instead of interest-free. Apparently, that was a battle he knew he could not win, as his defeat in *Combs Lumber* and *Society Brand Clothes* had convincingly demonstrated.[28] Instead, he directed his attention to the shareholders and argued that, by being able to use corporate funds interest-free, they had received a taxable benefit.[29] In support of his contention, the Commissioner relied on the ruling in *Dean I* and in similar cases that rent-free use of corporate property by shareholders or officers constitutes taxable income. He argued that if rent-free use of property is taxable, so is interest-free use of money.[30]

The Commissioner's argument is extremely persuasive. Unless it were willing to overturn its own (and several Circuit Courts') previous decisions regarding rent-free use of property, the Tax Court would seem compelled to come to the same conclusion with regard to interest-free use of money. Nonetheless, the Tax Court, while reaffirming its decision in *Dean I*, rejected the Commissioner's position in *Dean II*, and held that the interest-free use of corporate funds does not constitute income in the hands of a shareholder.

The Tax Court's decision in *Dean II* relied upon two lines of reasoning. The first was that interest-free use of money is essentially different than rent-free use of property. The court noted that in those cases of rent-free use of property relied upon by the Commissioner, the rent, had it been paid, would not have been deductible by the shareholders. In contrast, had the shareholders in *Dean II* paid interest, they would have been able to deduct it (prior to 1986, almost all interest payments were deductible, the primary exception being where the loan proceeds were invested in tax-free

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27 Dean v. Comm'r, 35 T.C. 1083 (1961) (hereinafter *Dean II*).

28 Even in the earlier cases, the Commissioner had not contended that the corporation must report income that it neither received nor was entitled to receive. Rather, relying on the fact that the shareholders had signed notes requiring them to pay interests and on the parole evidence rule which he argued disqualified any contradictory oral evidence, the Commissioner claimed that the corporation was actually entitled to receive interest and should be taxed accordingly. Once the court rejected the factual argument, the conclusion was self-evident. In *Dean II*, the notes were on their face non-interest bearing.

29 In quantifying the benefit, the Commissioner assumed that the taxpayers could have borrowed money at the prime rate of interest.

30 *Dean II, supra* note 27, at 18.

bonds).[31] Thus, if the rent-free loans were considered gross income, they would be offset by the interest deduction.[32]

The second reason was that "[w]e have hitherto given full force to interest-free loans, holding that they result in no interest deduction for the borrower nor interest income to the lender. We think it equally true that an interest-free loan results in no taxable gain to the borrower, and we hold that the Commissioner is not entitled to any increased deficiency based upon this issue."[33]

Neither of the two lines of reasoning stands up under close scrutiny. Let us consider each of them in turn.

The first ground was that interest-free use of money is different than rent-free use of property because, as opposed to rent, interest, had it been paid, would have been deductible. In a concurring opinion, Judge Opper convincingly refuted that argument by noting that neither of the two presumptions—i.e. that interest is deductible and that rent is not—is necessarily true. Suppose a shareholder who receives rent-free use of corporate property sub-leases the property to a third party. Presumably the shareholder, having included the rental value of the property in gross income, could deduct that same amount as an expense of earning income. On the other hand, assume that a shareholder who borrowed money interest-free from the corporation invested the funds in tax-free bonds;[34] in which case the interest would not be deductible.[35] In other words, the deductibility or non-deductibility of either rent or interest cannot be presumed and depends upon the facts of the particular case.[36]

The second ground was that the court had previously given "full force to interest-free loans."[37] In other words, the court claimed to be following its own precedents, which established that interest-free loans have no tax

31 I.R.C. § 163 (2009).

32 *Dean II, supra* note 27, at 19-20.

33 *Dean II, supra* note 27 at 20-21.

34 I.R.C. § 103 (2009).

35 I.R.C. § 265 (2009).

36 *Dean II, supra* note 27, at 22-26. Judge Opper was of the opinion that the court need go no further than to conclude that in the circumstances of the case before it there was no taxable income. He felt it was unnecessary and inadvisable to determine whether the absence of taxable income was due to there being no gross income (as the court had concluded) or whether there was gross income but also a corresponding deduction.

Judge Bruce, in his dissent, went one step further. The interest-free use of corporate funds clearly constitutes an economic benefit to the borrower and just as clearly constitutes gross income in the hands of the shareholders. With regard to the corresponding interest deduction, Judge Bruce held that, to justify the deduction, the shareholders had to stipulate and prove that the funds were not invested in interest-free bonds. This they had not done. Judge Bruce concluded, therefore, that the interest-free use of corporate funds constituted gross income, that the shareholders were not entitled to an interest deduction and that the Commissioner was justified in adding the benefit inherent in the loans to the taxable income of the shareholders.

37 *Dean II, supra* note 27, at 20-21.

consequences for either the lender or the borrower. However, a closer examination reveals that the decision in *Dean II* is incompatible with the previous decisions the court cites. Giving "full force" to interest-free loans entails accepting that a loan can actually be interest-free. The alternative would be to deny that there can exist, for tax purposes, such a thing as an interest-free loan and to consider the borrower as having paid interest and the lender as having received interest.[38] Giving "full force" to interest-free loans does not mean ignoring them for income tax purpose but rather deriving the appropriate income tax consequences from the presumption that they are in fact interest-free.

In *Dean II*, the starting point for the Commissioner's argument was that the loans were interest free. Only where the use of money is interest free (or, more precisely, only when the interest charged is less than the market rate) does the shareholder receive any economic benefit from the loan. Thus it was actually the Commissioner who gave "full force" to the interest-free loans. The court, on the other hand, rejected the Commissioner's argument by holding that, had the shareholders paid interest, they would have been entitled to a deduction. In other words, the court determined the income tax consequences by considering what would have happened had the loan not been interest-free, an analysis contradicting the "full force to interest-free loans" position it had adopted in the cases it cited.

Despite the flaws in the Tax Court's reasoning, the Commissioner did not appeal the decision. Moreover, he waited a full twelve years before finally issuing a non-acquiescence and again litigating the issue.[39] One might assume that in doing so, the Commissioner would have adopted the position taken in *Dean II* by Judge Bruce in dissent, and implied in the concurring opinion by Judge Opper; namely that the economic benefit inherent in the interest-free use of corporate funds is gross income and that the question of whether the shareholder is entitled to an offsetting deduction should be determined on a case-by-case basis. However, the Commissioner went beyond that. He argued that, while the economic benefit of the interest-free loan is gross income, there can never be an interest deduction. Section 163(a) of the Code allows a deduction for interest "paid or accrued." Seeing as interest was neither paid nor accrued—the loan, after all, was interest free—the Commissioner contended that no deduction was permissible.[40]

The Fourth Circuit was the first to consider the Commissioner's argument.[41] In a short decision it declared the *Dean* rational persuasive, as applied to the fact of the case before it, and affirmed the Tax Court's decision.

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38 I.R.C. § 7872 (2009). Enacted in 1984, it essentially proceeds from this presumption, i.e., that there can be no such thing as an interest-free loan. *See infra* Part II.E.

39 1973-2 C.B. 4.

40 In other words, the Commissioner continued to give "full force" to interest-free loans.

41 Suttle v. Comm'r, 625 F.2d 1127 (4th Cir. 1980).

While the court did not specify what it meant by the qualifying phrase "as applied to the fact of this case,"[42] it is reasonable to assume that the court was referring to situations in which interest, had it been paid, would have been deductible. The court was apparently withholding judgment on the question of whether *Dean II* would continue to apply if, for example, the shareholder had invested the borrowed funds in tax-free bonds.

A year later the issue was brought before the Fifth Circuit.[43] The Tax Court had reiterated the *Dean II* rule and had held that an interest-free loan produced no gross income;[44] the Commissioner argued that there was gross income and no corresponding deduction. The Court of Appeals affirmed.

In a long and vigorous dissent, Judge Goldberg rejected both the *Dean II* approach and the Commissioner's position and opted for a middle path, similar to that of Judges Opper and Bruce in *Dean II*, but further developed. In essence he presented a form-over-substance analysis, arguing that the receipt of an interest-free loan is equivalent to receiving cash and then borrowing at prevailing interest rates and that the tax consequences of the two scenarios should therefore be identical.[45] Thus, he claimed that the economic value of the interest-free loan (what the borrower would have had to pay for the use of money at prevailing interest rates) should be considered gross income, while the interest the borrower would have had to pay for a market loan should be considered an income expense. He emphasized, however, that the income and expense need to be taken into account separately and not netted one against the other. Even when it is recognized that the borrower, in effect, incurs an interest expense, there may be bottom-line income tax consequences to the loan. As already pointed out by the concurring and dissenting opinions in *Dean II*, interest paid or accrued is not necessarily deductable, as when the funds are investing in tax-free bonds. But Judge Goldberg noted that even when the interest would have been deductible, the result is not necessarily a wash. The deduction of interest may require the taxpayer to itemize deductions, meaning that those taxpayers who prefer the standard deduction are not entitled to deduct the interest;[46] the rule in *Dean II* in effect allows the taxpayer to claim both the interest deduction and the standard deduction. Miscellaneous deductions are only allowed to the extent they exceed a given percentage of adjusted gross income.[47] Thus, even if the taxpayer itemizes and properly deducts the interest expense, if that deduction is "below the line" it will only reduce taxable income; it will not reduce adjusted gross income. Including the economic

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42 *Id.* at 1128.
43 Martin v. Comm'r, 649 F.2d 1133 (5th Cir. 1981) (hereinafter *Martin*).
44 Martin v. Comm'r, T.C.M. (P-H) P79, 469 (1979).
45 *Martin, supra* note 43, at 1136-37.
46 I.R.C. § 63(b) (2009).
47 I.R.C. § 67 (2009).

value of the interest-free loan as gross income and allowing the same amount to be deducted "below the line" will result in an increased adjusted gross income and the consequent reduction of the amount of miscellaneous deductions allowed.[48]

Although commending the dissent's attempt to replace the "rough equity" of the gross income exclusion by a more precise attribution of income and deductions,[49] the court nonetheless decided to affirm the Tax Court on the basis of *Dean II*. Primarily it did so because it felt that the *Dean* rule was established law and that disturbing it would not only be inadvisable after twenty years but would also create a conflict between the Fourth and Fifth Circuits.[50] In addition, the court noted that the dissent merely substituted one fiction for another: instead of the *Dean* fiction that an interest-free loan produces no economic benefits, the dissent relied on the fiction that interest is paid or accrued.[51]

Other circuits followed suit. Although some expressed apprehension about the *Dean* rule and questioned whether they would have decided similarly had the issue arisen as a case of first impression, six circuit courts had affirmed the rule by 1982.[52] At this point in time, two key questions remained. The first was whether one of the remaining circuits—despite his string of losses, the Commissioner continued litigation—would either uphold the Commissioner's position or adopt a middle-of-the-road approach such as that championed by Judge Goldberg's dissenting opinion in *Martin*, thus creating a conflict among the circuits and justifying a petition of certiorari for review by the Supreme Court. The second was whether, assuming it were not overturned, the *Dean* rule would apply when the shareholder would not have been entitled to deduct interest had interest in fact been paid, such as when the loan proceeds were invested in tax-free bonds. Recall that the *Dean* Court decided that because the interest would have been deductible, the economic benefit inherent in the interest-free loan is not gross income. Was the *Dean* rule that tax-free loans do not constitute gross income or was it that interest-free loans do not constitute gross income only when interest would have been deductible if paid?

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48 *Martin, supra* note 43, at 1140-42.

49 *Id.* at 1134.

50 *Id.* at 1144. The court also expressed concern that the computations involved in implementing the construction urged by Judge Goldberg could prove arduous. Judge Goldberg countered that, as the government, in quantifying the benefit, announced its intention to rely on the prime rate of interest, and as the taxpayer had agreed that such a rate represents a bargain, the computations required to determine taxable income are "a grade school exercise in multiplication."

51 *Id.* at 1133.

