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Federal Gift Taxation of Non-Interest-Bearing Loans: Crown v. Commissioner

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CONCLUSION

An implied warranty of habitability recognizes that if premises are to be in a state of good repair, it is the landlord who must have the obligation to repair them. The considerations outlined above indicate that such an obligation should apply to HUD as landlord in the same way that it increasingly has been applied to private landlords. It is therefore submitted that there is a need for a uniform federal rule regarding federally owned housing and that the rule which best effectuates congressional policy is that of an implied warranty of habitability. The implication of a warranty of habitability is not a guarantee that federal housing policy goals are being met but rather is a rule which alters the common law duty to repair and grants to tenants a contractual remedy where the premises are below minimum standards of fitness. The Seventh Circuit in *Alexander* should not have deferred a decision to Congress but instead should have decided the issue presented on the merits and held that there is an implied warranty of habitability in HUD housing. Since it seems inappropriate that tenants of the federal government should be afforded fewer rights than those tenants who have contracted in the private sector, the federal courts should adopt as a uniform rule of federal common law an implied warranty of habitability in urban residential leases where the United States is the lessor.

DAVID A. SLACTER

Federal Gift Taxation of Non-Interest-Bearing Loans: *Crown v. Commissioner*[1]—Lester Crown and his two brothers were equal partners in Areljay Company, an Illinois general partnership.[2] Prior to 1967, twenty-four trusts benefiting children and other relatives of the Areljay partners were established and funded in part by the partners.[3] During 1967, Areljay made various non-interest-bearing loans to the trusts so that by December 31, the trusts owed Areljay a total of $18,030,024, all of which were recorded in the books of Areljay and the respective debtor trusts, and were payable on demand.[4] Throughout 1967, interest was neither due nor paid on any of these loans.[5]

In 1974, the Commissioner of Internal Revenue (Commissioner) issued a notice of deficiency, claiming that Crown owed $46,084.54 in additional gift tax for 1967.[6] The Commissioner alleged that the deficiency

[1] 67 T.C. 1060 (1977), *appeal docketed*, No. 77-1898 (7th Cir. Sept. 2, 1977).

[2] *Id.*

[3] *Id.* at 1061. In 1967, the Areljay partners had a total of 15 children, separate trusts for 12 of whom were involved in *Crown*. Harry N. Wyatt was the sole trustee of all the trusts.

[4] *Id.* All were evidenced either by demand notes or by open account entries in Areljay's records. No interest was charged on any of the open account loans. The demand notes similarly required no payment of interest before demand, but did call for six percent interest after demand. As of December 31, 1967, loans represented by demand notes totaled $2,073,649 and loans on open account totaled $15,956,375.

[5] *Id.* at 1060. At all pertinent times, Areljay, its partners, and all of the trusts have operated on the cash basis method of accounting. During 1967, the market prime rate of interest ranged between five and one-half percent and six percent per annum, averaging 5.63 percent.

[6] *Id.*

arose because Crown erroneously had failed to include the value of the use of the moneys loaned to the trusts as gifts on his 1967 return.[7] The Commissioner took the position that not charging interest on the loans constituted a gift of the value of the use of the money loaned and that such use value was subject to gift taxation under section 2501 of the Internal Revenue Code of 1954 (Code).[8] Accordingly, the Commissioner computed the value of the gift to be $1,086,407.75.[9] Crown, as one-third owner of Areljay, was deemed by the Commissioner to have made a gift of one-third of the amount so calculated, or $362,135.92.[10] The additional gift tax due if this sum had been included in Crown's 1967 return was $46,084.54, the amount of the alleged deficiency.[11]

Crown brought suit in the Tax Court, asserting that the Commissioner's attempt to tax these loans was beyond the legal authority granted to the Commissioner under section 2501 of the Internal Revenue Code of 1954.[12] Accepting Crown's position, the Tax Court HELD: The making of non-interest-bearing loans to family members is not a taxable event within the scope of section 2501.[13] In reaching its decision, the court actually did not consider the legal sufficiency of the Commissioner's decision to tax such loans. Rather, the court examined three factors which it determined precluded acceptance of his position. First, the court noted that the Commissioner only recently has begun to assert that making non-interest-bearing loans may give rise to gift tax liability.[14] Second, the court pointed to both the lack of case authority supporting the Commissioner's position that such loans be taxed and the existence of case authority explicitly rejecting the Commissioner's contentions.[15] Finally, the court observed that tax-

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[7] *Id.* at 1061.

[8] *Id.* at 1061-62. Section 2501(a)(1) of the Code provides in part: "A tax, computed as provided in section 2502, is hereby imposed for each calendar quarter on the transfer of property by gift during such calendar quarter by any individual, resident or non-resident."

In 1973, the year before the notice of deficiency was sent to petitioner, the Commissioner announced his position that:

> The right to use property, in this case money, is itself an interest in property, the transfer of which is a gift within the purview of section 2501 of the Code unless full and adequate consideration in money or money's worth is received. The tax . . . would be imposed on the value of the right to use the money . . . .

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

[9] 67 T.C. at 1061. The Commissioner determined that six percent per year was a reasonable rate of interest, since this rate was only fractionally above the prime rate which prevailed during 1967. In order to compute the amount of interest which would have been due had interest been charged, the Commissioner applied this rate to the outstanding balance on a daily basis. *Id.*

[10] *Id.* at 1061-62.

