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BELOW MARKET LOANS: FROM ABUSE TO MISUSE—A SPORTS ILLUSTRATION

*Phillip J. Closius**

*Douglas K. Chapman***

Below market loans have been traditionally used as substitutes for gifts, salaries, and dividends for the primary purpose of tax avoidance in the transfer of wealth. The Supreme Court's opinion in Dickman v. Commissioner *subjected both demand and term loans in an intrafamilial setting to the federal gift tax. Congress, while subjecting all below market loans to either income or gift tax, applied different valuation formulas to term and demand loans and, in so doing, favored the use of demand loans as a salary substitute. This Article analyzes the current status of below market loans by examining their use in a typical business setting—the professional sports industry. Dean Closius and Professor Chapman argue that Congress should establish tax neutrality as between term and demand loans. This result can be achieved by providing an income tax for demand loans, by ascribing the borrower's below market benefit to the lender, or by statutorily imputing a term of years to all demand loans.*

INTRODUCTION

BELOW MARKET LOANS[1] were first utilized primarily as tax-avoidance substitutes for dividends and gifts. Directors of close corporations perceived such loans as a "tax-free" method of distributing money to shareholders, frequently themselves. Family mem-

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1. A loan is a transaction in which a lender transfers money to a borrower based upon the borrower's promise to repay the principal amount. The repayment may be subject to a variety of terms and conditions, but the two common forms of repayment are a term of years (repayment of the principal amount at a time specified at the initial transfer) or a demand (repayment when the lender mandates a return of the principal amount).

Traditional loans require the borrower to pay interest to the lender at some specified interval of time at a percentage rate agreed upon at the time of contract or at a percentage rate adjusted at certain periods of time according to a formula agreed upon at the time of contract. Loans which do not provide for the borrower to pay interest to the lender ("interest-free" loans) or which provide for the borrower to pay a percentage of interest below the fair market rate of interest charged on similar types of loans are collectively referred to in this Article as "below market" loans. *See infra* notes 80-87 and accompanying text.

bers also realized that the federal gift tax filing and reporting requirements could arguably be ignored if the money furnished to the recipient were characterized as a loan rather than as a gift. The Internal Revenue Service (Service) attacked the tax-free treatment of below market loans in these contexts for over two decades.[2] Until quite recently, these challenges were unsuccessful.[3] Because the Service's attempts to tax these loans had failed, employers began to utilize below market loans as compensation for employee services. As interest rates rose and as the economy became more diverse and inflationary, employee compensation schemes at all levels became more complex than the simple salary. In this economic climate, the below market loan gained considerable popularity as a component of a negotiated compensation package.[4] Under widely accepted case law interpretation, loans in the dividend, gift, or compensation contexts provided significant economic benefits to borrowers without generating reporting or tax liability.

From the taxpayer's standpoint, the use of below market loans made sound economic sense. Through such loans, the taxpayer could successfully shift income and the income tax liability to the borrower and easily circumvent an intricate anti-avoidance system in the Internal Revenue Code (Code) and case law.[5] In 1984, however, the Supreme Court in *Dickman v. Commissioner*[6] altered the tax treatment of below market loans in the intrafamilial setting by effectively subjecting both demand and term loans to the federal gift tax. While the tax "exemption" for below market loans employed as a dividend or compensation substitute was literally unaffected by

2. *See infra* notes 17-67 and accompanying text.

3. *See infra* notes 39-41, 63-72, and accompanying text.

4. *See, e.g.*, Keller, *The Tax Treatment of Interest-Free Loans: A Two-Transaction Approach*, 1 VA. TAX REV. 241, 241 n.2 (1981).

5. I.R.C. §§ 671-678 (1982). Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940); Susie Salvatore v. Commissioner, 29 T.C.M. (CCH) 89 (1970). The below market loan, particularly the demand loan, provided a device that avoided all the drawbacks of short-term trusts yet still allowed the taxpayer to "give away" the income-producing property without having to relinquish "control" over the property. The taxpayer could call the loan at any time and immediately retake possession of the principal. The essence of such a transaction was not in substance different from a short-term revocable trust, but judicial treatment allowed substantially different, favorable tax treatment to both parties. For a thorough analysis of the distinctions among these transactions, see Joyce & DelCotto, *Interest-Free Loans: The Odyssey of a Misnomer*, 35 TAX L. REV. 459, 459-60 (1979-80). Perhaps an original attack on these transactions as substantively no different than a revocable trust would have avoided years of struggle. *See also* Comment, *An Interest-Free Borrower or Lender Be: Gift Tax Implications of Interest-Free Loans*, 53 N.Y.U. L. REV. 941, 952-54 (1978).

6. 465 U.S. 330 (1984).

Dickman, the "exemption" was at least questionable after that decision. These legal uncertainties were soon clarified by Congressional passage of section 7872 of the Tax Reform Act of 1984.[7] The statute substantially altered the tax status of below market loans in all three contexts—dividend, compensation, and gift substitute—by including them within the scope of either the gift or the income tax. This reform filled a substantial gap in taxation enforcement by limiting the utility of a simple device that had allowed significant wealth transfers without corresponding tax consequences. Nonetheless, Congress diminished the economic efficiency of the statutory income tax effect by adopting a valuation procedure favoring demand over term loans.[8] Congress should adopt additional reform legislation to subject demand loans to a meaningful income tax. This final step would achieve true neutrality by imposing a tax on both demand and term loans in the gift and income contexts.