52 *See, Suttle*, *supra* note 41; *Martin*, *supra* note 43; Beaton v. Comm'r, 664 F.2d 315 (1st Cir. 1981); Comm'r v. Greenspun, 670 F.2d 123 (9th Cir. 1982) (although *Greenspun* did not involve a loan from a corporation to its shareholders but rather from a service recipient to a service provider, the court nevertheless considered *Dean II* controlling); Baker v. Comm'r, 677 F.2d 11 (2nd Cir. 1982); Parks v. Comm'r, 686 F.2d 408 (8th Cir. 1982).

The second question reached the Court of Appeal for the Federal Circuit in *Hardee*.[53] The taxpayers received interest-free loans from a closely-held corporation and invested the funds largely in tax-free bonds. In a 3-2 decision, the court held, not only that *Dean* was established law and that the rule of *stare decisis* required that it be followed,[54] but that *Dean* stood for the proposition that an interest-free loan falls outside the definition of "income" as that term is used in § 61 of the Code.[55] Thus, the fact that the taxpayers would not have been entitled to a deduction had they paid interest is irrelevant.

When examining the position taken by the Commissioner following his non-acquiescence in 1973, one can hardly avoid wondering how the Commissioner could have pressed the argument that, on the one hand, the economic benefit inherent in an interest-free loan constitutes gross income, but that, on the other, the taxpayer was not entitled to a deduction even in those circumstances where interest would have been deductible if paid.[56] To explain the apparent absurdity of the Commissioner's approach, consider a situation in which (a) a corporation lends $1,000, interest-free, to its shareholder, and (b) the shareholder then lends the money to a third party and charges full market interest of ten percent. At the end of the year, the third party will pay the shareholder $1,100. The shareholder will pay the corporation $1,000. Clearly the economic gain to the shareholder from the described transactions is $100.

What would the shareholder's taxable income be, according to the Commissioner? The economic benefit inherent in the interest-free loan, equal to $100, is gross income. The $100 interest received from the third party is also gross income. On the other hand, the shareholder, who was not charged interest by the corporation, would not be entitled to a deduction. Taxable income would be $200, even though the total economic gain is only $100.[57] Is it any wonder, one may ask, that the courts rejected the position advanced by the Commissioner?

The case law is equally difficult to fathom. Why should the fact that interest would have been deductible had it been paid mean that the loan

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53 Hardee v. United States, 708 F.2d 661 (Fed. Cir. 1983),(reversing *Hardee v. United States*, 82-2 U.S. Tax Cas. (CCH) P9459 (1983)).

54 *Id.* at 667-68. With regard to the question of how it would have ruled in the absence of what it considered binding precedent, the court equivocated: "This is not to say . . . that were we 'writing on a clean slate' we would reach the result reached in *Dean* [II]. Perhaps we would, perhaps not." *Id.*

55 *Id.* at 665.

56 It is arguable that the Commissioner's position was merely a litigation tactic and that he was actually hoping for a "compromise" result that the use of corporate funds is taxable and that a deduction is possible under appropriate circumstances. If so, it appears that the tactic backfired. As will be argued in the text, the courts could not accept the Commissioner's position and therefore refused to consider the interest free use of corporate funds as income.

57 It is worth noting that in the time period concerned, the top individual tax rate was 70 percent. Economic gain of $100 would produce a tax liability of $140.

itself does not constitute gross income? Most surprising is *Hardee*, in which the economic benefit inherent in the interest-free loan was held not to constitute gross income even though interest, had it been paid, would not have been deductible.

As a prelude to answering these questions, it would be helpful to flesh out in greater detail the implied reasoning of both the Commissioner and the courts. The Commissioner's line of reasoning may have run as follows:

(a) Interest-free use of corporate funds is similar to rent-free use of corporate property.

(b) Rent-free use of corporate property by shareholders is gross income in the hands of the shareholders.[58]

(c) From (a) and (b), the interest-free use of corporate funds constitutes gross income in the hands of the shareholders.

(d) The shareholders did not pay nor were they obliged to pay interest.

(e) For income tax purposes, a corporation that lends money interest-free to its shareholders does not conceptually receive interest.[59]

(f) From (e), shareholders who borrow money interest-free cannot be considered as having conceptually paid interest.

(g) From (d) and (f), the shareholders are not entitled to any interest deduction.

(h) From (c) and (g), an interest-free loan from a corporation to its shareholder constitutes gross income with no potentially offsetting interest deduction.

For their part, the courts could not agree with the Commissioner's conclusion that a taxpayer with $100 of economic gain could have $200 of taxable income (and, at the then-prevailing tax rate of 70 percent, a tax liability of $140). Their implied reasoning was teleological:

(a) Assume that shareholders borrow $1,000 interest-free from a corporation and lend that money to a third party at the market rate, the shareholders receiving interest of $100.

(b) The shareholders' economic gain is $100.

(c) Shareholders should be taxed on an amount equal to (and in any case not exceeding) economic gain.

(d) From (b) and (c), taxable income should be $100.

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58 *See supra* notes 12-15 and the accompanying test.

59 *See supra* Part II. A.

(e) As the shareholders neither paid nor were they obliged to pay interest, either actually or conceptually, they are not entitled to an interest deduction.[60]

(f) Taxable income is the difference between gross income and deductions (gross income – deductions = taxable income).[61]

(g) From (f), gross income is the sum of taxable income and deductions (taxable income + deductions = gross income).

(h) From (d), taxable income is $100. From (e), deductions are $0. Therefore, from (g), gross income is $100 + $0 = $100.

(i) Gross income is the sum of the interest received from the third party and the taxable benefit of the interest-free loan (gross income = interest received + taxable benefit of the loan).

(j) From (h), the taxable benefit of the interest-free loan is the difference between the shareholders' total gross income and the interest received from the third party (taxable benefit of the loan = gross income – interest received).

(k) From (j), (h), and (a) the taxable benefit of the interest-free loan is $100 - $100 = $0. In other words, the interest-free use of corporate funds is not gross income in the hands of the shareholders.

The common presumption relied upon by both the Commissioner (line (d)) and by the courts (line (g)) was that the shareholders were not entitled to an interest deduction for use of the corporate funds, even though the funds were used for the purpose of generating income. It was from here that their paths diverged; the Commissioner concluded that the interest-free loan is gross income with no corresponding deduction, the courts concluded that there must not be any gross income in the first place.

Judge Goldberg's dissent in *Martin* challenged that presumption. Describing the Commissioner's argument that the shareholders are not entitled to an interest deduction as "technical, literal and myopic,"[62] Judge Goldberg viewed the substance of the transaction as a loan at full interest along with a dividend equal to amount of that interest. The dividend is gross income, while the interest constructively paid may be deductible, depending on the facts of the particular case.[63]

As persuasive as Judge Goldberg's argument is, it contains a crucial omission. Judge Goldberg ignored the effect of his construction on the corporation. If an interest-free loan is viewed as a loan at market interest

60 *See* I.R.C. § 163(a) (2006).
61 I.R.C. § 63(a) (2009).
62 *Martin,* 649 F.2d at 1136.
63 *See supra* notes 45-48 and the surrounding text.

coupled with a dividend payment equal to the amount of the interest, then the corporation should report as income the interest conceptually received. Thus, Judge Goldberg's line of reasoning leads to the conclusion that the principle established in *Combs Lumber* should be overturned, and yet nowhere is his opinion does he suggest doing so.[64]

The symbiotic connection between *Combs Lumber*, on the one hand, and *Dean II*, on the other, was hinted at by several of the judges who considered the Commissioner's argument in the cases following *Dean II*. For example, in explaining its affirmation of the principle underlying *Dean II*, the *Hardee* court wrote:[65]

> Since we do not reach our result by imputing to the borrower an interest payment and a corresponding interest deduction, we are not theoretically constrained to impute interest income to the corporation.

A similar thought was expressed in a dissent by Tax Court Judge Nims, the only judge who accepted the position advanced by the Commissioner:[66]

> The majority opinion, following the *Dean* [*II*] rationale, in effect provides petitioner a constructive interest deduction with which to offset the conceded income. If this approach is pursued, the Court may expect to be eventually confronted with a case in which the Commissioner asserts imputed interest income to the lender—a quid pro quo for the constructive deduction allowed the borrower. One can easily visualize this occurring, for example, in the stockholder-controlled corporation context.

Thus it would appear that the roots of both the Commissioner's position and the *Dean II* rule can be traced to *Combs Lumber*. One solution to the dilemma would have been to overturn *Combs Lumber* and hold that a corporation lending money interest-free to its shareholders must report as income the interest it would have received had it lent the money at full market interest. If the corporation were viewed as having received interest, there would be no impediment, in the appropriate circumstances, of permitting an interest deduction to the shareholders. If an interest deduction were possible, the courts would be able to consider the interest-free use of funds as gross income to the shareholders: where the notional interest payments were deductible, they would offset the gross income; where they were not, the shareholders would realize taxable income. However, there is no indi-

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64 The two-transaction approach found support in the literature of the time. *See, e.g.*, Robert I. Keller, *The Tax Treatment of Interest-Free Loans: A Two Transaction Approach*, 1 VA. TAX REV. 241 (1981); G.F.I., *The Income Tax Treatment of Interest-Free Loans,* 1 VA. TAX REV. 137 (1981).

65 Hardee v. United States, 708 F.2d 661,666 (Fed. Cir. 1983).

66 *Greenspun v. Comm'r*, 72 T.C. 931,957-58 (1979), *aff'd* 670 F.2d 123 (9th Cir. 1982).

cation that any court seriously considered overturning *Combs Lumber* and imputing income to the corporation.

D. Gift Tax Consequences of Interest-Free Loans

Perhaps due to the uniformity among the circuits, the Supreme Court did not consider the income tax consequences of interest-free loans from corporations to their shareholders. However, it did consider a seemingly related issue. In *Dickman*, the Court held that an interest-free loan from one individual to another constitutes a gift for the purposes of gift tax.[67]

Ostensibly, *Dickman* would appear to undermine *Dean II*. If the interest-free use of money is recognized as a valuable benefit, the conferring of which can obligate the lender to pay gift tax, then the receipt of such a benefit should, in the absence of a statutory exclusion, constitute income.[68] To emphasize the connection between the two cases, recall that one of the reasons the *Dean II* court gave for holding that interest-free use of money does not constitute gross income was that the court had "heretofore given full force to interest-free loans[.]"[69] As already noted, the court apparently did not mean that it had previously derived the tax consequences of interest-free loans from the presumption that they were actually interest free. Such a presumption would not have saved the Dean's from recognizing gross income; in fact, the Commissioner's position explicitly relied on the presumption that the loan actually was interest free. Rather, what the court meant was that no tax consequences should flow from interest-free loans;[70] *Dickman* undermined that presumption. It was the first time that the Supreme Court considered whether an interest-free loan could have tax consequences, and it answered in the affirmative.

On the other hand, *Dickman* appears to have little effect on the line of reasoning sketched above leading from *Combs Lumber* to *Dean II*. Had the Supreme Court held that an interest-free loan is the economic equivalent of a loan at market interest rates coupled with a transfer from the lender to the borrower of an amount of money equal to the interest and should be taxed as such,[71] the decision would have undermined *Combs Lumber*, *Howell Turpentine*, and *Dean II*. It would have required the corporation to recognize interest income, it would have required the shareholders to recognize

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67 Dickman v. Comm'r, 465 U.S. 330 (1984). In an earlier case, *Crown v. Comm'r*, 585 F.2d 234 (7th Cir. 1978), the seventh circuit held that the giving of an interest-free loan did not subject the lender to gift tax.

68 In the case of a gift loan, the borrower would presumably be entitled to exclude the benefit received under I.R.C. § 102. This provision does not apply to shareholders receiving interest free use of corporate funds.

69 *Dean II*, 35 T.C. at 1090.

70 *See supra* note 38 and the accompanying text.

71 *Dickman*, 465 U.S. at 336.

dividend income, and it would have allowed the shareholders, in the appropriate circumstances, an interest deduction. But the Supreme Court did not so hold. It held that the interest-free use of money was itself the gift. In other words, it recognized that the loan was actually interest free and that an interest-free loan constitutes an economic benefit.[72] There is nothing in the language or the reasoning of the case from which one can conclude that, for tax purposes, the lender should be viewed as having received interest or that the borrower should be viewed as having paid interest. The implicit reasoning of the Tax Court and the circuit courts – starting from actual economic gain and working backwards to gross income – can remain intact.