[11] *Id.* at 1060.

[12] *Id.*

[13] *Id.* at 1062. The Tax Court's opinion included a strong dissent which, after noting the congressional intent to have the gift tax broadly applied, the longstanding practice of discounting fixed term notes to net present value, and the fact that giving use of property can support a charitable gift deduction, concluded that the gift tax should apply in *Crown*. Further, the dissent criticized the majority for applying erroneous and irrelevant precedents, for failing to recognize the Commissioner's authority to change earlier interpretations of the Code, and for overstating the administrative problems involved in applying the Commissioner's new position.

[14] *Id.* at 1063.

[15] *Id.*

ing "permissive use" of assets between family members would be administratively unmanageable.[16] Weighing all these factors, the court concluded that if the making of non-interest-bearing loans among family members is to become a taxable event, further congressional action is required.[17] Although the Commissioner maintained that such loans clearly were subject to gift tax under the Code, the court declined to decide this question on its merits, preferring instead to leave unchanged what it deemed to be the present law.[18]

Crown v. Commissioner is significant because, if upheld on appeal,[19] it could result in a serious diminution in the efficacy of the gift tax provisions of the Code. Since a debtor is able to earn a return on a loan principal, a person effectively could transfer large amounts of wealth to a debtor by allowing a non-interest-bearing loan to remain outstanding over time. Under *Crown*, neither the creditor nor the debtor would be subject to tax from the transfer of the use of such loan funds.[20] Particularly in the area of intrafamily loans, this result would enable parents to give their children the equivalent of a beneficial life estate in a large sum of money without incurring any gift tax liability. Furthermore, holding that such loans are not subject to taxation frustrates the effectiveness of the gift tax in preventing income tax avoidance through income splitting schemes. Such income splitting schemes could occur if the loan funds are invested at a profit, since the income earned would be taxable to the debtor rather than to the creditor.[21] Thus, adherence to the *Crown* ruling would undermine the efficacy of the gift tax provisions of the Code by presenting taxpayers with

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[16] *Id.* at 1065.

[17] *Id.*

[18] *Id.*

[19] *Crown* is presently on appeal to the Seventh Circuit, and is scheduled for hearing in the spring of 1978. See note 1 *supra*.

[20] For example, if in *Crown* the loans had remained open for 30 years and the borrowing trusts earned six percent interest on the balance, over $70 million would have been transferred to the trusts. Even if the trusts earned only four percent interest, nearly $35 million would be transferred. The computations are: one dollar at four percent interest, compounded annually, will equal $3.2433975 ($(1.04)^{30}$) at the end of 30 years; at five percent the amount is $4.3219424 ($(1.05)^{30}$); and at six percent the amount is $5.7434912 ($(1.06)^{30}$). Thus, if $15 million is invested or lent at those rates of return, the total amounts owned at the end of 30 years would be, respectively, $48,650,962; $64,839,136; and $86,152,368. Subtracting the $15 million of principal, which must be repaid, yields, respectively, $33,650,962; $49,839,136; $71,152,368. Even if some substantial diminution is assumed as a result of annual income taxes (which may be entirely avoided through investment in tax-free municipal obligations) it is apparent that very substantial sums have been effectively bestowed upon the debtor trusts.

[21] The primary motivating factor in income splitting schemes is the minimization of the impact of the progressive rate structure. If an income producing asset is transferred from a high income, high bracket taxpayer to a lower income, lower bracket taxpayer, the income generated by the asset is taxed to the lower income taxpayer at his lower marginal rate. This results in a net loss of revenue to the treasury. In *Crown*, the asset was the principal of the loans. If these funds were used to procure income producing assets, say bonds or debentures, the income would be taxed at the rate applicable to each trust. This would result in the income being taxed at a lower rate, assuming, as is likely, the rate applicable to each trust was lower than the rate applicable to Crown himself. The overall effect of such a scheme is a reduction in the total revenue paid to the treasury. Congress passed the gift tax to minimize both estate tax avoidance through depletion of a taxpayer's estate by making inter-vivos transfers and income tax avoidance through income splitting schemes predicated on the transfer of income producing assets. By levying a tax on the transfer of assets, Congress intended to discourage transfers undertaken solely to avoid income taxes.

several ways effectively to transfer large sums of money to family members without the imposition of a gift tax.

This casenote will first analyze the Tax Court's opinion in *Crown*, considering, in turn, each of the three factors relied upon by the court and demonstrating how the court's reliance on these factors was unwarranted. The casenote will then focus on the gift tax provisions of the Code and will analyze the intended scope of application of these provisions. Finally, it will consider the actual transactions involved in *Crown* and will indicate how the intended scope of the gift tax should have led to the conclusion that the transactions in *Crown* are subject to a gift tax.