"Salary-substitute" below market loans rarely possess independent economic value as loans but rather utilize the loan format to provide compensation which avoids tax liability. Employees obsessed with obtaining immediate tax benefits frequently negotiate below market loans. These loans may, in reality, economically disadvantage their long-term financial interests, especially if the loan repayment will be forgiven or accomplished by an accounting transfer. Continued use of below market term loans as a salary substitute reflects either taxpayers' ignorance of the impact of section 7872 or their willingness to gamble on a lack of enforcement. The professional sports industry mirrors the national trend in the increased use of such loans as part of an employee's financial package. Sports contracts are an excellent vehicle for examining both the economic realities of these loan transactions and the true impact of reform legislation.

This Article examines current tax treatment of below market loans by analyzing the case law which culminated in the *Dickman* opinion and the post-decision reform legislation.[9] The Article then analyzes the practical application of these new rules by explaining the new income tax treatment of "salary substitute" below market loans.[10] This Article investigates the below market loan in a particularized context—the professional sports industry. The Article concludes that, by favoring demand loans over term loans, section

7. I.R.C. § 7872 (1984).
8. *See infra* notes 91-107 and accompanying text.
9. *See infra* notes 12-89 and accompanying text.
10. *See infra* notes 90-136 and accompanying text.

7872 fails to provide the full uniform system of taxation needed to eliminate tax avoidance and to confine the use of the below market loan to situations where true economic considerations warrant its employment.[11]

I. Tax Treatment of Below Market Loans

Taxpayers use below market loans in compensation, dividend, and gift contexts. These contexts provide significant wealth transfer between taxpayers. In addition, these loans frequently have limited economic utility to the parties aside from the tax avoidance benefits potentially available by the loan format. Most lower courts, however, failed to perceive the absence of substance in this loan format and allowed large wealth exchanges to escape gift or income tax liability. These interpretations of the Code frustrated the enforcement efforts of the Service and produced a significant loophole in the tax system. Increased use of the below market loan culminated in Supreme Court and congressional activity which reversed the existing case law and included below market loans within the scope of the gift or income tax.

A. *Case Law Development Under the Income Tax*

Code section 61 defines gross income as "all income from whatever source derived."[12] The Treasury Regulations similarly define gross income as "all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services."[13] The Tax Court has stated that "[t]he income taxed is in sweeping terms and should be broadly construed."[14] However, borrowed money is not considered income.[15] Consequently, the incurring of indebtedness is not considered a taxable event. At its inception, the below market loan was conceived as a method of distorting this legitimate exemption from tax liability in order to provide tax-free income to an

11. *See infra* notes 105-08 and accompanying text.

12. I.R.C. § 61(a) (1982).

13. Treas. Reg. § 1.61-1(a) (as amended 1979).

14. Greenspun v. Commissioner, 72 T.C. 931, 946 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982). The *Greenspun* court established this principle by noting that § 22 of the 1969 Code, the predecessor of the current § 61, "is broad enough to include in taxable income any economic or financial benefit conferred on an employee as compensation, whatever the form or model by which it is effected." *Id.*

15. J. Freeland, S. Lind & R. Stephens, Cases and Materials on Fundamentals of Federal Income Taxation 56 n.2 (4th ed. 1981) (citing Dilks v. Commissioner, 15 B.T.A. 1294 (1929); Stayton v. Commissioner, 32 B.T.A. 940 (1935)).

employee or shareholder. In a typical transaction the principal amount, characterized as a loan, was not reported as income by the borrower. The note frequently provided that no interest was due on the loan. The borrower therefore had full use of the principal amount for the loan period at no cost. The employer or corporation claimed no deduction for the loan. Neither the borrower nor the lender reported the transaction to the Service.[16]

The Service challenged this tax treatment of below market loans because of the economic benefit the loans conferred on the borrower. The Service argued that since the borrower was relieved from paying market rate interest, he or she received transferred value. Income, therefore, should be imputed to the borrower in the amount of the unpaid interest. The landmark case in which the Service first asserted this position was *J. Simpson Dean*.[17] In *Dean*, the petitioner husband and wife were controlling shareholders of a closely held corporation. During 1955 and 1956, the petitioners had outstanding interest-free loans from their corporation in excess of four million dollars.[18] The Service charged them with income on the loans equal to interest at the then-prevailing prime rate. Several prior cases had held that rent-free use of corporate property constituted gross income.[19] The Service argued that use of corporate property is indistinguishable from use of corporate money for less-than-adequate consideration.[20]

The Tax Court firmly rejected the Service's attempt to tax the imputed interest by holding that the petitioners were not required to recognize income from the interest-free loans.[21] The majority distinguished the cases on which the Service relied from the facts in *Dean* on the ground that an actual taxpayer expense in the earlier cases to procure the benefit derived would not have been deductible.[22] If the petitioners in *Dean* actually paid interest on the loans, they could have fully deducted that amount under section 163 of the Code.[23] The Tax Court held that any "income" derived by the borrower from this free use of the loan proceeds would be offset by the

16. Since the borrower had no income from such a loan, he had nothing to report. The lender was not entitled to a deduction, so nothing would appear on her return.

17. 35 T.C. 1083, 1087 (1961).

18. *Id.*

19. *Id.* at 1088.