E. A Comprehensive Legislative Solution – Section 7872

In 1984, Congress stepped in and imposed a legislative solution to the tax consequences of interest-free loans.[73] Section 7872 provides that where a term loan (which is not a gift loan) carries less that the statutorily prescribed interest rate,[74] the lender shall be treated as having transferred to the borrower, and the borrower shall be treated as having received from the lender, the difference between the amount of the loan and the present value (calculated according to the statutorily prescribed rate of interest) of the borrower's future payment obligations under the terms of the loan.[75] The amount deemed as transferred from the lender to the borrower and received by the borrower from the lender will constitute a dividend or compensation, depending on the nature of their relationship. The loan is then considered as having original issue discount equal to the amount deemed transferred.[76]

To demonstrate, assume that on July 1, 2010, a corporation lends its shareholders $1,000 interest-free for a period of one year and the statutorily

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72 *See, e.g.*, *Dickman*, 465 U.S. at 340.

It is certainly true that no law requires an individual to invest his property in an income-producing fashion, just as no law demands that a transferor charge interest or rent for the use of money or other property. An individual may, without incurring the gift tax, squander money, conceal it under a mattress, or otherwise waste its use value by failing to invest it. Such acts of consumption have nothing to do with lending money at no interest. The gift tax is an excise tax on *transfers* of property; allowing dollars to lie idle involves no transfer. If the taxpayer chooses not to waste the use value of money, however, but instead transfers the use to someone else, a taxable event has occurred.

73 In so doing, Congress was responding to a direct appeal from the courts to rescue them from the morass in which they found themselves. Greenspun v. Comm'r, 72 T.C. 931, 955 (1979), *aff'd* 670 F.2d 123 (9th Cir. 1982); Beaton v. Comm'r, 664 F.2d 315 at 317 (1st Cir. 1981); Greenspun v. Comm'r, 670 F.2d 123, 126 (9th Cir. 1982); Baker v. Comm'r, 677 F.2d 11, 13 (2nd Cir. 1982); Parks v. Comm'r, 686 F.2d 408, (8th Cir. 1982); Hardee v. United States, 708 F.2d 661,664, 668 (Fed. Cir. 1983). The uncertainty created by *Dickman* was the final impetus to Congressional action.

74 The statutorily prescribed interest rate is the Federal short term rate for loans of not over three (3) years, the Federal mid-term rate for loans of three (3) to nine (9) years, or the Federal long-term rate for loans of over nine (9) years, interest in each case compounded semi-annually. I.R.C. §7872(f)(2)(A) (2009).

75 I.R.C. §7872(b)(1) (2009).

76 I.R.C. §7872(b)(2) (2009).

prescribed interest rate is twenty-five percent.[77] According to the terms of the loan, the shareholders are obligated to pay the corporation $1,000 on July 1, 2011. The present value of that obligation, as of July 1, 2010, is $800.[78] According to § 7872, the corporation is deemed as having distributed to its shareholders, and the shareholders are deemed as having received from the corporation, a dividend of $200. The loan is then considered to have original issue discount of $200. The tax consequences are as follows:

(a) The corporation will report original issue discount income of $200, part of which will accrue in 2010 and part of which will accrue in 2011.[79]

(b) The shareholders will report a dividend of $200 in 2010.

(c) The shareholders may be able to take an interest deduction of $200, depending on what they did with the borrowed funds.[80]

The construction described is appropriate only for term loans. It is inapplicable to "demand loans," loans where the lender has the right to demand repayment at any time, because one cannot calculate on the date the loan is made, the present value of future payments. Therefore, § 7872 prescribes that in the case of demand loans, the lender shall be viewed as having paid the borrower, on the last day of each year, an amount equal to the difference between the interest that actually accrued and the interest that would had accrued had the loan been made at the statutorily prescribed rate of interest.[81] The amount deemed paid is considered a dividend, as a gift, or as compensation. Simultaneously, the borrower is viewed as retransferring the same amount to the lender as interest.[82]

A superficial reading of § 7872 might lead one to the conclusion that Congress imposed tax on imputed income and permitted the deduction of imputed expenses. According to this reading, the corporation did not, in fact, receive any interest, nor was it entitled to receive any interest; nevertheless, it is taxed as if it did receive income. Similarly, the shareholders did not pay any interest nor were they obliged to pay interest; nevertheless, they are deemed to have paid interest and may be entitled to take an interest deduction. With regard to the dividend income of the shareholders, instead

77 The extraordinarily high interest rate used in the example is to emphasize an important feature of § 7872. With a lower interest rate, the principle would be less obvious. To avoid unnecessary complications, the example will ignore the semiannual compounding of interest. *See supra* note 74.

78 $1,000/1.25 = $800.

79 I.R.C. § 1272 (2009).

80 I.R.C. §163 (2009); I.R.C. § 265 (2009).

81 I.R.C. §7872(a)(1)(A) (2009). The statutorily prescribed rate of interest for demand loans is the short-term Federal rate. I.R.C. § 7872(f)(2)(B) (2009).

82 I.R.C. § 7872(a)(1)(B) (2009).

of taxing them on the actual interest-free use of corporate funds (a benefit the Tax Court and the circuit courts were never willing to subject to taxation), the Code is taxing them on the cash dividend they would have received had the corporation paid them a cash dividend instead of allowing them to use its funds interest free. In other words, the Code solved the issue of whether the free use of corporate funds is income by substituting a constructive cash dividend for the interest-free loan.[83]

However, a closer analysis will show that § 7872 does not tax imputed income, nor does it recognize imputed expenses. If Congress had intended to tax imputed income, i.e., if it had intended to tax the income that the corporation could have earned had it lent its money at market rates, it would have provided that, in the case of a term loan, the interest income of the corporation, the dividend income of the shareholders, and the possible deduction of the shareholders would be equal to the amount of the loan times the prescribed interest rate. Recall the previous example, in which the corporation lent its shareholders $1,000 for a year when the prescribed interest was twenty-five percent. Had the corporation lent its money at the prescribed rate of interest (the Code irrefutably assumes that the prescribed interest rate represents the interest rate at which the shareholders could borrow money and the return that the corporation could have earned), it would have received interest in the amount of $250. Therefore, if Congress had been interested in taxing the corporation on the income that could have been earned, Congress would have provided that the corporation's income would be $250 (and that that same amount would be the shareholder's income and the shareholder's potential interest deduction). This Congress did not do. Section 7872 provides that the interest income of the corporation, the dividend income of the shareholder, and the shareholder's potential interest deduction are each only $200.

What § 7872 does is simply to recharacterize the money transferred from the corporation to the shareholder at the time the loan was made. The parties to the transaction called the entire $1,000 a loan. The Code views it otherwise. Seeing as the present value of the repayment is only $800, the Code bifurcates the $1,000 transferred from the corporation to the shareholders and characterizes $800 of it as a loan and the remaining $200 as a dividend. The shareholder is taxed on the $200 actually received on the day the loan was made. The corporation is taxed on the interest: the difference between the amount of the repayment ($1,000) and the amount of the loan ($800).

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83 *See, e.g.*, Michael C. Hartigan, *From Dean and Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans*, 60 NOTRE DAME L. REV. 31, 47 (1984). For a description of § 7872 from an assignment of income perspective, see Brien D. Ward, *The Taxation of Interest-Free Loans*, 61 TUL. L. REV. 849 (1987); Phillip J. Closius & Douglas K. Chapman, *Below Market Loans: From Abuse to Misuse – A Sports Illustration*, 37 CASE W. RES. 484, 497-98 (1987).

The § 7872 recharacterization follows from fundamental income tax principles. Loan proceeds are not taxable because of the corresponding obligation to repay the borrowed funds; if and when it becomes apparent that the loan will not be repaid in full, the amount that will not be repaid is income in the hands of the borrower.[84] Section 7872 merely applies that principle using a time-value-of-money approach. When the present value of the future repayments is less than the amount of the loan, the borrower realizes an accession to wealth at the time the loan is made.

In enacting § 7872, Congress overturned the case law, but it did so in the most unobtrusive way possible: by adopting a construction the courts could have adopted based on existing law. Courts can and often do reject the characterization of transactions presented by the parties thereto. What the parties claim to be interest, a loan repayment, or compensation, the court can call a dividend.[85] What the taxpayer represents as a gift, a court can call compensation and vice versa.[86] No specific statutory authority is needed to effect such a recharacterization. In other words, in *Combs Lumber* and in *Howell Turpentine*, the Board of Tax Appeals and the Tax Court

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84 *See*, *e.g.*, I.R.C. §61(a)(12) (1984); United States v. Kirby Lumber Co., 284 U.S. 1 (1931); Commissioner v. Tufts, 461 U.S. 300, 309-10 (1983) ("[T]he original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property."); Zarin v. Comm'r, 92 T.C. 1084, 1095 (1989), *rev'd* 916 F.2d 110 (1990) ("We conclude here that the taxpayer did receive value at the time he incurred the debt and that only his promise to repay the value received prevented taxation of the value received at the time of the credit transaction."); Zarin v. Comm'r, 916 F.2d 110, 117 (per Judge Stapleton in dissent) (3rd Cir. 1990); Boris I. Bittker & Barton H. Thompson, Jr., *Income From the Discharge of Indebtedness*, 66 CAL. L. REV. 1159 (1978); Deborah Schenk, *The Story of Kirby Lumber*, TAX STORIES 137, 147-49 (Paul L. Caron, ed., 2009).

85 Interest: John Kelly Co. v. Comm'r, 326 U.S. 521 (1946); Ruspyn Corp. v. Comm'r, 18 T.C. 769 (1952); Arthur R. Bachrach v. Comm'r, 18 T.C. 479 (1952), *aff'd* 205 F.2d 151 (2d Cir. 1953); Gazette Telegraph Co. v. Comm'r, 19 T.C. 692 (1953), *aff'd* 209 F.2d 926 (10th Cir. 1954); Gooding Amusement Co. v. Comm'r, 23 T.C. 408 (1954), *aff'd* 236 F.2d 159 (6th Cir. 1956); Gilbert v. Comm'r, 248 F.2d 399 (2d Cir. 1957); P.M. Finance Corp. v. Comm'r, 302 F.2d 786 (3rd Cir. 1962); Schine Chain Theatres v. Comm'r, 22 T.C.M. (CCH) 488 (1963); Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967); Fin Hay Realty Co. v. United States, 298 F.2d 294 (3d Cir. 1968); Bauer v. Comm'r, 748 F.2d 1365 (9th Cir. 1984); Marathon Oil Co. v. Comm'r, 838 F.2d 1114 (10th Cir. 1987); Laidlaw Transportation, Inc. v. Comm'r, 75 T.C.M. (CCH) 2598 (1998); Indmar Products Co., Inc. v. Comm'r, 444 F.3d 771 (2006).

Loan repayment: Estate of Mixon. v. United States, 464 F.2d 394 (5th Cir. 1972).

Compensation: Mayson Mfg. Co. v. Comm'r, 178 F.2d 115 (6th Cir. 1949); Harold's Club v. Comm'r, 340 F.2d 861 (9th Cir. 1965); Edwin's Inc. v. United States, 501 F.2d 675 (7th Cir. 1974); Owensby & Kritikos, Inc. v. Comm'r, 819 F.2d 1315 (5th Cir. 1987); Rapco, Inc. v. Comm'r, 85 F.3d 950 (2d Cir. 1996); Exacto Springs Corp. v. Comm'r, 196 F.3d 833 (7th Cir. 1999); Label-Graphics, Inc. v. Comm'r, 221 F.3d 1091 (9th Cir. 2000); Eberl's Claim Service, Inc. v. Comm'r, 249 F.3d 994 (10th Cir. 2001).