I. THE *Crown* OPINION

In declining to permit the Commissioner to change his past practice, and consequently declining to pass on the validity of the Commissioner's claim that interest-free loans are subject to gift tax under the Code, the *Crown* court relied upon three factors. First, and of primary importance to the court, was the fact that the Commissioner only recently had attempted to apply the gift tax to non-interest-bearing loans between family members.[22] The court decided that it was improper for the Commissioner to change his earlier position of not taxing such loans without first obtaining a specific mandate from Congress to accomplish the proposed change in scope of the gift tax.[23]

As the second factor, the court surveyed what it deemed to be the relevant case authority.[24] The court began its consideration of the cases by discussing with approval *Johnson v. United States.*[25] There, the United States District Court for the Northern District of Texas refused to permit the application of the gift tax in a fact situation virtually the same as that in *Crown.*[26] The *Johnson* court determined that the gift tax should not apply to any transfer that does not directly deplete the transferor's estate, since, the court noted, the gift tax was enacted to complement the estate tax.[27] Because the value of any outstanding loans is included in the transferor's estate at death, the court reasoned that the making of a non-interest-bearing loan does not diminish the transferor's estate and accordingly should not be subject to the gift tax.[28] Without independently analyzing this issue, the court in *Crown* adopted the *Johnson* rationale, thus ruling that on the facts of *Crown* the gift tax should not be imposed.[29]

After stating that *Johnson* was the only reported case concerning the applicability of the gift tax to non-interest-bearing loans, the *Crown* court noted that other courts also have rejected uniformly the Commissioner's attempts to subject such loans to liability under the income tax.[30] The court first cited *J. Simpson Dean.*[31] There, the Tax Court rejected the Commis-

[22] *Id.* at 1063.
[23] *Id.* at 1064.
[24] *Id.*
[25] 254 F. Supp. 73 (N.D. Tex. 1966).
[26] *Id.* at 77.
[27] *Id.*
[28] *Id.*
[29] 67 T.C. at 1064.
[30] *Id.*
[31] 35 T.C. 1083 (1961).

sioner's attempt to tax the imputed interest on interest free loans from a corporation to its shareholders and held that a shareholder's receiving of over two million dollars in non-interest-bearing loans does not subject him to income tax liability.[32] The *Dean* court reasoned that, had the taxpayers borrowed the funds on interest-bearing notes, their payment of interest would have been fully deductible. Therefore, the court concluded, any income that might be imputed as a result of receiving the loaned funds would be cancelled by a like deduction under the interest expense deduction provisions in the Code.[33] The *Dean* court decided that it was much simpler to hold that receiving non-interest-bearing loans does not result in income.[34] The *Crown* court also cited two additional income tax cases involving non-interest-bearing loans which, like *Dean*, refused to impose income tax liability.[35]

After considering the past practices argument, and routinely applying what the court deemed to be the relevant case law, the *Crown* court concluded that the administrative difficulties involved in applying the Commissioner's approach weighed heavily against accepting his position.[36] The court noted that, if the Commissioner's approach were adopted, it could be extended to a multitude of situations involving gratuitous use or sharing of property among relatives.[37] This, the court reasoned, would lead to an administratively unmanageable situation.[38]

By aggregating these factors, the Tax Court reached the conclusion that the established policy of not taxing non-interest-bearing loans should not be altered at this time by judicial action.[39] Rather, the court indicated that future congressional action would be required if such a change were to take place.

It is submitted that the Tax Court failed to analyze properly all three of the grounds upon which its decision was based. Consequently, the court erred in concluding that non-interest-bearing loans should not be subject to the gift tax. With respect to the first ground, in relying upon the fact that the Commissioner's past practice had been not to tax such loans the court failed to consider the broad authority possessed by the Commissioner to change his earlier interpretations of the Code.[40] Indeed, the Supreme

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[32] *Id.* at 1090.

[33] The *Dean* Court relied upon the applicability of § 163 as providing the requisite deduction. That section states, in part, that there "shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." I.R.C. § 163.

[34] *Id.* For a criticism of this general approach see, in this issue, Keller, *The Tax Consequences of Interest-Free Loans From Corporations to Shareholders and From Employers to Employees*, *supra* at ——.

[35] The two further cases considered by the *Crown* court were Saunders v. United States, 294 F. Supp. 1276 (D. Hawaii 1968), *rev'd on other grounds*, 450 F.2d 1047 (9th Cir. 1974), and Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862 (3d Cir. 1974).

[36] 67 T.C. at 1065.

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] This authority stems from I.R.C. § 7805, which provides in part:

> Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Court specifically affirmed this authority to change earlier interpretations in *Dixon v. United States.*[41] In *Dixon,* the taxpayers relied on the Commissioner's published acquiescence in a Tax Court decision,[42] and, accordingly, bought and later sold certain notes.[43] Subsequent to the sale of the notes, the Commissioner reversed his position and announced his non-acquiescence in the case relied on by the taxpayers.[44] The result of the Commissioner's new position was that the gain from the sale of the notes did not qualify for preferential capital gains treatment, but rather was taxable as ordinary income.[45] In upholding the Commissioner's change of position[46] and his application of the new interpretation to the taxpayers, the Supreme Court held that the Commissioner indeed does have the authority not only to change his past interpretations of the Code but also to apply those changes retroactively.[47] The Court further concluded that a taxpayer's reliance on an earlier interpretation does not operate as a bar to the Commissioner's ability to change his interpretation.[48] Accordingly, under *Dixon,* a prior erroneous interpretation or policy of the Commissioner does not gain the force of law but rather is a "mere nullity."[49] The Commissioner is thus free to change such prior interpretations and policies, and neither the taxpayer's reliance on the earlier interpretation nor the passage of time need impair the Commissioner's ability to do so.[50]

Applying the *Dixon* principle to the situation in *Crown,* it is clear that the Tax Court should not have considered the Commissioner's past practice, but rather should have evaluated the legal sufficiency of the Commissioner's new position. *Dixon* should control the situation presented in *Crown* because it clearly upholds the Commissioner's authority to change past interpretations of the Code, thereby permitting him to be responsive to changes in the economic environment to which the Code applies.[51]

In fact, the countervailing facts in *Crown* are not even as strong as those found by the *Dixon* Court to be insufficient to deny the Commis-

. . . The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to internal revenue laws, shall be applied without retroactive effect.