20. *Id.* at 1089.

21. *Id.*

22. *Id.* at 1090.

23. *Id.*

"interest" deduction that they would have received.[24] Therefore, no income resulted from the loan. The *Dean* decision solidified the favorable tax treatment which such loan borrowers received. Surprisingly, the Service did not publish its nonacquiescence to *Dean* until 1973, twelve years after the opinion was announced.[25] *Dean* increased the popularity of below market loans and effectively initiated their modern use as tax-free compensation and dividend substitutes.[26]

The Tax Court more fully analyzed *Dean* in *Greenspun v. Commissioner*.[27] In *Greenspun*, the taxpayer received a loan at a three percent interest rate when the prevailing market rate was six percent.[28] The Service determined a deficiency in Greenspun's federal income tax on the theory that he had realized gross income in an amount equal to the economic benefit between the market rate of interest and the actual rate of interest on his loan.[29] The Tax Court again rejected the Service's argument but altered its position slightly by holding that the *Dean* result was actually based on the conclusion that "an interest free loan results in no taxable gain to the borrower" rather than on an imputed interest deduction theory.[30] The court reasoned that an interest-free loan from a corporation to an employee is substantively no different than a loan in which interest is charged and which is accompanied by an increase in compensation to pay the interest. To illustrate the point, the court formulated the following hypothetical loan example:

> Assume that A, an employee of X Co., received as his only form of compensation an interest-free loan from X Co. in the amount of $20,000 for a period of 1 year. Further assume the prevailing interest rate at the time was 5 percent or $1,000 a year. The economic effect of this transaction is the same as if X Co. had

24. *Id.* Judge Opper, in a concurring opinion joined by three other judges, stated that the majority's "no taxable gain" conclusion was an overbroad generalization. *Id.* at 1091. He would have decided the case for the petitioners because the Service failed to prove that an offsetting interest deduction would not have been available to them. *Id.* at 1090-91. Judge Bruce's dissent disagreed with Judge Opper's evidentiary presumption. Judge Bruce believed that the petitioners had the burden of proving that, if they had been required to pay interest on the loan, they would have been entitled to an interest deduction. *Id.* at 1092.

25. 1973-2 C.B. 4.

26. There are no records to indicate how widespread was the use of interest free loans prior to *Dean*. With *Dean*, the Service began to seek out and to challenge such cases. The *Dean* decision probably so strengthened the taxpayers' position that the use of interest-free loans increased.

27. 72 T.C. 931 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982).

28. *Greenspun*, 72 T.C. at 940.

29. *Id.* at 941.

30. *Id.* at 946 (quoting *Dean*, 35 T.C. at 1090).

> charged A interest at 5 percent on the $20,000 loan, and at the same time, paid him a salary of $1,000 which A in turn used to pay the interest. Assuming no other facts, A would have gross income from his salary of $1,000 and an interest deduction of $1,000 or taxable income of $0.[31]

The Service challenged this analysis by contending that the taxpayer was not entitled to an offsetting interest deduction because the imputed interest was neither actually paid nor incurred.[32] The court, however, justified its result by pointing to the economic reality of the transaction.[33] It nonetheless agreed with the concurring and dissenting opinions in *Dean* that not every interest-free loan would lead to the same result. For example, the result would have differed had the taxpayer used the proceeds of the interest-free loan to invest in municipal bonds. In that event, section 265(2) prohibits a deduction for interest paid on indebtedness incurred to purchase tax-exempt securities. The borrower's taxable income would equal the interest differential.[34] Aside from that type of statutory limitation, the *Greenspun* court effectively affirmed the *Dean* tax-free characterization of below market loans. The Tax Court and appellate circuit courts utilized the *Dean* and *Greenspun* holdings to reject later attempts by the Service to tax the economic benefit of below market loan transactions.[35] These opinions failed to provide a consistent rationale for exempting the loans from the income tax, relying instead on some variant of the *Dean-Greenspun* "no-gain" or imputed interest deduction theories. The courts' failure to enunciate a clear supporting analysis reflected their misunderstanding of the loan structure. These below market loans frequently had little economic utility as borrowings to the parties but instead were employed solely as tax avoidance devices. As inflation increased com-

31. *Id.* at 948. *See* Keller, *supra* note 4, at 242.

32. *Greenspun*, 72 T.C. at 950.

33. *Id.* at 951. The Tax Court cited Revenue Ruling 73-13, in which a corporate officer received personal financial advice from professional financial advisors. Although deemed taxable as an economic benefit, the officer was entitled to a corresponding deduction under § 212 even though he did not actually pay or incur the advising expenses. The result was justified because the transaction was substantially analogous to the corporation's increasing the officer's salary and the officer's purchasing the deductible advice. Rev. Rul. 73-13, 1973-1 C.B. 43.

34. *Greenspun*, 72 T.C. at 948.