86 Comm'r v. Duberstein, 363 U.S. 278 (1960); Kaiser v. United States, 363 U.S. 299 (1960); United States v. Harris, 942 F.2d 1125 (7th Cir. 1991).

could (and probably should) have bifurcated the cash transfer into a loan and a dividend, but instead they accepted the characterization of the payment as an interest-free loan. In the words of the *Dean II* court, *Combs Lumber* and *Howell Turpentine* gave "full force" to interest-free loans.[87] Congress refused to do so. From Congress' perspective, there cannot be any such thing as an interest-free loan. Whatever is equal to the present value of the expected payments is a loan. Anything more is something else, the exact nature of which is determined by the relationship between the parties. Where that relationship is corporation-shareholder, the additional amount is a dividend.

The difference between taxing imputed income and recharacterizing the payment is crucial for our discussion. Imputed income is a legal fiction. It is income that the taxpayer could have earned but in fact did not. If in our example above, Congress had provided that the corporation's income would be $250, it would have been taxing imputed income: the corporation did not earn $250, but it could have and so it is taxed as if it did. When taxation is based upon the recharacterization of a transaction, the taxpayer is taxed on income actually earned.[88]

In contradistinction to term loans, it might appear that, with regard to demand loans, Congress did choose to impose tax on imputed income instead of recharacterizing. However, the fact that the provisions regarding demand loans and those regarding term loans are both part of the same statutory scheme implies that the same principles should guide their interpretation. If the taxation of term loans is based upon recharacterization rather than taxation of imputed interest, we should assume, at least initially, that the taxation of demand loans is based on a similar construction. In other words, we should first examine how demand loans would be taxed under a similar recharacterization model and compare it to the provisions of the statute. Only if it turns out to be impossible to reconcile the term loan construct with the demand loan provisions would we allow that they are based on fundamentally different concepts.

How, then, would we recharacterize a demand loan? Assume that the lender has the right to call the loan in with a single day's notice. By not calling in the loan on any particular day, the lender is in effect allowing the borrower to keep the money for one more day. As long as the loan is out-

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87 *Dean II*, 35 T.C. at 20-21.

88 It is possible to speculate that one reason Congress chose to recharacterize the transaction instead of imposing tax on imputed income was uncertainty regarding the constitutionality of taxing imputed income. The Sixteenth Amendment authorized Congress to impose tax on "income from any source derived." Ostensibly, Congress cannot impose income tax where there is no actual income. *See, e.g.*, Helvering v. Indep. Life Ins. Co., 292 U.S. 371, 378 (1934) ("If the statute lays taxes on the part of the building occupied by the owner or upon the rental value of that space, it cannot be sustained, for that would be to lay a direct tax requiring apportionment.").

standing, the lender is, by his silence, constantly extending the term of the loan.[89]

Assume that the amount of the loan is $100,000 and that the daily interest is equal to a hundredth of a percent (0.01 percent). When the loan is made, the lender is not promising to let the borrower keep the money for more than one day. So we may treat the transaction as a one-day loan. The present value of the obligation to pay $100,000 in one day's time is $99,990. Accordingly, we will recharacterize the transfer as being a $99,990 interest-bearing loan and an additional $10 whose character will depend on the relationship of the parties: where the lender is a corporation and the borrower is a shareholder, the $10 will be classified as a dividend.

The following day, if repayment is not demanded, the corporation is simply allowing the shareholder to hold on to the money for an additional day. The debt, including the $10 in accrued interest, is at present $100,000. The present value of the obligation to repay the loan the following day, should the corporation so demand, is $99,990, so by implicitly extending the loan for another day, the corporation is in effect waiving its right to receive $10. This waver is a dividend in the hand of the shareholder. The same analysis would apply day-by-day as long as the loan is outstanding.

The point of the preceding analysis is to demonstrate that the §7872 demand loan provisions can and should be interpreted as a recharacterization and not as the imposition of tax on imputed income. Since a construction based upon recharacterization conforms to traditional tax principles, while taxing imputed income radically departs from those principles, and since the term loan provisions are best understood as a recharacterization, it is reasonable similarly to construe the demand loans provisions.

To sum up what we have seen so far, the tax consequences of interest-free loans from corporations to their shareholders were extensively analyzed by courts for over 40 years. During that period they identified the major issues presented by those loans: whether the lender recognizes income, whether the borrower may take an interest deduction, whether the borrower recognizes income, and, if so, whether that income is properly described as a dividend. Most crucially, they struggled with the interplay among those issues, i.e., how the question of whether the lender has income affects the borrower's possible deduction and how the borrower's potential

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[89] One day is an arbitrary unit, but the same analysis would apply no matter what the time period concerned. In any demand loan, the borrower will, explicitly or implicitly, have a certain period of time to repay the loan after the submission of the demand. It might be a day or an hour or a number of minutes, but clearly the lender cannot demand that the borrower repay the loan literally immediately upon demand (even a bank, holding funds payable "on demand", may require a depositor to wait a few minutes to fill out the appropriate forms or to accommodate a time-release mechanism on its safe). Whatever the time frame concerned, by not demanding repayment, the lender is in effect continually extending the loan by that period of time.

entitlement to a deduction affects whether the borrower has any gross income. However, the courts were unable to work out a satisfactory set of answers to those questions. In the end, Congress showed how the courts could have developed a consistent and satisfactory model by bifurcating what was characterized by the parties as a loan into a loan and a dividend.

III. THE NON-APPLICABILITY OF THE PRINCIPLES UNDERLYING SECTION 7872 TO RENT-FREE USE OF PROPERTY

In the meantime, the tax consequences of shareholders' rent-free use of corporate property received relatively scant attention by both the judiciary and the legislature. The question of whether a corporation that allows its shareholders to use its property rent-free needs to report any income has never been addressed by the courts. The reason for that is simply that the Commissioner has never taken the position that the corporation needs to report income from such a transaction. As already noted, prior to the enactment of § 7872, the Commissioner had also never taken the position that a corporation has taxable income from lending its shareholders money interest free; however, that fact did not prevent the Tax Court from addressing the issue. In *Combs Lumber* and in *Society Brand Clothes*, the Commissioner's position was that the written documents containing a provision for the payment of interest precluded the admissibility of oral evidence showing that the corporations, in fact, neither had received nor were entitled to receive any interest. In both instances the court rejected the Commissioner's procedural contention and held that lending money to shareholders interest-free does not generate gross income for the corporation.[90]

There is little room for doubt that the court would arrive at the same conclusion were the question of taxing corporations for allowing their shareholders to use their property rent-free ever to arise.[91] The term "income" in the Code – and possibly also the Constitution – has never been held to include income that the taxpayer could have earned but chose not to.[92] One who uses property in a way that generates less income than it

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90 *See supra* Part II.A.

91 *See supra* note 17.

92 The doctrine of constructive receipt is not an exception to this principle. Constructive receipt is a timing principle in cash-basis reporting and concerns situations in which a taxpayer is offered cash or cash equivalent but prefers to wait and receive it at a later date (often in an attempt to postpone the tax liability). In those situations the taxpayer is considered to have constructively received the income when he could have received it.

The doctrine of constructive receipt does apply when the taxpayer waives the right to receive income. Comm'r v. Giannini, 129 F.2d 638 (9th Cir. 1942). In other words, it does not impose tax on imputed income. It merely helps define the terms "receipt" for the purpose of cash-base reporting.

could have generated is taxed on the actual income and not on the potential income.[93]

Has the adoption of §7872 changed this in any way? True, the scope of §7872 is limited to interest-free and low-interest loans; it is not directly applicable to rent-free use of property. Nonetheless, this article has argued that § 7872 is not a radical departure from traditional principles of taxation. It legislatively imposed a construction the courts could and perhaps should have adopted on their own. Therefore, the question that arises is whether, having been shown the way by Congress, the courts could apply the principles underlying §7872 to other fact situations. Specifically, could they, using traditional tax principles but guided by §7872, view a corporation that purportedly allowed its shareholders to use its property rent-free as having actually collected rent and having simultaneously paid a dividend?

The answer is that they could not. The principle underlying §7872 is the bifurcation and recharacterization of the original transfer of funds from the corporation to the shareholder. That a certain amount of money was transferred from the corporation to the shareholder is a fact. Determining the nature of the funds transfer is a question of interpreting those facts. Calling part of the payment a loan and part of it a dividend, even when the corporation and the shareholder both called it a loan, is not counterfactual. It is a different way of interpreting those same facts.

Consider now the case of rent-free use of property. In the English language, the words "lend" and "borrow" are equally applicable to both property and money. However, this semantic detail must not obscure the fact that lending or borrowing property is conceptually different than lending or borrowing money. When one lends another one's property, title remains in the hands of the lender.[94] The borrower acquires no more than the right temporarily to use that property. On the other hand, when one lends another one's money, the money then belongs to the borrower. The lender agrees to waive his right to the money and in exchange he receives the promise of the borrower. A *jus in personam* has replaced a *jus in rem*.

When a corporation lends money to a shareholder, the money becomes the shareholder's. Where the interest rate is too low, we can say that part of that money is a dividend and that, in present value terms, only the remainder needs to be repaid. On the other hand, when a corporation lends property to its shareholders, what the shareholders receive is merely the right to use the property, and the difference between the use value of the property and

93 Section 7872 avoids the constitutional issue by refraining from imposing tax on imputed income and instead recharacterizing the loan proceeds and taxing income actually received. *See supra* Part II.E.

94 In cases where the borrower is not obligated to return the specific property borrowed but may return similar property (as in the proverbial cup of flour), the transaction is conceptually closer to borrowing money than to borrowing property.

the rent actually paid is a taxable benefit. But as the corporation had not transferred title to the shareholders, there is nothing that can be bifurcated and recharacterized.

Thus, § 7872 focuses, in effect, on the one trait that distinguishes interest-free use of money, on the one hand, from rent-free use of property or any other service, on the other. If interest-free loans are given "full force" for tax purposes, that is, if the tax law were to recognize that a loan actually can be interest-free and were to derive the tax consequences from that assumption, then the tax treatment of interest-free loans and rent-free use of property would be identical: in both cases the shareholder is receiving from the corporation a service free of charge. But with the legislation of § 7872, the Code no longer proceeds from that presumption.

It is noteworthy that, although the issue of taxing interest-free loans arose primarily within the context of the corporation-shareholder relationship, the scope of § 7872 is considerably broader and encompasses almost all instances of interest-free loans.[95] It applies even to what it refers to as "gift loans," that is to money lent without interest or at a low rate of interest as a favor from one individual to another.[96] A person who, as a favor, allows another to use her property is not taxed on the fair market rent. The single exception to the rule that volunteering services does not produce gross income for the service provider is the giving of an interest-free loan, and the reason is that the Code does not view the money transferred as an interest-free loan. It views part of the money as an interest-bearing loan and part of it as a gift.

IV. Taxing Shareholders' Rent-Free Use of Corporate Property

A. Use Value as Income and Deduction of Use Value

As we saw, case law held that a corporation lending money interest-free to its shareholders realizes no gross income.[97] Furthermore, we saw that the courts and Commissioner both used that rule as a starting point for their analyses of the tax consequences of the loan as far as the shareholders were concerned, but that they arrived at radically different conclusions. The Commissioner, we posited, reasoned that, if the corporation did not

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95 In addition to the specifically mentioned gift loans, I.R.C. § 7872(c)(1)(A) (2006), compensation-related loans, I.R.C. § 7872(c)(1)(B) (2009), corporation-shareholder loans, I.R.C. § 7872(c)(1)(C) (2006), and loans to continuing care facilities pursuant to a continuing care contract, I.R.C. § 7872(c)(1)(F) (2006), the provisions of the section apply to any below market loan, one of the principle purposes of the interest arrangements of which is the avoidance of Federal tax, I.R.C. § 7872(c)(1)(D) (2006), and other below market loans, the interest arrangements of which have a significant effect on any Federal tax liability of the lender or the borrower, I.R.C. § 7872(c)(1)(E) (2006). Most types of loans are subject to a series of *de minimus* provisions, §§ 7872(c)(2), 7872(d) (2006).