I.R.C. § 7805 (subtitles omitted).

[41] 381 U.S. 68 (1965).

[42] The case relied upon by the *Dixon* taxpayers was Caulkins v. Commissioner, 1 T.C. 656 (1943), *aff'd,* 144 F.2d 482 (1944). In *Caulkins,* the court held that gain received upon retirement of an "Accumulated Investment Certificate" (which was essentially an annuity contract) was entitled to capital gains treatment. 144 F.2d at 484.

[43] 381 U.S. at 69-70.

[44] *Id.* at 71.

[45] *Id.* at 70.

[46] *Id.* The Supreme Court previously had upheld the merits of the Commissioner's position in United States v. Midland-Ross Corp., 381 U.S. 54 (1965). There, the taxpayers had bought non-interest-bearing notes at an original issue discount. Subsequently, the taxpayers realized a gain on the sale of the notes before maturity. The Court held that this gain was ordinary income rather than capital gain. *Id.* at 67.

[47] 381 U.S. at 75. (Setting the standard of review of the Commissioner's action as abuse of discretion).

[48] *Id.* at 80.

[49] *Id.* at 74.

[50] *Id.* at 80.

[51] This desired flexibility is generally regarded as one reason for employing an administrative structure for applying a complex statute, and is consistent with accepted principles of administrative law. *See generally* 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE 34-44 (1958).

sioner the right to correct past interpretations. First, the Commissioner's position in *Crown* had been foreshadowed by his discounting of notes for a fixed term to net present value in other tax situations,[52] thus indicating his and the Code's recognition of the time value of money. Second, the Commissioner had never expressly announced his acquiescence in a case inconsistent with his "new" position.[53] His alleged "prior interpretation" consisted merely of failing to apply the Code aggressively to the transactions in question.[54] In *Dixon*, on the other hand, the Commissioner's change in position had not been foreshadowed and his prior inconsistent position had been formally announced. It seems clear that if the Commissioner can change retroactively an announced interpretation which has been relied upon, he certainly can change his position with respect to an interpretation which never had been formally announced, even where such interpretation is inconsistent with his prior practice. While a court may determine that the Commissioner's new position is in fact erroneous, it should not refuse to permit him to revise his interpretation without determining that the proposed interpretation is, in fact, in error. The authority to promulgate the new interpretation cannot itself be judicially circumscribed.

The Tax Court's second ground, that of relying in prior cases, was also flawed in that the court did not analyze critically the rationale underlying the cases which it maintained supported the position that the making of non-interest-bearing loans is not a taxable event. The first case discussed, *Johnson,* was based on the premise that, in order to be subject to the gift tax, a transfer must deplete the transferor's estate.[55] However, in view of the legislative intent behind the gift tax, the imposition of this requirement is unwarranted. The legislative history of the gift tax indicates that, in addition to preventing estate tax avoidance by depleting an estate through inter vivos transfers, the gift tax also was intended to prevent income splitting schemes designed to minimize the effect of the progressive income tax rates.[56] The Committee Reports relating to the gift tax state:

> The gift tax will supplement both the estate tax and the income tax. It will tend to reduce the incentive to make gifts in order that distribution of future income from the donated

[52] The Commissioner has generally required the valuation of notes for a fixed term to be determined by computing the net present value of the notes at prevailing interest rates. This clearly indicates that the Commissioner's position is that the Code does indeed take cognizance of the time value of the use of money. *See* Gertrude H. Blackburn, 20 T.C. 204, 207 (1953) (Tax Court upheld the Commissioner's method of valuing a note on a net present value basis in dealing with a bargain sale in a gift tax situation).

[53] The Commissioner's failure to announce non-acquiescence in *Johnson* until 1973 should not be construed as his accepting its reasoning or result. The Commissioner need not announce his acquiescence or non-acquiescence in district court cases. *See* S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 66 (1972).

[54] The Commissioner took no action to apply the gift tax to non-interest-bearing loans between the 1966 decision in *Johnson*, which was adverse to the Commissioner's position, and his issuance of Rev. Rul. 73-61, 1973-1 C.B. 408 in 1973. The Commissioner did not announce non-acquiescence in *Johnson* until 1973. Rev. Rul. 73-61, 1973-1 C.B. 408.

[55] 254 F. Supp. at 77.

[56] H.R. REP. No. 708, 72d Cong., 1st Sess. 8 (1932), 1939-1 (part 2) C.B. 457, 462; S. REP. No. 665, 72d Cong., 1st Sess. 11 (1932), 1939-1 (part 2) C.B. 496, 504.