35. Baker v. Commissioner, 677 F.2d 11 (2d Cir. 1982); Beaton v. Commissioner, 644 F.2d 315 (1st Cir. 1981); Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981); Estate of Liechtung v. Commissioner, 40 T.C.M. (CCH) 1118 (1980); Hardee v. United States, 708 F.2d 661 (Fed. Cir. 1983). In *Hardee*, the Court of Claims held that an interest-free loan from a corporation to its employee/major shareholder resulted in taxable income to the borrower. The U.S. Court of Appeals for the Federal Circuit reversed that decision and applied the reasoning of *Dean* and *Greenspun*. *Hardee*, 708 F.2d at 662.

pensation levels, a salary substitute transferring funds to the recipient with no corresponding income tax liability grew in popularity. Judicial support for this result created an expanding loophole in the elaborate enforcement of tax liability and compromised the integrity of the tax system. Larger amounts of money were committed to below market loans.[36] The enforcement difficulties created by the judiciary were particularly exacerbated in those transactions where the intent to repay the loan was either unclear or illusory.[37]

B. *Case Law Development Under the Gift Tax*

The courts refused to impose income tax liability on below market loans; however, they included these transactions within the ambit of gift tax liability. In *Blackburn v. Commissioner*,[38] the taxpayer transferred property valued at $245,000 to her children in exchange for a 414-month note with a face value of $172,517.65 and a below market interest rate. The taxpayer acknowledged that the excess of the actual property value over the note value was a gift, but she challenged the Service's assertion that the note's below market interest rate generated an additional gift.[39] The Tax Court ruled in favor of the Service that the transaction generated an additional gift of $37,979.35. That gift amount was computed by calculating the difference between the face value of the note ($172,517.65) and the fair market value of the note discounted to reflect the below market interest rate ($134,538.30).[40] This result was consistently applied to term loan transactions by later courts.[41]

The gift tax treatment of below market loans was nevertheless confused by the courts' refusal to find a gift in the demand loan context. In *Johnson v. United States*,[42] the taxpayer lent money which was repayable on demand without interest to her children. The Service argued that the taxpayer had made a gift on the "use of the money" at the then-prevailing interest rate as applied to the av-

36. *See, e.g.*, Bond, *The Use of Interest-Free or Low Interest Loans by Publicly Held Corporations to Reward Executives*, 58 TAXES 542 (1980).

37. *See infra* notes 123-36 and accompanying text.

38. 20 T.C. 204 (1953).

39. *Id.* at 206-07.

40. *Id.* at 207. The formula used to determine the present value of the note was not provided in the case.

41. Berkman v. Commissioner, 38 T.C.M. (CCH) 183 (1979); La Fargue v. Commissioner, 73 T.C. 40 (1973).

42. 254 F. Supp. 73 (N.D. Tex. 1966).

erage unpaid balance for each year.[43] The District Court held, however, that the taxpayer had not made gifts within the meaning of section 2501.[44] The court reasoned that these loans did not defeat the purpose of the gift tax in allowing the taxpayer to avoid estate tax by reducing her estate through inter vivos gifts.[45] The court also ruled that the taxpayer had no right to interest and implied that there was "no property right" that would bring the transaction within the statute.[46] Additionally, the court emphasized that Congress, not the courts, should decide this issue.[47] When the Service announced its nonacquiescence seven years later, the revenue ruling correctly perceived no economically justified reason for distinguishing demand loans from term loans.[48]

The first opportunity to determine whether the decision in *Johnson* or the position in the revenue ruling would be followed by other courts came in *Crown v. Commissioner*.[49] This case involved an interest-free demand loan made to the lender's relatives.[50] The Tax Court followed the *Johnson* reasoning to find no taxable gift.[51] The

43. *Id.* at 76. *See also* Note, *Gift Taxes— Interest-Free Demand Loans Are Not Taxable Gifts*—Johnson v. United States, 65 MICH. L. REV. 1014, 1014 n.2 (1967) ("The government selected the factor of 3-½% from the regulations providing for the valuation of annuities, life estates, terms for years, remainders and reversions . . . .") (citing brief for defendant).

44. *Johnson*, 254 F. Supp. at 77.

45. *Id.* The court reasoned that the taxpayer had no duty to lend or invest her money to provide additional income. Thus, where the principal of such loans would remain in the lender's estate at death, the making of this loan would have no effect on decreasing the taxable estate. *Id. See also* Note, Dickman v. Commissioner: *Gift Tax Consequences of Interest Free Loans*, 402 ARK. L. REV. 400, 403 (1982).

46. *Johnson*, 254 F. Supp. at 77. There is some dispute regarding what the court meant by this statement. Some interpret the sentence to mean that because there was no right to interest, there was no property right to transfer. *See* Comment, *Gift Taxation of Interest Free Loans*, 19 STAN. L. REV. 870, 871 (1967). Others interpret the court as implying that, because there was no right to interest, the transfer was for full and adequate consideration. *See* Dickman v. Commissioner, 690 F.2d 812, 813 (11th Cir. 1982); *see infra* note 66 and accompanying text.

47. *Johnson*, 254 F. Supp. at 73. The court reasoned that a legislative decision would allow the people to voice their opinions and would involve a prospective rather than an ex post facto application. *See infra* note 77 and accompanying text.

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

49. 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978) [the Seventh Circuit decision hereinafter *Crown II*].