96 I.R.C. § 7872(c)(1)(A) (2006).

97 *See supra* Part II.A.

actually or conceptually receive any interest, then the shareholders did not actually or conceptually pay any interest; if the shareholders did not actually or conceptually pay any interest, they are not entitled to an interest deduction; the use of money, like the use of property, is a taxable benefit; therefore, the shareholder should be taxed on the economic benefit inherent in the loan with no possibility of a corresponding deduction, even if the money is used by the shareholder to produce taxable income.[98] The courts, on the other hand, implicitly reasoned as follows: if the corporation did not actually or conceptually receive any interest, then the shareholders did not actually or conceptually pay any interest; if the shareholders use the money to earn taxable income, taxing them on both the income thus earned and on the economic value of the no-interest loan with no corresponding deduction is clearly unjustified; therefore, the economic value of the loan cannot be included in gross income.[99] As noted, neither of these lines of reasoning is satisfactory. In cases where the money is used to produce taxable income, the Commissioner's position leads to double taxation. In cases where the money is used in such a way that interest, had it been paid, would not be deductible, the courts' reasoning leads to undertaxation.

A corporation that allows its shareholders to use its property rent-free does not recognize income.[100] This principle would seem to return us to the dilemma of choosing either (a) to tax the shareholders on the economic value of the rent-free use and end up double taxing them when the property is subleased or otherwise used to generate income, or (b) not to tax the shareholders on the economic value of the rent-free use and allow them to avoid tax completely when they consume the property's use value. Without referring to this dilemma or the problem of shareholders' deducting rent in the appropriate circumstances, the courts have held that rent-free use of corporate property by shareholders is a taxable benefit.[101] The result of the case law would seem to be that where the shareholders sub-lease the property they are double taxed: both the economic benefit of the free use of the property and the rent from the sub-lessee would be gross income in the hands of the shareholders, while, not having actually or constructively paid any rent, they would have no corresponding deduction.

This conclusion is neither justified nor necessary. The Commissioner's and the courts' implicit lines of reasoning sketched above share a common element besides the starting point that – stated in broader terms instead of specifically interest-free loans – a corporation performing a service for its shareholders recognized no gross income. The additional common element is the inference that because the corporation did not actually

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98 *See supra* notes 58-59 and the surrounding text.
99 *See supra* notes 60-61 and the surrounding text.
100 *See supra* note 17 and the surrounding text.
101 *See supra* note 12 and the surrounding text.

or conceptually receive any compensation for the service the shareholders are not entitled to a deduction. This inference needs to be examined.

Judge Goldberg's dissent in *Martin* argued – again, stated in more general terms – that in the corporation-shareholder context a free service is the equivalent of a service sold for cash along with a corresponding cash dividend equal to the price of the service. By analogy, if in the latter case the shareholders, having actually paid for the service, would be entitled to a deduction, they should also be entitled to a deduction in the former. The Commissioner's reliance on the letter of the law must fail, as substance must triumph over form.[102]

As we noted earlier, the argument that shareholders should be able to deduct expenses that they would have incurred had the transaction been structured in a different but economically equivalent manner is problematic. In the alternative transaction the corporation would have received consideration (interest, rent, etc.) for the service it provided and would have had to include that amount in its gross income.[103] Judge Goldberg did not propose as much and several judges noted that they refrained from viewing the shareholder as having income and a corresponding deduction precisely to avoid such a result.[104]

However, we do not need to involve virtual words, where transactions were structured differently than were in fact, in order to allow the shareholders to deduct the value of the services they received.[105]

In *Philadelphia Park Amusement,*[106] the question that arose was the basis of property acquired in a barter transaction. Assume that a taxpayer

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102 649 F.2d at 1136-37. While reserving judgment on Judge Goldberg's approach,677 F.2d at 13, the *Baker* court rejected the Commissioner's attempt to deny an interest deduction based on the language of the Code:

> The Government, contending that the interest-free use of corporate funds confers the same economic benefit as an increase in salary sufficient to secure an equivalent interest-bearing loan, would include the imputed value of the interest-free loan in income under *§ 61*. But the Government is not so attentive to economic reality when it argues further that the taxpayer may not deduct that imputed value because it is not actually "interest paid" within the language of *§ 163*. 677 F.2d at 12.

A similar point was made in dictum by the Tax Court in *Greenspun*:

> A . . . no-interest loan as a form of compensation in kind is indistinguishable [from] an interest-bearing loan accompanied by an increase in compensation and should be treated accordingly. Hence, if a taxpayer…is to be charged with gross income . . . he may be entitled, depending on the facts, to an offsetting deduction under *§ 163(a)* . . . . [T]he parties do not dispute that if petitioner had in fact paid the additional interest in question to [the lender], such interest would have been fully deductible…. That being so, whether or not we base our decision on *Dean*, the result will be the same. 72 T.C. at 952.

103 *Supra* note 64 and the surrounding text.

104 Hardee v. United States, 708 F.2d 661 at 666 (Fed. Cir. 1983); Greenspun v. Comm'r, 72 T.C. 931 at 957-58 (Nims, J., dissenting) (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982).

105 The text is assuming that the deduction would have been permissible had the shareholders paid for the service instead of receiving it for free.

trades asset A for asset B. What is the basis of asset B? Ordinarily, the basis of an asset is what is paid for it.[107] Since the taxpayer purchased asset B with asset A, it would seem to follow that the basis of asset B is the fair market value of asset A at the time of the trade. However, this turns out to be inaccurate. The court explained that the basis of asset B is not the value of asset A at the time of the trade, but rather the value of asset B at the time of the trade.[108]

The reason for this counterintuitive result is that at the time of the trade, the taxpayer reports a gain or loss on the exchange of asset A. The "amount realized" for computation of that gain or loss is the value of what is received in return, in this case the value of asset B.[109] The finishing point for computing the gain or loss from asset A needs now to be the starting point for computing gain or loss from asset B.

Assume the following facts:

The basis of asset A was 300.

The fair market value of asset A at the time of the exchange was 500.

The fair market value of asset B at the time of the exchange was 550.

The taxpayer later sold asset B for 700.

The gain on the sale of asset A is the difference between what was received in exchange for that asset minus the basis of that asset. What was received was asset B, worth 550. As the basis of asset A was 300, the gain is clearly 250.

The taxpayer now sells asset B. The amount realized is 700. If the basis of asset B is the value of asset A at the time of the exchange (on the seemingly reasonable theory that the taxpayer "paid" asset A to acquire asset B), then the gain on the sale of asset B would be 200, and the taxpayer's total gain from the two transactions would be 450. But this result does not conform to economic reality. In truth the taxpayer, who started with 300 and ended with 700, gained a total of only 400 from the two transactions.

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106 *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

107 I.R.C. § 1012 (2009) ("The basis of property shall be the cost of such property[.]").

108 Where asset B is difficult to value, the court might assume that it is equal to asset A, for which it was traded in a commercial transaction, but this is merely a rebuttable factual presumption. *Infra* note 112. In *Philadelphia Park Amusement*, the circuit court, having determined that the basis of asset B was its value at the time it was received, remanded for the purpose of determining what that value was. It instructed the lower court that it might take into consideration the value of asset A at the time of the exchange, but that the determination of asset A's value is not dispositive.

109 I.R.C. § 1001(b) (2009) ("The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of property (other than money) received.").

What is the source of the discrepancy? The problem is that at the time of the exchange the government took its share of the increase in the taxpayer's wealth up to 550. Therefore, in the future the government should have the right to participate only in the increase above 550. If the taxpayer sells asset B for 550, his wealth has not increased beyond the level for which he has already paid tax and he should owe no more taxes. If, as here, he sells asset B for 700, his accession to wealth is 150. Taxable gain can be made to conform to accession to wealth by assigning to asset B a basis equal to the "amount realized" on the sale of asset A, i.e. the fair market value of asset B at the time of the exchange.

Where the asset received is worth less than the asset given in exchange, the result of using what was paid for an asset as its basis would be undertaxation, as demonstrated by the following example:

The basis of asset A was 300.

The fair market value of asset A at the time of the exchange was 550.

The fair market value of asset B at the time of the exchange was 500.

The taxpayer later sold asset B for 700.

Here the gain from the exchange of asset A is 200 (the difference between the 500 value received and the basis of 300). If we use the value of asset A at the time of the exchange as the basis of asset B, the result is that the gain from the sale of asset B will be 150. Despite the fact that the taxpayer's total economic gain is 400, the total gain taxed is only 350. To rectify the situation, we need to use as the basis of asset B the value of asset B at the time of the exchange. If the basis of asset B is 500, the taxable gain from the sale of asset B will be 200, and the total taxable gain from the two transactions will equal the economic gain of 400.

The principle underlying *Philadelphia Park Amusement* is that when a taxpayer pays tax, the gain (in asset A) on which tax is imposed becomes the starting point for the computation of future gains (in asset B). This principle is equally applicable when the taxpayer acquires services. Assume that the taxpayer gives an asset worth 500 and with a basis of 0 to an employee in exchange for services worth 550. The services are used by the taxpayer in the production of current income from the business, and the question is the amount of the deduction allowable in computing taxable business income. As before, limiting the deduction to what was paid for the services – in this case 500 – would result in overtaxation. The amount realized on the sale of the asset was 550, and taxable gain was calculated accordingly.[110] In other words, the taxpayer has already paid tax on his acces-

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[110] *Int'l Freighting Corp., Inc. v. Comm'r*, 135 F.2d 310 (1943) (Transfer of shares to employees is sale, and – despite I.R.C. § 1001(b) (2009) defining "amount realized" as "money . . . plus the fair

sion to wealth up to the level of 550. Allowing a deduction of only 500 would result in double taxation of 50 of the gain. To demonstrate, assume that the services in question were the only expenses of the business and that gross income from the business was 700. From an economic perspective, the taxpayer's total gain is 700: the asset cost him nothing (basis of 0), he traded the asset for services, and he used the services to produce revenue of 700. Allowing a deduction of only 500 would mean that taxable gain from the business activity is 200. This is clearly inaccurate. On the sale of the asset the taxpayer reported a gain of 550. If taxable income from business activity is 200, then the total gain on which the taxpayer is taxed will be 750.[111]

Let us now consider shareholders who receive rent-free use of corporate property. If the market rent is 500, the shareholders will report a taxable benefit of this amount.[112] Assume now that the shareholders sublease the property and manage to get 550 for it. The 550 must be included in gross income. How much should they be able to deduct in computing taxable income: what they paid the corporation for the use of the property (0) or the amount for which they paid tax when he received the right to use the property (500)? *Philadelphia Park Amusement* tells us that the once tax was paid on the 500, that becomes the starting point for calculation of future gain. By subletting the property for 550, the shareholders realize additional gain of 50. Only that 50 should be taxed, and in order to effectuate that result, the 500 already taxed must be deducted.

Rephrasing the same concept, we would say that the shareholders could have put the property to personal use and consumed its use value of 500. Because they subleased the property on the terms that they did, their ability to consume has increased to 550. This 50 increase in ability to consume is the accession to wealth derived from the lease. Therefore, taxable income from the lease should be 50.

The difference between the *Philadelphia Park Amusement* analysis and Judge Goldberg's analysis in *Martin* is that, in allowing a deduction or

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market value of [other] property . . . received" – the value of the services received is the amount realized).

111 The analysis assumes that it is possible to value the services independently of the asset used to acquire them. In practice this is most unlikely. In a barter transaction, when something difficult to value is exchanged for something easy to value, a (rebuttable) presumption arises that the former is equal in value to the latter. Since services are usually very difficult to value, they will in almost all cases be considered worth what was given in exchange. United States v. Davis, 370 U.S. 65 at 72 (1962) ("Absent a readily ascertainable value it is accepted practice where property is exchanged to hold . . . that the values of the two properties exchanged in an arm's length transaction are either equal in fact, or are presumed to be equal."); *Philadelphia Park Amusement*, 126 F. Supp. at 189.

Nonetheless, the analysis in the text is relevant for our discussion. When shareholders receive rent-free use of corporate property, clearly the value of what they receive is greater than the value of what they give in exchange.