> property may be to a number of persons, with the result that the taxes imposed by the higher brackets of the income tax are avoided.[57]

The Supreme Court, moreover, recognized this dual function of the gift tax in *Smith v. Shaughnessy*,[58] where the Court upheld the imposition of the gift tax on the transfer of a future interest which, for estate tax purposes, would be included in the transferor's estate and thus would be subject to the estate tax upon his death. After noting that "[t]he gift tax was passed not only to prevent estate tax avoidance, but also to prevent income tax avoidance through reducing yearly income and thereby escaping the effect of progressive surtax rates . . . ,"[59] the Court concluded that the transfer and income taxes were not mutually exclusive and that the imposition of both taxes upon the same property was permissible.[60]

Johnson, then, is based on an assumption that has been expressly repudiated by the Supreme Court, and which is contradicted by the legislative history of the gift tax. By narrowly focusing on only one purpose of the gift tax, the *Johnson* court imposed as a prerequisite to the application of that tax a requirement that is not expressed in any statutory provision or other relevant authority. This requirement—that a transfer must deplete the transferor's prospective estate before it is subject to the tax—seriously undermines the efficacy of the gift tax in preventing income tax avoidance through income splitting schemes. The transfers in *Crown* had precisely the effect of splitting the income earned on the loan principal among the debtor trusts. Thus, the *Crown* court erred in applying the mistaken reasoning in *Johnson* to *Crown*, since the gift tax was expressly designed to tax such income splitting schemes.

Similarly, the *Crown* court's reliance on the cases refusing to impose income tax liability based on the receipt of interest-free loans was inappropriate. The court apparently concluded that the income tax cases were relevant to its consideration of the applicability of the gift tax to such interest-free loans.[61] However, the fallacy of this conclusion is readily apparent. The rationale in *Dean,* and the other income tax cases, was grounded upon the existence of a corresponding interest expense deduction which would offset any income that might be imputed as a result of receiving the loans.[62] "There is, however, no such offsetting deduction in the gift tax provisions of the Code. This absence of any applicable offsetting deduction renders the rationale used in the income tax cases inappropriate in the gift tax situation. Therefore, the *Crown* court's reliance upon the income tax cases was misplaced, and the *Crown* court should not have followed the reasoning in *Dean* and similar cases. Since the reasoning in *Johnson* was incorrect and the analogy to the income tax cases was inappropriate, the *Crown* court was mistaken in deciding that there was clear case authority for its position.

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[57] H.R. REP. No. 708, 72 Cong., 1st Sess. 28 (1932), 1939-1 (part 2) C.B. 457, 476; S. REP. No. 665, 72d Cong., 1st Sess. 40 (1932), 1939-1 (part 2) C.B. 496, 524.

[58] 318 U.S. 176 (1943).

[59] *Id.* at 179 n.1.

[60] *Id.* at 179.

[61] 67 T.C. at 1064.

[62] I.R.C. § 163. For text of § 163, see note 33 *supra.*

The *Crown* court's third ground, that of the administrative difficulties involved in applying the Commissioner's position, is likewise unconvincing. The court expressed concern that the tax would be extended to "a multitude of situations involving the gratuitous use or sharing of real or personal property among relatives."[63] However, a large number of intrafamily situations involving permissive use of property would not be subject to the gift tax because of the annual exclusion of section 2503(b).[64] Under that section, only when the rental value of property being used exceeds $3,000 does the gift tax apply. Thus, for example, in the case of a non-interest-bearing loan, the section 2503(b) exclusion would preclude application of a gift tax until the principal of the loan exceeds $50,000.[65] Another large number of transactions likewise would not be subject to tax since the gift tax is not applicable to transfers from parent to child if the transfers are part of the parent's legal obligation to furnish support to the child.[66] Taken together, these two considerations would eliminate the administrative problems of taxing a substantial number of intrafamily transfers of the use of property and would leave only the exceptional transfer, such as that in *Crown*, subject to the tax. Furthermore, and more important, it is the Commissioner, not the courts, who has the authority to make exceptions to the statutorily mandated application of the tax.[67] Even if administrative problems do result from applying the Commissioner's position, it is he, not the courts, who must solve those problems by issuing regulations and procedures. It is not proper for a court to refuse to permit the Commissioner to interpret the Code in an otherwise legally acceptable manner solely on the basis that such interpretation may lead to administrative problems. The *Crown* court thus not only overstated the problems involved in applying the Commissioner's approach, but also misconceived its own role in administering the tax laws. Accordingly, the *Crown* court incorrectly gave undue weight to the supposed difficulty in applying the new interpretation, and

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[63] 67 T.C. at 1090.

[64] Section 2503(b) provides in part:

> In computing taxable gifts for the calendar quarter, in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year 1971 and subsequent calendar years, $3,000 of such gifts to such person less the aggregate of the amounts of such gifts to such person during all preceding calendar quarters of the calendar year shall not, for purposes of subsection (a), be included in the total amount of gifts made during such quarter.

I.R.C. § 2503 (b) (subtitles omitted).

For gifts made after December 31, 1976, the annual exclusion has been supplemented by the unified credit against gift tax. This should further enhance the effect of the annual exclusion in eliminating many common family situations involving the use of property from taxation, since the credit raises the minimum size of the gift required before any gift tax is due.

[65] Under § 2513, if a husband and wife jointly made the loan, no tax is due until the loan principal exceeds $100,000. This assumes that the Commissioner continues to apply six percent interest to the loans. If he imposes a higher rate, naturally, the size of the loan qualifying for the exemption would be reduced.

[66] Transfers made to satisfy a legal obligation, such as support or alimony, are considered made for full consideration, and thus are not taxable. *See generally* Estate of Fabrikant v. Commissioner, 39 T.C. 714 (1963) (payments made in discharge of marital obligation); Mitchell v. Commissioner, 6 T.C. 159 (1940) (payments to settle support obligation to wife).