50. *Crown II*, 585 F.2d at 234-35. The taxpayer and his brother were equal partners in an incorporated company. Prior to and during 1967, the taxpayer made loans of approximately $18 million to a series of 24 trusts established for the benefit of the children and other close relatives of the three brothers. *Id.*

51. *Crown*, 67 T.C. at 1062. In a forceful dissent, Judge Simpson stated that the majority's holding would result in ignoring a gift in excess of one million dollars. Furthermore, he stated that the transaction was within the "broad" reach of the statute and that, in fact, nearly identical transactions had in earlier cases resulted in gift taxes. He also argued that

Service appealed to the Seventh Circuit Court of Appeals (*Crown II*).[52] That court agreed with the Service's position that the failure to tax this loan was inconsistent with the treatment of other practical alternatives.[53] Additionally, it found the loan inimical to the purpose of the gift tax provisions preventing income tax avoidance.[54] Despite these "good policy reasons," the circuit court refused to impose a gift tax, noting that "[n]o statutory language or statements in the legislative history [had] been cited dealing specifically with interest-free loans."[55] The opinion also rejected attempts by the Service to bring the transaction within the "broad reach" of the statute as an "unequal exchange" or "property right."[56] In reaching its conclusion, the court found that taxing the demand loan would create an administrative burden and would be inequitable to the taxpayer.[57] The Service chose not to appeal *Crown II*, fearing that a Supreme Court denial to review the decision would so strengthen the taxpayers' position as to make further attack futile.[58]

The lower court cases therefore inconsistently treated below market loans. In employer/employee, corporation/shareholder and intrafamilial demand loan contexts, below market loans were not considered taxable events.[59] Intrafamilial term loans were subject to a gift tax based on the difference between the face value of the loan and its discounted fair market value.[60] The cases failed to elaborate any economic or tax principles which justified taxing intrafamilial term loans while exempting all other below market loans from tax liability. These results had the economically incongruous effect of encouraging demand loans and discouraging term loans for

the purported "widespread ramifications" and administrative problems which would result from adoption of the Commissioner's interpretation did not justify the court's decision. He believed the decision was "inconsistent with the explicit terms of the statute, its intended scope as set forth in the legislative history, long-standing Treasury regulations, and the Supreme Court's expansive interpretation of such provision." *Id.* at 1065-70.

52. *Crown II*, 585 F.2d at 234.

53. *Id.* at 237. (The court specifically stated that the treatment of interest-free demand loans was inconsistent to that of term loans, irrevocable and revocable trusts.) *See supra* note 5 and accompanying text.

54. *Crown II*, 585 F.2d at 235-36; F. GERHART, THE GIFT TAX 2 (1980). *See supra* note 5 and accompanying text.

55. *Crown II*, 585 F.2d at 237.

56. *Id.* at 238-40.

57. *Id.* at 240-41. The court argued that "[s]imilar reasoning might find . . . a gift when a neighbor borrows your lawnmower and fails to return it immediately, or when out-of-town guests are provided a night's lodging by friends instead of going to a hotel." *Id.* at 241.

58. Official Transcript Proceedings Before the Supreme Court of the United States, Dickman v. United States, 465 U.S. 330 (1984) (No. 82-1041).

59. *See supra* notes 17-38, 43-58 and accompanying text.

60. *See supra* notes 39-42 and accompanying text.

intrafamilial use.[61] In addition to this theoretical inconsistency, the cases had effectively allowed large wealth transfers to escape tax liability. In this climate, the Service intensified its efforts to pressure the Supreme Court or Congress to create a consistent rule subjecting all such transactions to tax liability.

C. *The* Dickman *Decision*

After *Crown II*, the Service focused its attention on a different demand loan case, *Dickman v. United States.*[62] Esther Dickman and her late husband, Paul, made numerous large interest-free demand loans to their son, Lyle, and to Artesian Farms, Inc. (Artesian), a closely held Florida corporation owned by Esther, Paul, Lyle, and Lyle's wife and children. After Paul's death in 1976, the Commissioner audited his estate and determined that the loans made by Paul to Lyle and Artesian resulted in taxable gifts in the amount of the value of the use of the loaned funds. Following this audit, the Commissioner issued statutory notices of gift tax deficiency to both Esther Dickman and Paul Dickman's estate. The notices asserted a deficiency of $42,212.91 against Paul Dickman's estate and a deficiency of $41,107.78 against Esther Dickman.[63] Both taxpayers petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court reaffirmed its decision in *Crown* and found that because the loans were intrafamilial demand loans, they were not subject to the gift tax.[64] On appeal, the Eleventh Circuit reversed the Tax Court and found a taxable benefit for gift tax purposes where a taxpayer makes an interest-free demand loan.[65] The Commissioner determined the value of the gift by applying an interest rate to the balance of each loan outstanding during the tax year.[66]

In a seven-to-two decision, the Supreme Court affirmed the Eleventh Circuit.[67] It concluded that an accurate reading of the

61. *See infra* notes 105-07 and accompanying text.

62. 41 T.C.M. (CCH) 620 (1980), *rev'd*, 690 F.2d 812 (11th Cir. 1982), *aff'd*, 465 U.S. 330 (1984).

63. *Dickman*, 41 T.C.M. at 620-21.

64. *Id.* at 624.

65. *Dickman*, 690 F.2d 812, 819 (1982).

66. *Id.* at 814 n.4. The court expressed no view on the valuation aspects of this case. *Id.* at 820 n.11.