112 *Supra* note 12 and the surrounding text.

recognition of basis, the former relies on what actually happened, while the latter relies on what could have happened had the parties to the transaction structured it differently. *Philadelphia Park Amusement* says that the taxpayer is entitled to a deduction because of the gain on which he previously paid tax; Judge Goldberg says that the taxpayer is entitled to a deduction because of what he might have paid.[113]

The advantage of the *Philadelphia Park Amusement* approach over the Goldberg approach is at least twofold. First of all, there are often several ways of structuring transactions and not always do they have the same tax consequences. For example, a person can donate his services to a charitable organization or he can charge for his services and then donate the compensation received. Does the fact that his pay is taxed in the second instance mean that he should be taxed in the first? Does the fact that he is not taxed in the first instance mean that in the second he should not pay tax on his compensation?[114] Economically equivalent acts are not necessarily taxed the same.[115] While perhaps regrettable, this is a salient and probably unavoidable feature of tax law.

Secondly, consistency would demand that, when taxing a transaction in accordance with the tax consequences of a different although economi-

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113 In rejecting Judge Goldberg's approach, the *Martin* majority pointed out that "the proposed solution substitutes one fiction (i.e. that interest is "paid", which then is "deducted") for the *Dean* fiction[.]" 649 F.2d at 1133. *See also* Brian D. Ward, *The Taxation of Interest-Free Loans*, 61 TUL. L. REV. 849 at 888 (1987) ("The attempt to bridge this problem through artificial transfers only confuses the analysis.").

114 Albeit, if the donation is deductible, the bottom-line results of the two cases might be identical. However, the donation may not be deductible – because the organization does not qualify under I.R.C. § 170, because of the percentage limitations of that section, or because the taxpayer does not itemize deductions – in which case taxable income in the second instance will be greater than in the first. Furthermore, even if the donation is deductible, including the compensation in gross income will increase adjusted gross income, affecting, for example, the deductibility of miscellaneous expenses, which are deductible only to the extent that they exceed 2 percent of adjusted gross income. I.R.C. § 67 (2009).

For a discussion of the place of charitable deductions in a normative income tax and of whether the economic equivalence of the two situations described in the text is relevant, see William Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Mark Kelman, Pe*rsonal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831 (1979).

115 *See, e.g.*, Eisner v. Macomber, 252 U.S. 189 at 215 (1920) (stock dividend held not taxable although distribution of cash followed by issuance of shares in exchange for cash would have been); Comm'r v. Giannini, 129 F.2d 638 (9th Cir. 1942) (waiver of bonus by employee and donation of funds by employer to establish foundation in employees name held not taxable even though receipt of funds by employee and donation by him would have constituted income); Comm'r v. Court Holding Co., 324 U.S. 331 (1945) (distribution of property to shareholders after corporation had begun negotiations for its sale and subsequent sale by shareholders taxed as if corporation had sold property and distributed cash); United States v. Cumberland, 338 U.S. 451 (1950) (distribution of property to shareholders after corporation had received purchase offer and subsequent sale of property by shareholders not taxed as sale by corporation); Chamberlain v. Comm'r, 207 F.2d 462 (6th Cir. 1953), *cert. denied* 347 U.S. 918 (1954); United States v. Davis, 397 U.S. 301 at 312-13 (1970) (shareholder taxed on redemption of preferred stock, the Court rejecting as irrelevant his contention that had he would not have been taxed had he made an economically equivalent subordinated loan instead of receiving preferred shares).

cally equivalent transaction, all parties involved in either the real or the virtual transaction would be taxed according to the alternative transaction. Specifically, if we tax a person receiving a free service as if she had paid for the service and then was refunded the money, we should also tax that person, whether an individual or an entity, who performs the free service as if he had been paid and then given the money away. To the best of my knowledge, no one has actually proposed the adoption of such a rule. As already noted, Judge Goldberg himself was noticeably silent with regard to the tax consequences vis-à-vis the corporation of giving its shareholders a free service.[116]

The third advantage – no more than a consequence of the two already mentioned – of the *Philadelphia Park Amusement* rule is predictability and consistency. Whenever income tax is paid, the taxed gain, unless it is consumed, will constitute the starting point for the computation of further gain. With the Goldberg approach it is never certain when the approach will be implemented, which alternative transaction's tax consequences will be adopted, and whom they will affect. A separate or supplemental set of rules, explaining when, how and to whom the approach should be applied, would need to be iterated.[117]

What we have seen so far is (a) that allowing its shareholders to use its property rent-free does not constitute or generate taxable income for the corporation, (b) that rent-free use of corporate property constitutes a taxable benefit in the hands of shareholders, and (c) that the value of that rent-free use of property is deductible by the shareholders if the property is subleased or is otherwise used to generate current income. It is noteworthy that only (b) has explicit support in the case law. There is no direct judicial support for (a), although it is implicit in *Combs Lumber* and *Society Brand Clothes*.[118] With regard to (c), Judge Opper, concurring in the result reached by the court in *Dean II*, opined that where shareholders receive rent-free use of corporate property, which they then sublease, they "could presumably deduct . . . the hypothetical rental value theoretically paid . . . to the

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116 *Supra* note 64 and the surrounding text.

117 Judge Goldberg's approach would have been more persuasive had it been proposed as a method of analyzing barter transactions rather than provision of services from corporations to their controlling shareholders. In a barter transaction, each party realizes actual income, albeit not in the form of cash. When taxpayers A and B exchange services, A is selling a service to B and B selling a service to A. Each of the parties realizes gross income and incurs a (possibly deductible) expense.

The situation with regard to services provided by corporations for shareholders is different. When providing uncompensated services to their shareholders, corporations do not receive any income, neither in cash nor in kind, and shareholders do not pay (in cash, property or services) for the benefits they receive. Imputing an imaginary exchange of cash fundamentally changes the form of the transaction. There is a substantive difference between providing a free service, on the one hand, and selling a service, on the other.

118 *See also supra* note 17.

corporation."[119] However, this presumption has never been tested. Furthermore, the parallel question that arose prior to the enactment of § 7872 in relation to interest-free loans – that is, whether or not shareholders were entitled to an interest deduction – was answered in the negative.[120] As we have seen, the conceptual difficulty the courts encountered regarding allowing a deduction for interest neither paid nor accrued prevented them from reaching a satisfactory resolution of the taxation-of-interest-free-loans dilemma and precipitated the imposition of a legislative solution.

B. Is Allowing Shareholders Rent-Free Use of Corporate Property a Distribution?

One question, lying at the heart of the issue, remains to be discussed: How should the benefit inherent in the rent-free use of corporate property by shareholders be classified? Specifically, is the income attributable to such shareholders properly considered a distribution for tax purposes?[121] One's first reaction to such questions might be to reread them in search of some deeper meaning, since the answers to the questions as phrased appear too simple to warrant discussion. The benefit concerned was received by the taxpayers by virtue of their being shareholders in the corporation distributing that benefit. How could this not be a distribution?

Nonetheless, this article will argue that the benefit of using corporate property by shareholders, while it is income under the Code, it is not a distribution. Although perhaps counterintuitive, it is mandated both by the express language of the Code and, much more significantly, by substantive considerations. Section 301(a) of the Code introduces the subject of corporate distributions by providing that "a distribution of **property** (as defined in §317(a)) made by a corporation to a shareholder in respect to its stock shall be taxed in the manner provided in §(c)." Section 317(a) defines "property" as "money, securities, and other property[.]" In other words, § 301(c), which describes the tax consequences of distributions, applies only to the distribution of money, securities, and other property. It does not apply to distributions of services.

The language of § 316(a), which defines the term "dividend," is consistent with the language of §§ 301(a) and 317(a). Section 316 defines "dividend" as "any distribution of **property** made by a corporation to its

119 35 T.C. at 1091.

120 *Supra*, Part II.B.

121 The text uses the broad term "distribution" instead of the more narrow term "dividend," defined as a distribution out of earnings and profits as opposed to a distribution of capital. I.R.C. § 316 (2009). Only after it is determined that what is received is a distribution can possible classification as a dividend be considered. For several courts' consideration of the relationship between classification of the benefit as a dividend and the existence of earnings and profits, see *infra* note 130.

shareholders . . . out of earnings and profits[.]" Again, the distribution of services will not be considered a dividend.

On the other hand, there is nothing in the language of § 61 to exclude from the definition of gross income services (including rent-free use of property) received by shareholders. There is clearly an economic benefit, and, as income is not limited to cash receipts only, such economic benefit must be considered income. The language of the Code leads us inexorably to the conclusion that rent-free use of corporate property by shareholders is income but not a distribution for purposes of § 301.

Nonetheless, the conclusion that rent-free use of corporate property by shareholders is not a distribution cannot rely exclusively on the language of the Code. There are instances in which the Code refers in a definition only to "property," and yet services are implicitly included. For example, take the definition of "amount realized" in §1001(b): "The amount realized from the sale of other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." A taxpayer trades property for services. What is the amount realized for the purpose of computing gain or loss? As the taxpayer received no money and no property, a strict interpretation of § 1001(b) would force us to arrive at the conclusion that the amount realized is zero. This result is clearly unjustified. Therefore, without any explicit statutory anchor, the courts have included the fair market value of services received as part of the amount realized.[122]

If, from a substantive perspective, it were clear that services from a corporation to its shareholders should be considered a distribution, it could be argued that, notwithstanding the apparently unambiguous language of the Code, the terms "distribution" and "dividend" must be read so as to include services. However, the opposite is the case. For a number of substantive reasons, unrelated to the language of the Code, it is clear that services should not be considered distributions.

Distributions are either distributions of earnings and profits (in which case they are termed "dividends") or they are distributions of capital.[123] The Code provides that dividends are taxed as ordinary income[124] – albeit subject at present to a preferred rate of tax when the shareholder is an individual[125] or entitling the shareholder to a dividend received deduction when it is a corporation[126] – and that distributions in excess of earnings and profits

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122 *Int'l Freighting Corp. v. Comm'r*, 135 F.2d 310 (2d Cir. 1943); *Wood v. Comm'r*, 39 T.C. 1,7-8 (1962); *Smith Mfg. Co. v. United States*, 364 F.2d 831 (Ct. Cl. 1966); *Tasty Baking Co. v. United States,* 393 F.2d 992 (Ct. Cl. 1968).

123 I.R.C. § 316 (2009).

124 I.R.C. § 301(c)(1) (2009).

125 I.R.C. §§ 1(h)(10) (2009), 243 (2009).

126 I.R.C. § 243 (2009).

reduce the basis of the appropriate shares.[127] Once basis has been reduced to zero, additional distributions in excess of earnings and profits are considered capital gain.[128]

Distribution of services is neither the distribution of earning and profits nor the distribution of capital. Assume that a corporation with no earnings and profits buys land, which it allows its shareholders to use rent-free. The use of the property is income in the hands of the shareholders. Is it a dividend? No, because the corporation has no earnings and profits. Is it for tax purposes a distribution of capital? Again, the answer is no. The corporation could continue to allow its shareholders to use the land forever without depleting its capital. Assume that the cost of the land is $1,000 and that fair market rent is $100 a year. Ignoring possible fluctuation in the value of the land, if the land were the only asset of the corporation and it had no liabilities, the corporation's capital would be $1,000 and would remain $1,000 forever. If in fact it were distributing $100 a year (the rent-value of the land), one would expect that after ten years its capital would be depleted. As the service is neither a dividend nor a distribution of capital, it cannot be considered a distribution.[129]

To demonstrate further why the service cannot be considered a distribution, let us assume that a taxpayer owns a parcel of land he wishes to rent out for $100 a year. Were he to do so directly, he would be taxed at full income tax rates on the rent received. Instead, he sets up a corporation and contributes the land to the capital of the corporation. The corporation then allows the shareholder to use the property rent-free and the shareholder

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127 I.R.C. § 301(c)(2) (2009).