[67] Section 7805 provides the authority to the Commissioner to make such administrative exceptions to taxability, as in welfare payments. This, too, is consistent with general administrative law principles. *See generally* 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE 75-158 (1958).

failed to perform its proper role by declining to evaluate the legal sufficiency of the Commissioner's position.

As a consequence of applying the "past practices" argument, uncritically accepting erroneous and irrelevant precedents, and exaggerating the administrative problems entailed in applying the Commissioner's position, the *Crown* court never examined the economic substance of the transactions involved and thus avoided consideration of the rationale underlying the Commissioner's claim. The insufficiency of the Tax Court's reasons for refusing to consider what the Code required in the *Crown* case leads to the conclusion that the only proper role for the court would have been to evaluate the merits of the Commissioner's position. Since none of the Tax Court's grounds withstands close scrutiny, it is submitted that the following analysis should be adopted on appeal.

II. SUGGESTED ANALYSIS OF THE *CROWN* TRANSACTIONS

A proper analysis of the Commissioner's position and the situation in *Crown* would begin with an investigation of the intended scope of the gift tax. After the limits to the applicability of the statute are ascertained, the court should analyze the specific transactions involved in the case to determine whether Congress intended to reach such transactions. This section will first discuss the intended scope of the gift tax and then will consider, in turn, the actual transactions involved in *Crown* and whether these transactions fall within the intended scope of the gift tax.

A. *Intended Scope of the Gift Tax*

An analysis of the general provisions of the gift tax reveals a broadly phrased statute which is to be applied liberally so as to include a wide range of transactions. The statute defines in expansive terms the taxable event which triggers the tax.

Specifically, section 2511(a), which defines the concept of transfer, applies section 2501 "[w]hether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible . . . ."[68] Section 2512(a) in turn provides that "[w]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift . . . ."[69] This expansive statutory language, without expressed limits, clearly suggests that Congress intended the tax to be broadly applied.

Furthermore, the conclusion that Congress intended the gift tax to be broadly applied is buttressed by the legislative history of its provisions. The committee reports relating to these provisions declared:

> The terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense; the term "property" reaching *every species of right or interest protected by law* and having an exchangable value.

[68] I.R.C. § 2511 (a).
[69] I.R.C. § 2512(a).

> The words "transfer ... by gift" and "whether ... direct or indirect" are designed to cover and comprehend all transactions (subject to certain express conditions and limitations) whereby, and to the extent ... that property or a property right is donatively passed or conferred upon another, *regardless of the means or the device employed in its accomplishment.*[70]

Thus, the legislative history supports the conclusion that Congress intended an extremely broad application of the statute.

The clear mandate of the legislative history and the broad statutory language was recognized by the Supreme Court in *Commissioner v. Wemyss.*[71] There, the Court considered the intended scope of the tax, and, in adopting a broad construction and application of its provisions said:

> [T]o reinforce the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions .... [O]n finding that a transfer in the circumstance of a particular case is not made in the ordinary course of business, the transfer becomes subject to the gift tax to the extent that it is not made for an adequate and full consideration in money or money's worth.[72]

Thus, the language of the statute, the legislative history and the unequivocal recognition by the Supreme Court of Congress' intent lead inescapably to the conclusion that the gift tax was intended to attach to the transfer of any benefit derived from property that is made without adequate consideration. The unanimity of authority supporting an extremely broad application of the gift tax is complete.[73] Therefore, it is clear that the form of the transaction or the type of property transferred should not preclude application of the tax.

B. *The Transactions in* Crown

In order to determine whether the transactions in *Crown* conform to the broadly stated requirements of the gift tax, it is necessary to determine

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[70] H.R. REP. No. 708, 72d Cong., 1st Sess. 27, 28 (1932), 1939-1 (part 2) C.B. 457, 476; S. REP. No. 665, 72d Cong., 1st Sess. 39 (1932), 1939-1 (part 2) C.B. 496, 524 (emphasis added).

[71] 324 U.S. 303 (1945).

[72] *Id.* at 306-07. In *Wemyss,* the Court held that the gift tax was applicable to a transfer of property made pursuant to an antenuptial agreement, irrespective of the donee's promise to marry since such promise did not have a monetary value. Therefore, the Court reasoned, the exchange was not for a full and adequate consideration.

[73] In addition to the statutory language, the legislative history and the case law, the treasury regulations also provide for broad application of the tax. Treas. Reg. § 25.2511-1(c) (1978) expansively provides that "all transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax ...." Further, Treas. Reg. § 25.2512-8 (1978) provides:

> [T]ransfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceed the value in money's worth of consideration given therefor ....

first whether the transactions involve property which falls within the ambit of the gift tax provisions, and second whether such property has been transferred without full and adequate consideration. The first issue, then, is whether the permissive use of money is a sufficient property right to be itself classified as property for gift tax purposes.[74]

Courts have recognized, in a variety of circumstances, that the use of property has a value which the Code can reach. First, courts often have found that donating the use of property can qualify for the income tax deduction allowed for charitable gifts under section 170.[75] Of special interest in regard to the concept of use of property as a charitable gift is the Seventh Circuit's decision of *Mason v. United States*,[76] since, in that case, the property being used by the charity was money, and since the appeal from *Crown* will be decided by the same court that decided *Mason*. In *Mason*, a taxpayer sold an asset to a charity for a total price equal to its fair market value.[77] The taxpayer, however, received in payment only a small amount in cash and a long-term note for the balance of the purchase price.[78] The note called for interest substantially below the "going" rate.[79] As a result, the sum of the cash received and the present value of the note was less than the fair market value of the asset transferred. The *Mason* court held that the taxpayer had made a deductible charitable contribution equal to the difference between the prevailing conventional cost of financing the purchase and the interest actually charged.[80] Accordingly, the court allowed the taxpayer a deduction based upon his giving the charity the use of his money for less than the going rate.[81] Essentially then, the court recognized that donating the use of money was sufficient to support a charitable gift deduction.