67. *Dickman*, 465 U.S. 330 (1984). At the time the Supreme Court heard the arguments, 31 similar cases were pending. The estimated tax liabilities in those cases were $5,500,000. Memorandum for the Respondent at 25-26, Dickman v. Commissioner, 690 F.2d 812 (1982) (No. 82-1041).

pertinent statutes and committee reports established that the gift tax should be imposed on gratuitous transfers, however effectuated. The majority stated: "The plain language of the statute reflects this legislative history; the gift tax was designed to encompass all transfers of property and property rights having significant value."[68] The Supreme Court analogized interest-free demand loans to tenancies at will, stating that "use" under a tenancy at will had long been recognized as a property right. The Court found no distinction between the right to use property under a tenancy at will and the right to use money transferred in an interest-free demand loan transaction. Both transactions represent a measurable economic value associated with the use of the transferred property.[69] Interest-free demand loans therefore result "in taxable gifts of the reasonable value of the use of the money lent."[70] The Supreme Court noted that although Congress could change the effect of the decision by amending the statute, the result in favor of finding tax liability effectuated congressional intent to protect the estate and gift tax system.[71]

The *Dickman* decision unified the gift tax treatment of below market loans by subjecting both term and demand loans to liability. The Court correctly perceived the economic reality of these wealth transfers and subjected the exchanged transfer value to gift tax liability. The case law now provided for different methods of computing the gift value depending upon whether the parties had made a demand or a term loan. Term loan gift value was determined by computing the difference between the face amount of the loan and its discounted present value.[72] The demand loan gift value was calculated annually by imputing an interest rate to the principal balance outstanding for each year of the loan.[73] In the gift tax context, however, this difference provided no significant economic incentive favoring one type of below market loan over the other, as both were effectively subject to a meaningful gift tax. Unfortunately, the decision did not address the issue of below market loans as compensation for services or as alternatives for dividends because *Dickman* dealt only with the loans' gift tax implications. In the employer/employee and corporation/shareholder contexts, the loan

68. *Dickman*, 465 U.S. at 334.
69. *Id.* at 336-37.
70. *Id.* at 344.
71. *Id.*
72. *See supra* notes 41-42 and accompanying text.
73. *See supra* note 67 and accompanying text.

could not be validly characterized as a gift. Both parties to such transactions continued to treat the loan as having no meaningful tax effect. With the case law virtually unanimous against imposing income tax liability on below market loans, taxpayers could continue to take advantage of a significant tax loophole after *Dickman.*

D. *Section 7872 of the Tax Reform Act of 1984*

After *Dickman,* Congress was pressed to enact clarifying legislation. Although happy with *Dickman,* the Service was still dissatisfied with the income tax treatment of below market loans.[74] Taxpayers were unhappy with the *Dickman* result and the confusing distinction between gift and income tax liability.[75] Almost all the relevant judicial opinions had stated that regulation of these loans was more properly a legislative function.[76] Finally, Congress felt pressed to increase tax revenues in order to assist in deficit reduction.[77] It responded by enacting section 7872 of the Tax Reform Act of 1984 to provide consistent income and gift tax treatment for below market loans.[78]

The statute operates on the finding that a loan is a below market loan. The first inquiry is whether the transaction satisfies the statutory definition of a "loan."[79] The Committee Reports accompanying section 7872 explained that:

> It is intended that the term "loan" be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans.[80]

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74. The Service never acquiesced to the *Dean* line of cases. *See supra* note 6.

75. Immediately after *Dickman,* an interest-free loan between related parties would generate a taxable gift, but such a loan in an employment setting would have no tax consequences because it had been held to generate no income to the borrower. *See supra* notes 39-42 and accompanying text.

76. Johnson v. United States, 254 F. Supp. 73, 77 (N.D. Tex. 1966) ("Passage of a law providing for tax like the one here contended for should be sought through Congress instead of the courts."); Crown v. Commissioner, 585 F.2d 234, 241 (7th Cir. 1978) ("We express no view here as to whether a prospective regulation making such loans taxable would be valid or whether, on the other hand, the problem would best be left to Congress."); Crown v. Commissioner, 67 T.C. 1060, 1065 (1960) ("Accordingly, if the scope of the gift tax is to be expanded to encompass such permissive use, we think it should come through congressional action, and not through necessarily broad judicial interpretation.").

77. H.R. REP. No. 432, 98th Cong., 2nd Sess. 2, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1017, 1018, 1021, 1025.

78. I.R.C. § 7872 (1984).

79. Treas. Reg. § 1.7872-2(a) (1984).

80. H.R. CONF. REP. No. 861, 98th Cong., 2d Sess., *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1706.

Since the Committee Reports called for a broad interpretation, all transactions providing for repayment of a principal amount of money fell within the purview of the statute. If no repayment terms were provided, the recipient realized gross income at the time of transfer.

The statute distinguishes between demand loans and term loans. A "demand loan" is any loan that "is payable in full at any time on the demand of the lender" or any non-transferable loan which conditions the benefits of the interest arrangement upon the future performance of substantial services by the individual.[81] A "demand loan" is a below market loan if the interest called for on the loan is less than the "applicable federal rate."[82] A "term loan" is defined as "any loan that is not a demand loan."[83] A term loan is a below market loan if the amount of the loan exceeds the present value of all payments due under the loan.[84] The statute uses a discount rate equal to the applicable federal rate as of the date of the loan. The applicable federal rate for a term loan depends upon the repayment period.[85] The difference in interest between the applicable statutory rate and the interest anticipated by the terms of a demand or term loan is the "foregone" interest.[86]

Section 7872 taxes below market loans by imputing transfers between lender and borrower. The loans have three basic legislative components:[87]

1. The loan, regardless of the actual contract terms, is deemed to be subject to an interest payment at a statutorily prescribed interest rate.
2. The borrower is treated as paying interest on the loan to the lender in the amount of the foregone interest.
3. The lender makes a gift (in a gratuitous transaction), dividend payment (in a corporation/shareholder situation), or com-

81. I.R.C. § 7872(f)(5) (1984).

82. *Id.* § 7872(e)(1)(A). In a demand loan situation, the applicable federal rate is the short term rate in effect, compounded semiannually for the period for which the amount of foregone interest is determined.