128 I.R.C. § 301(c)(3)(A) (2009).

129 In *Reynard Corp. v. Comm'r*, 30 B.T.A. 451, 453 (B.T.A. 1934), the Board of Tax Appeals touched on the relationship between rent-free use of corporate property, on the one hand, and earning and profits, on the other, and decided that, because of the problems involved, it was best to classify the benefit as compensation:

> The respondent has treated this income as additional compensation in one year and as a dividend in the next. We think he was right in his first determination. The residence was built not for the temporary use of Fox, but for his use at all times, and this irrespective of whether the corporation had a surplus or made earnings and profits. It would be anomalous to hold that when there was sufficient surplus the value of the right of occupancy constituted a dividend, and when there was no such surplus the value of the right was additional compensation.

Cf. Stan Frisbiev. Comm'r, T.C. Memo 1990-419, 60 T.C.M. (CCH) 440 (T.C. 1990) ("We conclude that Frisbie received constructive dividend income attributable to the fair rental value of the sailboat in 1981 . . . . SFI failed to show that in 1981 it did not have earnings and profits sufficient to cover the dividend."); Royce C. McDougal. v. Comm'r, 49 T.C.M. (CCH) 731 (T.C. 1985) ("The personal use of corporate property by a shareholder is a constructive dividend to the shareholder in amount equal to the fair value of the benefits conferred[.] [T]o the extent of earnings and profits such distributions will be dividends to the shareholder."); Gil v. Comm'r, T.C. Memo 1994-92, 67 T.C.M. (CCH) 2311 (T.C. 1994). I am unaware of any case in which a court considered the situation of shareholders who received rent-free use of corporate property in the absence of sufficient earnings and profits.

sublets it for $100 a year. The corporation has no gross income.[130] The shareholder had a total of $200 of gross income: $100 from the use of corporate property and an additional $100 rent received from the third party. On the other hand, seeing as the use of the property is serving to generate income, the use-value, which was included in his gross income, is deductible.[131] The result is as follows:

Income from use of corporate property	$100	Income from rent	$100
Deductions	------	Deduction of use-value	($100)
Taxable Income	$100		$0

After deducting the use-value from the rent received, the taxpayer is left with $100 of income from the rent-free use of corporate property. If he is allowed to pay the tax for this income at the reduced rates applicable to dividends, he will end up paying less than had he simply rented out the land. Through the technique described, he will have succeeded in transforming rent into a dividend.[132]

This example and the previous analysis make clear that the rent-free use of corporate property by shareholders must not, and should not, be considered a dividend. It should be classified as ordinary income taxable at ordinary rates.

V. Rent-Free Use of Property v. Renting at Market Rates and Distributing the Rent Received

In *Martin*, Judge Goldberg argued that one who borrows money interest-free is in an identical position to one who pays interest and then receives either compensation or a dividend equal to the amount of the interest; therefore, the tax consequences should be the same.[133] Applying that line of reasoning to the question of classifying the benefit, we could say that the rent-free use of corporate property is economically equivalent to the payment of rent to the corporation and the subsequent distribution of the rent received. In such a case, the income would be a distribution (i.e., a dividend if the corporation has sufficient earnings and profits, or a distribution of capital if not). Therefore, the income in the economically equivalent scenario of rent-free use should be the same: the benefit is a distribution.

Judge Goldberg's analysis proceeds from the assumption that economically equivalent transactions should be taxed the same. We saw earlier,

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130 *See supra* note 17.

131 *See supra* notes 107-113 and the accompanying text.

132 Were the corporation to have rented out the property and distributed the rent to the shareholders, this would clearly be a distribution out of profits. In the case described in the text, there is no corporate-level income to distribute.

133 *See supra* note 45.

though, that tax law does not always treat economically equivalent transactions similarly.[134] For example, Judge Goldberg's analysis focused exclusively on the shareholder. It did not address the tax liability of the corporation. A consistent application of the principle that economic equivalence entails similar tax treatment would require that the corporation be taxed on the income it would have earned had it rented out its property at market rates. Nonetheless, Judge Goldberg did not extend his equivalence argument to the corporation, and it is fairly obvious why he did not: imposing tax because a taxpayer could have experienced an accession to wealth violates long-standing income tax principles and might even be beyond Congress' constitutional mandate. As we have seen, §7872 circumvented the problem of imposing tax on imputed income by bifurcating and recharacterizing the loan proceeds so that tax is imposed on income actually received.[135] On the other hand, seeing as the recharacterization technique of §7872 is unavailable in the case of rent-free use of property, imposing tax on a corporation that allowed shareholders to use its property rent-free would necessarily involve taxing income the corporation could have earned, but in fact did not.

The inapplicability of the equivalence principle – the principle that economically equivalent transactions should be taxed the same – to the corporation is more than simply a counterexample to prove that the principle is unreliable as a determinant of tax consequences. The fact that the corporation receives no income for the performance of its service directly impacts the nature of the benefit received by the shareholders. When a corporation receives rent and distributes that rent to its shareholders, the distribution is out of earnings: the profit being distributed is the rent that was received from the shareholder/lessee. In contrast, when a corporation allows its shareholders to use its property rent-free, the corporation, *ex hypothesi*, receives no rent income and there are no profits to distribute.

Nonetheless, the concept of economic equivalence warrants a closer look. Take two scenarios. In the first, a corporation rents its property to its shareholders for market rent and simultaneously distributes a dividend. The shareholders then sublease the property. The corporation will pay tax on the rent it receives and the shareholders will pay tax on the dividend. The shareholders will not pay tax on the rent they receive from the sub-lessee, as they will be able to deduct the rent they paid to the corporation.[136] In the second scenario, the corporation allows its shareholders to use its property rent-free and they, again, sublease it to a third party. The shareholders will pay tax on the use-value of the property at ordinary rates. They will not pay

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134 *See supra* notes 64 and 104 and the surrounding text.

135 *See supra* Part II.E.

136 See the example in the text *supra* at notes 131-133.

tax on the rent they receive from the third party; as the use-value of the property was included in their gross income, they can deduct that use-value when it contributes to the production of income.[137] The difference between the two scenarios is that in the first, the corporation pays tax at the corporate rate and the shareholders pay tax at dividend rates, while in the second the shareholders pay tax at ordinary rates. Where the shareholders are individuals, this means that in the first scenario the total tax burden is equivalent to the tax burden on distributed corporate income, while in the second the tax burden is the same as that imposed on income derived directly by an individual.[138] Is there a principled justification for imposing different total tax burdens in the two scenarios? And if not, does this indicate that there is some flaw in the analysis of the tax consequences of the second scenario?

The answer to the first question is "probably not." The answer to the second question is "no"; while there is probably no principled justification for the difference, this does not indicate a flaw in the analysis. Actually, the opposite is the case. The difference in total tax burden actually supports the conclusions reached regarding the taxing of rent-free use of property by the corporation.

Under a non-integrated or partially integrated corporate tax structure, distributed corporate profits normally bear a higher tax burden than income earned by an individual. The question of whether the excess burden is justified has attracted a great deal of attention in the literature (and finds little support, which is why the answer to the first question is "probably not"), and a thorough investigation is beyond the scope of this article. For our purposes we will take the excess burden as a given.[139]

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137 *See supra* notes 107-113 and the accompanying text.

138 If the corporation and its shareholders are ordinarily subject to tax at the rate of 35 percent, (C.M.S. 6.25) and shareholders are subject to tax on dividends at the rate of 15 percent, then income earned directly by a shareholder will be taxed at 35 percent, while distributed corporate profits will be subject to a total tax burden of 35 percent + (15 percent x 65 percent) = 44.75 percent.

139 *See, e.g.,* DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, *in* vol. 1, 118-119 (1984); Fred W. Peel, *A Proposal for Eliminating Double Taxation of Corporate Dividends*, 39 TAX LAW. 1 (1985); DEPARTMENT OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992); American Law Institute, FEDERAL INCOME TAX PROJECT, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, Reporter's Study (Warren) (1993); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENT OF TAX POLICY: INTEGRATION OF THE CORPORATE AND SHAREHOLDER TAX SYSTEMS (1993); Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325 (1995); Steven A. Bank, *The Story of Double Taxation*, in BUSINESS TAX STORIES 153, 153 (Steven A. Bank & Kirk J. Stark, eds.) (2005) ("This 'double taxation' is a much reviled, but stubbornly persistent feature of our current system. Few commentators suggest that we would consciously adopt it if we were working from a blank slate, and most openly recommend double taxation's demise."). *Cf.* Jefferey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporation Income*, 68 N.C.L. REV. 613 (1990); Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It*, 56 TAX L. REV. 329 (2003).

When a corporation rents its property (whether to its shareholders or to unrelated parties) at market rates and distributes the rent it receives ("the first scenario"), the income is earned by the corporation. When a corporation allows its shareholders to use its property rent-free and the shareholders rent out the property at market rates ("the second scenario"), the income is earned directly by the shareholders. A non-integrated or partially integrated tax structure will differentiate between the two. However, under Judge Goldberg's economic equivalency analysis – if, as consistency requires, it is extended to include the corporation and not only the shareholders – income earned directly by the shareholders in the second scenario will be taxed as if it were distributed corporate earning: the corporation will pay tax at the corporate rate and the shareholders will pay tax at the dividend rate.

Whether or not there is a substantive justification for imposing different tax burdens on distributed corporate profits as opposed to income earned by an individual, if this is the framework within which we are working, its principles must be respected. Economic equivalency does not do so: it taxes income earned by an individual as if it were earned by a corporation. As opposed to the economic equivalency analysis, the position presented in this article conforms to the basic precepts of the corporate tax structure. As noted, there may be no substantive justification for taxing distributed corporate profits differently than earnings by an individual, and the article is not suggesting that there is. Nevertheless, if that is the framework within which we are to work, then the tax consequences should follow accordingly. Thus, the answer to the second question raised above is "no": the fact that economically equivalent transactions are taxed differently does not indicate that the analysis is faulty. If there is a flaw, its source is the corporate tax structure not being fully integrated. Within such a structure, the fact that, although economically equivalent, income generated by the corporation and distributed, on the one hand, and income generated directly by the shareholders, on the other hand, are taxed differently would tend to validate the analysis.

Until 2002, the corporate tax structure in the United States was based on a "classic" or double-taxation model, in which income generated by a corporation is fully taxed at the corporate level and then taxed again, at full rates, at the shareholder level. Since 2003, dividends in the hands of individuals have been taxed at reduced rates.[140] The relatively low rate of tax on dividends, in recognition of the fact that the earnings distributed have already been taxed on the corporate level, mark a transition to partial inte-

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[140] I.R.C. §1(h)(10) (2009).

gration.[141] In a partially integrated model, distributed corporate profits bear a higher burden of tax than income generated directly by an individual, but a lower burden than they would under a system of full double taxation.

Under a fully integrated model of corporate taxation, distributed corporate earnings bear a tax burden identical to the tax burden imposed on income earned directly by an individual. As noted, the advantages of full integration, both from the perspective of horizontal equity and from the perspective of economic efficiency, have been extensively discussed in the literature and need not be further addressed here.[142] What we do need to consider is how the rent-free use of corporate property would be taxed under various schemes of full integration. We will see that, where the tax structure itself equalizes the treatment of distributed corporate earnings with that of income generated directly by an individual, so does the proposed analysis of rent-free use of property.

A number of different models of full integration are possible. We will here consider three basic models. The first is a dividend exclusion model, in which income is fully taxed at the corporate level and shareholders pay no additional tax when the (post-tax) earnings are distributed as dividends. The exact method by which shareholders are exempt from paying tax on their dividends – e.g., excluding dividends from gross income or, alternatively, including dividends in gross income but allowing a credit for taxes paid on the corporate level – is irrelevant to our discussion.[143] It is important, though, that for the dividend exclusion model to be fully integrated, the corporate tax rate needs to be equal to the ordinary individual rate.[144] The second method of integration is to exempt corporations from paying tax on their income and to tax at ordinary rates dividends received by individuals. The primary difference between the dividend exclusion model and the corporate exemption model is that in the former income is taxed as it accrues in the hands in the corporation, while in the latter income is allowed to accumulate tax free as long as it is not distributed. The third model we will consider is a split rate (or two stage) system in which tax is imposed on the corporation as earnings accrue and again on shareholders as earnings

141 President George W. Bush's original proposal was a system of full integration, in which dividends paid out of earnings that had been taxed on the corporate level would be excluded from gross income on the shareholder level. U.S. DEPARTMENT OF THE TREASURY, DETAILS OF THE PRESIDENT'S DIVIDEND EXCLUSION PROPOSAL (2003), *available at* http://www.ustreas.gov/press/releases/kd3781.htm.