In addition to recognizing the value of the use of property in the charitable gift context, it is well established that receiving the use of property can result in income tax liability to the recipient based upon the value of the use received. For example, in *Chandler v. Commissioner*,[82] the United States Court of Appeals for the Third Circuit upheld the imposition of the income tax on the value of the use of a home used by the taxpayer, where

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[74] The Commissioner in *Crown* conceded that the loans were bona fide loans with a reasonable expectation of repayment. No issue, therefore, was raised as to the application of the gift tax to the loan principal. Brief for Petitioner at 4.

[75] This result was changed by the Tax Reform Act of 1969. The new law requires a donor to relinquish all his rights in a property to qualify for the charitable gift deduction. However, this denial of a deduction is not based upon the premise that the use value is not property, but rather upon the policy decision that the gift of the use of property should not result in a deduction so long as the donor retains a beneficial interest in the property. *See* I.R.C. § 170(f)(3).

[76] 513 F.2d 25 (7th Cir. 1975).

[77] *Id.* at 26.

[78] *Id.* The taxpayer sold an asset worth $117,000. He received $4,507.50 in cash and a note for $112,689.42 payable over 20 years.

[79] *Id.* The note called for four percent interest per annum while the prime rate was approximately six percent.

[80] *Id.* The present value of the note was $81,000. The sum of the cash received and the present value of the note was $85,507.50. The difference between this and the value of the asset was $31,492.50.

[81] *Id.* at 29.

[82] 119 F.2d 623 (3d Cir. 1941).

the home was owned by a corporation for whom the taxpayer had performed valuable services.[83] The *Chandler* court thus recognized that the use of property, when it is received in exchange for services, may result in income and income tax liability to the recipient.

Since the use of property has been treated as itself a form of property right for purposes of charitable deductions and for calculation of income, it follows that the use of property could constitute "property" within the meaning of the gift tax. Given the broad scope of the gift tax statute and the judicial readiness to treat the value of the use of property as property itself, it seems that applying the gift tax to the use value of property is indeed correct.[84] Thus, the use of money in *Crown* should be held to constitute property.

Since the value of the use of the money involved in *Crown* should constitute property within the meaning of the gift tax, the next step in the analysis is to determine whether there has been such a "transfer" of the property as will trigger imposition of the tax. It is settled that the form of a transfer does not affect the applicability of the gift tax. The statute itself declares that the tax applies "whether the transfer is in trust or otherwise, whether the gift is direct or indirect . . . ."[85] The legislative history,[86] treasury regulations,[87] and case law[88] all support the conclusion that the form of the transfer is not relevant. Indeed, even a taxpayer's forbearance has been held to be sufficient to constitute a "transfer" within the meaning of the statute. In *Estate of Grace Lang*,[89] the taxpayer had allowed the statute of limitations to run on loans she had made to her son.[90] The Commissioner contended that her inaction, which had allowed the statute to run, constituted a "transfer" of the principal of the loans, thus triggering the imposition of the gift tax.[91] In upholding the Commissioner's imposition of the tax, the Tax Court held that even though the transfer of property was accomplished without positive action on the part of the taxpayer, such transfer was still subject to the tax. Accordingly, the fact that inaction accomplishes the transfer was irrelevant.[92]

The same reasoning should be applied to *Crown*, because in *Crown*, the transfer likewise was accomplished through inaction. Specifically, the use of money was passed to the debtor trusts through the use of either demand or open account loans. There was no irrevocable transfer of the use of the money, but rather it was through Areljay's forbearance in not

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[83] *Id.* at 626-27.

[84] The allowance of a deduction for the donation of property is not limited to cases where the use is granted for a fixed period of time. In Thriftimart, Inc., 59 T.C. 598 (1972), for example, the Tax Court upheld a charitable gift deduction for the gift of the use of office space, even though the use was revocable at will on sixty days notice. Therefore, the fact that in *Crown* the loans were repayable on demand should not preclude application of the tax.

[85] I.R.C. § 2511(a).

[86] H.R. REP. No. 708, 72d Cong., 1st Sess. 27, 28 (1932), 1939-1 (part 2) C.B. 457, 476; S. REP. No. 665, 72d Cong., 1st Sess. 40 (1932), 1939-1 (part 2) C.B. 496, 524.

[87] Treas. Reg. § 25-2511-1(c) (1978).

[88] *See, e.g.*, Commissioner v. Wemyss, 324 U.S. 303 (1945).

[89] 64 T.C. 404 (1975).

[90] *Id.* at 411.

[91] *Id.* at 411-12.