83. *Id.* § 7872(f)(6).

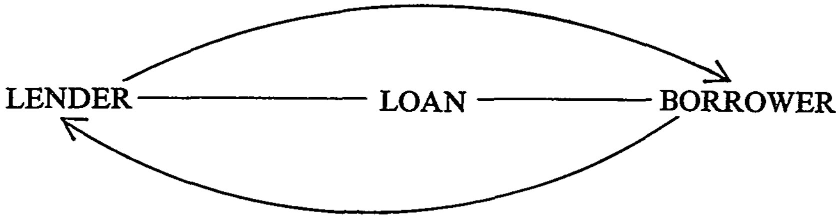
84. *Id.* § 7872(e)(1)(B).

85. *Id.* § 7872 (f)(2)(A). Under § 1274, three possible rates may apply, depending upon the length of the loan. The short-term rate applies to loans not exceeding three years, the mid-term rate applies to loans exceeding three years but not exceeding nine years, and the long-term rate applies to loans exceeding nine years.

86. *Id.* § 7872(e)(2)(A)-(B).

87. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984: EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 474, 479 (Comm. Print 1984). *See also* Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506, 512 (1986).

pensation payment (in a transaction involving services) to the borrower in an amount equal to the foregone interest plus the amount of the gift, dividend, or compensation.



Congress therefore accepted the Service's arguments by establishing a system which subjects the below market loan to taxation in all contexts. In so doing, it adopted the Supreme Court's reasoning in *Dickman* and extended its reach to include income tax liability. The statute therefore effected a significant change in the tax treatment of below market loans by reversing much of the existing case law and by at least arguably including all such loans within the scope of income or gift tax liability. By applying to the income tax the different valuation formulas for term and demand loans created by the judiciary in the gift tax context, however, section 7872 provides significant incentives for demand loans and corresponding disincentives for term loans. This result makes little economic sense and substantially undercuts the statute's remedial value.[88] The full impact of this aspect of the statute can be understood by analyzing the use of the below market loan in the employment setting.

II. TAXATION OF BELOW MARKET LOANS AS A COMPENSATION SUBSTITUTE

Although below market loans have been used in the dividend and gratuitous transaction settings, their broadest potential use is in the employer/employee context as part of a compensation package.[89] Section 7872 radically alters the tax benefits and disadvan-

88. *See supra* notes 41-42, 67, and accompanying text.

89. The emphasis of this Article is upon the employer/employee below-market loan, but gift loans and corporation/shareholder loans also have tax consequences. Gift loans generally are treated in a manner that negates any benefits that might have accrued to the parties. Regardless of whether the gift loan is a demand or term loan, the borrower is deemed to have transferred to the lender, and the lender is deemed to have transferred to the borrower, the imputed interest on the last day of the calendar year. When the loan is a demand loan, the gift is the amount of interest deemed to have been paid, calculated by using the federal short-

tages to the employer and the employee utilizing below market loans. The Tax Reform Act of 1986 further affects the tax treatment of below market loans. Analysis of the use of the below market loan in a particular industry—professional sports—provides an understanding of the impact of these changes.

A. *Section 7872*

In the case of a demand loan made by an employer to an employee, section 7872 treats the employer as receiving interest income equal to the foregone interest. However, the section treats the employer as if he or she paid the "foregone" interest back to the employee as compensation. Thus, the employer has income from the

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term interest rate under § 7872(a) and (e)(2). The effect of these transfers is to charge the lender/donor with two separate tax transactions. The first is the gift of the "imputed interest" to the borrower/donee, and the second is the receipt of income by the lender/donor of the imputed interest from the borrower/donee. The borrower/donee, subject to the normal limitations on interest deductibility, may deduct the amount of imputed interest he or she is deemed to have paid to the lender/donor. The net effect is to treat the parties as if no loan had been made: the lender/donor still has income from the principal amount and makes a gift of that amount to the borrower/donee. The borrower/donee receives an interest deduction for his or her deemed interest expense, which should offset what was actually earned from the loan proceeds. The parties would have ended up in this position had the lender/donor merely kept the loan proceeds, included any earnings in yearly income, and then transferred the earnings to the borrower/donee.

When the gift is a term loan, the gift is deemed to have been made on the day the loan is made. The amount of the gift is the excess of the loan principal over the present value of the projected payments under the loan. The lender/donor is treated as having issued a debt instrument with an original issue discount in the excess amount. Thus, the lender/donor is charged with a gift in the amount of the original issue discount at the time of the loan. Additionally, at the end of each calendar year that the loan is outstanding, the lender/donor is charged with income in the amount of any foregone interest calculated under the applicable federal rate for term loans. Subject to the normal limitations, the borrower/donee is entitled to an interest deduction for the foregone interest he or she is deemed to have paid to the lender on the last day of the year.