142 *See supra* note 140.

143 For a proposed shareholder imputation credit system see, e.g., AMERICAN LAW INSTITUTE, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION: SUMMARY AND PROPOSALS (Alvin C. Warren, Reporter, 1993).

144 In practice this could present a technical problem if individuals are subject to tax at progressive (or regressive) rates. With a fully integrated credit system, distributed corporate earnings will bear the same total tax burden as income earned directly by individual shareholders.

are distributed, but the tax rate imposed on both corporate earnings and dividends is reduced so that the total tax burden on distributed earnings equals individual rates. The split rate system occupies the middle ground between the dividend exclusion model and the corporate exemption model. The common denominator of all three is that distributed corporate earnings and income earned directly by an individual bear the same total tax burden. With regard to undistributed earnings, while the dividend exclusion model subjects them to tax and the corporate exemption model allows them to accumulate tax free, the split rate system subjects them to partial tax.[145]

Under a dividend exclusion model, a corporation that rents out its property will pay tax on the rent received. It will then distribute the rent net of corporate income tax to its shareholders, who will pay no further taxes. Should the corporation instead allow shareholders to use its property rent-free, it would pay no taxes (as it neither received nor was entitled to receive rent), and they would pay tax at ordinary individual rates on the use-value. As the corporate tax rate and the individual tax rate is presumptively the same, the tax burden on the two methods of structuring the transaction would be identical. Recall that a key component of the proposed analysis is that the service provided by the corporation to its shareholders is not a distribution, but rather ordinary income. Thus, the economic benefit inherent in using corporate property rent-free is not entitled to the exclusion available to dividends under the dividend exclusion model.

Under a corporate exemption model, a corporation that rents out its property would pay no tax and would be able to distribute the entire rent to its shareholders. They would then pay tax on what they received. Shareholders who, instead, received rent-free use of corporate property would pay tax at the same rate on the use-value of that property.

Finally, under a split rate system, a corporation that rents out its property would pay a low corporate tax and distribute the remainder to its shareholders as a dividend. They would then pay tax at the low dividend rate. In contrast, were the corporation to allow shareholders to use corporate property rent-free, the corporation would not pay tax and the shareholders would be taxed on the use value at ordinary rates. Assuming that the total burden of corporate tax plus dividend tax equals the individual tax rate, as it must if the system is fully integrated, the tax consequences of the two scenarios would again be identical.

A numerical example of the equivalence under the various models is annexed to the article.

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[145] In effect, the dividend exclusion model and the corporate exemption model are simply extreme examples of the two stage model. The two stage model merely divides the tax burden between the corporate and the shareholder: the corporation's tax rate can vary from 0 percent (corporate exemption model) to the full individual rate (dividend exclusion model), provided only that the total tax burden is equal to the individual rate.

VI. CONCLUSION

When considering the tax consequences of interest-free loans from corporations to their shareholders, the courts accepted, at face value, the characterization of these loans as "interest free" and ran straight into difficulty. Starting from the premise that the loans actually were interest free and applying traditional principles of income taxation, the courts were unable to arrive at a satisfactory solution to the quandaries surrounding the tax consequences of these loans from the perspective of the corporation and the shareholder. Eventually, a legislative solution was imposed. One might conclude that, like the laws of physics when reaching a singularity, traditional principles of income taxation, upon encountering the enigma of interest-free loans from corporations to shareholders, reach the limits of their applicability and need to be replaced by other rules more attuned to the reality of that specific situation.

The position taken by this article, in defense of traditional income tax principles, is twofold. First, the solution adopted by Congress with regard to taxing interest free loans is not as radical as might appear. Congress did not impose tax on imputed income, i.e. income that the taxpayer neither received nor was entitled to receive. Rather, Congress provided that what the parties to the transaction described as loan proceeds should be bifurcated, with an amount equal to the present value of the borrower's future payments characterized as a loan and the remainder constituting a dividend, compensation, or a gift, according to the circumstances. Whatever the relationship between the parties and subject to certain *de minimus* exceptions, the difference between the nominal amount of the reconstituted loan and the nominal amount to be repaid by the borrower constitutes interest in the hands of the lender and an interest expense, the deductibility of which depends on the use to which the borrowed funds are put, in the hands of the borrower. Recharacterizing (or bifurcating) a payment conforms to traditional tax principles and is something that courts have done innumerable times in other contexts. They could and probably should have done so in the case of "interest-free" loans.

Second, even without bifurcating the payment into a loan and a dividend, the courts could still have arrived at a satisfactory solution had they applied the principle that when a taxpayer pays tax upon receipt of property or services, that property or service acquires a basis, equal to the its value at the time of receipt and deductible if and when used for the production of income (or used in some other manner that conforms to the general rules for deducting expenses). In other words, although the shareholders did not actually pay any interest on the loan, had the economic value of the loan been included in their gross income, they should have been allowed, in accordance with the law at that time, to deduct that same amount as an interest expense unless the borrowed funds had been invested in tax free bonds.

The fact that even without bifurcation and recharacterization the courts could have arrived at a satisfactory resolution of the tax issues presented by interest-free loans is particularly significant with regard to the taxation of rent-free use of corporate property. Unlike interest-free loans (in which shareholders acquire full title to the money they receive and are under a corresponding obligation to return an equal amount of money to the corporation), rent-free use of corporate property (where title remains in the hands of the corporation and shareholders receive merely the temporary use of that property) cannot be bifurcated, so the bifurcation and recharacterization construction underlying § 7872 is inapplicable. Thus, unlike a corporation lending money to its shareholders "interest-free", a corporation allowing shareholders to use its property rent-free will not report any income. For their part, the shareholders will report the use value of the property as gross income and, despite not having paid the corporation rent for the use of the property, will be able to deduct the use value for which they were taxed, if the property was subleased by them or otherwise contributed to the production of income.

The article also took the position that, as the rent-free use of corporate property by shareholders is neither a distribution of earnings nor a distribution of capital, it does not constitute a "distribution" for tax purposes. The shareholders will pay tax on the benefit received at ordinary income tax rates.

Thus, the total tax burden for the rent-free use of corporate property by individual shareholders will be equal to the ordinary individual tax rate. On the other hand, the total tax burden for the economically equivalent transaction of renting property to shareholders at the market price and then distributing as a dividend the rent received would be that imposed on distributed corporate earnings. In a non-integrated or partially integrated corporate tax structure (like the presently prevailing system in the United States), the latter will be greater than the former. Nonetheless, the unequal treatment of economically equivalent transactions results, not from any flaw in the analysis, but from the corporate tax structure itself. When a corporation rents out its property and distributes the rent, shareholders receive distributed corporate profits. When a corporation allows shareholders to use property rent-free and they rent it out, the shareholders are generating the income. Where the tax burden on distributed corporate profits is greater than the tax burden imposed on individuals, one should not be surprised to discover specific instances of horizontal inequity.

To demonstrate that the source of the disparate tax treatment is the corporate tax structure and not any flaw in the analysis, the article examined how the two transactions would be taxed under various full integration models. In each of them, economically equivalent transactions bear equal tax burdens.

APPENDIX

For the purpose of the computations appearing in this appendix, the following will be assumed:

1. The corporation has $100,000, representing either post-tax earnings or shareholder contribution to capital.
2. The corporation will retain enough cash to cover any potential tax liability it might incur.
3. With the remaining funds it will purchase property for the use of its shareholders.
4. Shareholders will rent the property out at market rates.
5. The rate of return for all investments (interest or rent) is ten percent.
6. In all models, individuals are taxed on their ordinary income at the rate of forty percent.
7. Under Full Integration Model I, corporations are taxed at the rate of forty percent and dividends are excluded from gross income.
8. Under Full Integration Model II, corporations are not taxed on their income and dividends are taxed at ordinary rates.
9. Under Full Integration Model III, corporations are taxed on their income at the rate of twenty percent and dividends received by individuals are taxed at the rate of twenty-five percent.
10. Under the Partial Integration Model, corporations are taxed on their income at the rate of forty percent and dividends received by individuals are taxed at the rate of twenty percent.
11. Under the Classic Double Taxation Model, corporations are taxed on their income at the rate of forty percent and dividends are taxed at ordinary rates.

A. CORPORATION ALLOWS SHAREHOLDERS TO USE PROPERTY RENT-FREE

	Model:		Full Integration I	Full Integration II	Full Integration III	Partial Integration	Classic Double Taxation
A	Corporate level income tax		40%	0%	20%	40%	40%
B	Shareholder level income tax on dividends		0%	40%	25%	20%	40%
C	Total tax burden on distributed corporate profits		40%	40%	40%	52%	64%
D	Corporate funds available – used to purchase property for shareholder use		100,000	100,000	100,000	100,000	100,000
E	Benefit to share-holders from use of corporate property	Dx10%	10,000	10,000	10,000	10,000	10,000
F	Tax on use of corporate property	Ex40%	4,000	4,000	4,000	4,000	4,000
G	Shareholders' rental income from sublease	Dx10%	10,000	10,000	10,000	10,000	10,000

H	Shareholders' deduction (use of taxed benefit for production of income)	E	10,000	10,000	10,000	10,000	10,000
J	Shareholders' taxable income from sublease	G-H	0	0	0	0	0
K	Shareholders' tax on sublease	Jx40%	0	0	0	0	0
L	Shareholders' net income	G-(F+K)	6,000	6,000	6,000	6,000	6,000
M	Effective tax rate	[(Dx 10%)-L]/ (Dx 10%)	40%	40%	40%	40%	40%

14.

B. CORPORATION RENTS PROPERTY TO SHAREHOLDERS AND DISTRIBUTES AS DIVIDEND RENT RECEIVED

	Model		Full Integration I	Full Integration II	Full Integration III	Partial Integration	Classic Double Taxation
A	Corporate level income tax		40%	0%	20%	40%	40%
B	Shareholder level income tax on dividends		0%	40%	25%	20%	40%
C	Total tax burden on distributed corporate profits		40%	40%	40%	52%	64%
D	Corporate funds available		100,000	100,000	100,000	100,000	100,000
E	Investment to provide for future tax liability	CxA	40,000	0	20,000	40,000	40,000
F	Return on investment	Ex10%	4,000	0	2,000	4,000	4,000
G	Corporate level tax on return	FxA	1,600	0	400	1,600	1,600
H	Return on investment net of corporate level taxes	F-G	2,400	0	1,600	2,400	2,400

J	Purchase price of property for rent to shareholders	D-E	60,000	100,000	80,000	60,000	60,000
K	Rent paid by shareholders to corporation and distributed as dividend	Jx10%	6,000	10,000	8,000	6,000	6,000
L	Corporate level tax on rent (financed by net return on investment – line H)	KxA	2,400	0	1,600	2,400	2,400
M	Shareholder level tax on dividend	KxB	0	4,000	2,000	1,200	2,400
N	Shareholders' gross rental income from sublease	Jx10%	6,000	10,000	8,000	6,000	6,000
P	Shareholders' deduction for rent paid	K	6,000	10,000	8,000	6,000	6,000
Q	Shareholders' taxable income from sublease	N-P	0	0	0	0	0
R	Shareholders' tax on sublease	Qx40%	0	0	0	0	0
S	Shareholders' net income	N-(M+R)	6,000	6,000	6,000	4,800	3,600

T	Effective tax rate	[(Dx 10%)-S]/(Dx 10%)	40%	40%	40%	52%	64%

A comparison of the tables demonstrates that the effective tax of the two economically equivalent transactions is identical under all full integration models. Under non-integrated or partially integrated models, the effective tax rate of renting property to the shareholders is higher than the effective tax rate of allowing them free use of the property. This discrepancy is due the fact that under non-integrated and partially integrated models, the tax burden on distributed corporate earnings is greater than the tax burden on income generated directly by an individual.