[92] *Id.* at 413.

demanding repayment that the use of the money was transferred to the debtor trusts. Each day that repayment was not demanded resulted in the transfer to the trusts of the value of the use of the money for that day. Since, under the statute, any "transfer" is enough to trigger imposition of the tax, the forbearance in *Crown* should constitute a sufficient "transfer" to uphold the imposition of the gift tax.

It is thus clear that, for gift tax purposes, "property" was "transferred" in the *Crown* transactions. The only remaining issue, therefore, is whether, under section 2512(b), the transferor received "an adequate and full consideration in money or money's worth . . ." for making the transfers.[93] If not, under the terms of the statute, the gift tax applies to "the amount by which the value of the property [transferred] exceeded the value of the consideration."[94]

In *Crown*, the property transferred was the unrestricted use of the loan funds. In return, Areljay received a legally enforceable promise to have the principal of the loans repaid on demand. The promise to repay the loans on demand constituted sufficient consideration to preclude the application of the tax to the principal of the loans.[95] The promise to repay, however, does not constitute sufficient consideration to preclude completely application of the gift tax to the loans. The promise to repay on demand does not provide any consideration for the transfer of the use value of the loans. Normally, interest charged provides the consideration for receiving the use value of the loaned funds. However, Areljay received no consideration for allowing the loans to remain outstanding, since there was no provision in the loans for the payment of any interest on the loans. Hence, property was transferred without consideration. Since the transaction involved was a transfer by forbearance, with no provision for interest, it seems clear that no consideration passed in the transfer which the Commissioner sought to tax. Therefore, the gift tax should apply to the use value of the loan principal for the length of time the loans were allowed to remain open.

CONCLUSION

The Tax Court in *Crown* incorrectly determined that future congressional action was required to establish that the making of non-interest-bearing loans between family members is subject to the gift tax. The court's reliance on the Commissioner's past practice, on erroneous and irrelevant case law, and on the supposed administrative difficulties in applying the Commissioner's new position was clearly misplaced. Rather, the court should have examined the legal sufficiency of the Commissioner's position. An examination of the intended scope of the gift tax and of the actual transactions in *Crown* leads to the conclusion that the gift tax provisions require that the loans be taxable. The *Crown* opinion, then, should be over-

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[93] I.R.C. § 2512(b).

[94] *Id.*

[95] The Commissioner conceded the bona fide nature of the loans, thereby removing from potential tax liability the principal of the loans. Brief for Petitioner at 4.

ruled. Failure to do so would result in a serious diminution in the efficacy of the gift tax, allowing taxpayers the possibility both to transfer large sums without payment of tax and to avoid the effect of the progressive income tax rates through income splitting schemes.

THOMAS F. DAILEY

Definition of a Branch Under the McFadden Act: *St. Louis County National Bank v. Mercantile Trust Company*[1]—Mercantile Trust Company (Mercantile) is a national banking association with its principal office located in St. Louis, Missouri.[2] In February of 1970, Mercantile, which is engaged in the banking business and operates a trust department, opened a trust office in Clayton, Missouri, a suburb of St. Louis.[3] Prior to opening the Clayton office, Mercantile received notice from the Comptroller of the Currency of the United States (the Comptroller) approving the establishment of the trust office so long as Mercantile did not accept deposits, make loans or pay checks at the location. Performing such activities would bring the office within the definition of a branch set forth in 12 U.S.C. § 36(f).[4] Moreoever, the establishment of such a branch office is subject to the limitations of 12 U.S.C. § 36(c)[5] which permits national banks to establish branches only if they are authorized for state banks by the law of the state in which the national bank intends to open a branch.[6] Since Mercantile intended to open an office in Missouri and since Missouri law prohibits branching,[7] if the Comptroller considered Mercantile's office a branch, its

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[1] 548 F.2d 716 (8th Cir. 1976), *cert. denied*, 433 U.S. 909 (1977).

[2] *Id.* at 717.

[3] *Id.*

[4] *Id.* Section 36(f) provides:

The term "branch" as used in this section shall be held to include any branch bank, branch office, branch agency, additional office, or any branch place of business located in any State or Territory of the United States or in the District of Columbia at which deposits are received, or checks paid, or money lent.

12 U.S.C. § 36(f) (1970).

[5] 548 F.2d at 717. See note 6 *infra.*

[6] Section 36(c) provides in pertinent part:

A national banking association may, with the approval of the Comptroller of the Currency, establish and operate new branches: (1) Within the limits of the city, town or village in which said association is situated, if such establishment and operation are at the time expressly authorized to State banks by the law of the State in question; and (2) at any point within the State in which said association is situated, if such establishment and operation are at the time authorized to State banks by the statute law of the State in question by language specifically granting such authority affirmatively and not merely by implication or recognition, and subject to the restrictions as to location imposed by the law of the State on State banks.

12 U.S.C. § 36(c) (1970).

[7] The relevant Missouri statute, MO. REV. STAT. §362.105.1 (1) (1969) provides that ". . . no bank or trust company shall maintain in this state a branch or trust company, or receive deposits or pay checks except in its own banking house . . . ." In St. Louis Union Trust Co. v. Pemberton, 494 S.W.2d 408 (Mo. App. 1973) a trust company sought, via a declaratory judgment in state court, the authority to establish an office in Clayton to be used in connection with its exclusive trust business in downtown St. Louis. The company argued that the ref-