Section 7872(c)(2)(A) and (b) contains a de minimus exemption for gift loans if the proceeds are not used directly for the purchase of income-producing property. The exemption provides that on any day the aggregate outstanding loan balance between individuals does not exceed $10,000, § 7872 does not apply.

The corporation/stockholder loan treatment follows the same statutory pattern as in the employer/employee loan. The only substantive difference is that the deemed payment from the corporation/lender to the shareholder/borrower is treated as a dividend rather than as compensation. Thus, the borrower has the same tax consequences as under an employer/employee loan—income in the amount of the "deemed" dividend and a deduction for the "deemed" interest payment, subject to interest-deductibility limitations. The corporation, however, is making a dividend payment rather than paying compensation to an employee and is not entitled to any deduction for the deemed payment. Thus the corporation has income each year in the amount of the foregone interest but has no deduction to offset the receipt. For a detailed analysis of the tax treatment of below market gift loans and below market corporation/stockholder loans, see Chvisuk, *Taxation of Loans Having Below-Market Interest Rates*, 21 IDAHO L. REV. 257 (1985).

interest received and an equal deduction for the compensation paid. All such payments are treated as if they had been transferred on the last day of the calendar year.[90] This is essentially a wash.[91] At the same time, the employee has income from the extra compensation he or she is charged with having received[92] but is generally entitled to an offsetting interest deduction for the foregone interest he or she is deemed to have paid to the employer.[93] The following example illustrates the effects of a below market demand loan on both the employer and the employee. On January 1, 1986, the employer loans $100,000 to the employee at a 0% interest rate, payable on demand.

FOREGONE INTEREST

Jan. 1, 1986 - June 30, 1986	=	181/365 × 12% × $100,000	=	$ 5,951
July 1, 1986 - Dec. 31, 1986	=	184/365 × 12% × $105,951	=	$ 6,409
Total Interest Accrued	=	$5951 + $6409	=	$12,360
Less Interest Actually Paid			=	0
Foregone Interest				$12,360

The employer is charged with income of $12,360 from the foregone interest and receives a $12,360 deduction for the "compensation" paid to the employee. The employee is charged with $12,360 compensation income but generally is entitled to a $12,360 deduction for interest paid.

The statutory treatment of below market term loans and the re-

90. I.R.C. § 7872(a)(2) (1984).

91. A "wash" transaction is one with zero net impact to a taxpayer. The taxpayer/employer in this situation has received income in the amount of the foregone interest but has an equal offsetting deduction for compensation paid to the employee. The net effect to the employer is the cancelling of income and deduction.

92. In employer/employee below market loan transactions, the employer is deemed to have paid compensation to the employee in the amount of "foregone interest" in the demand loan or of the term loan original issue discount. Under § 7872(f)(9) this employee compensation is not subject to income tax withholding, but there is no saving provision for withholding under the Federal Insurance Contribution Act (FICA), 26 U.S.C. § 3101, Aug. 16, 1954, ch. 736, 68A Stat. 1. Neither is there a saving provision for withholding under the Federal Unemployment Tax Act (FUTA), 26 U.S.C. § 3301 (1982), Aug. 16, 1954, ch. 736, 68A Stat. 1. The employer therefore may be required to withhold specified amounts and to pay any employer's contribution under these acts.

The administrative burden of both FICA and FUTA can generally be avoided in the demand loan situation, as the imputed payments of the demand loans are deemed to have been made on the last day of the calendar year when the statutory limits for withholding have already been exceeded. This may not be so under a term loan, since employee compensation under a term loan is deemed to have been made on the date the loan is made, which may be before the employee has surpassed the annual limits of FICA and FUTA withholding.

93. This will generally result in a wash to the employee. *But see infra* note 101.

sulting tax consequences are substantially different from those for below market demand loans. In the term loan context, the employee is construed as receiving, at the time the loan is made, compensation in the amount of the excess of the actual loan over the present value of the total amount of principal and interest payments due under the loan.[94] The excess of the amount of the loan over the present value of all payments to be received under the loan is considered an original issue discount.[95] The term loan treatment provides for the foregone interest of the entire loan period to be charged to the employee in the year the loan is made. The employee is generally entitled to deduct the "interest payments," but under section 163 he or she is required to spread the deemed interest payments over the entire term of the loan, taking only a ratable share each year.[96]

Thus, the below market term loan creates a situation far different from the below market demand loan "wash." Under a demand loan, the foregone interest is calculated on an annual basis coincident with an annual (and generally offsetting) interest deduction to the employee. The income and deduction will generally offset and result in no tax liability to the employee. However, the unwary or uninformed term loan borrower could face significant adverse tax consequences from such a loan arrangement.[97] Although the total deduction allowed to the employee for the interest should eventually equal the income with which he or she is charged, the statute imposes four significant tax disadvantages on the borrower of a below market term loan. First, the deductions for "interest paid" will not offset the income generated in the year of the loan. For example, over a fifteen-year below market term loan, the borrower deducts only a ratable portion[98] of the "interest" each year, although the entire amount of foregone interest was reported in the year the loan was made. Second, by deferring the deductions over the life of the loan, the taxpayer has lost the use of the money saved through

94. I.R.C. § 7872(b)(1) (1984).

95. *Id.* § 7872(b)(2)(A).

96. *Id.* § 163(e); § 1272(a)(1)-(3).

97. *Id.* § 7872(c)(3)(A)-(B) provides a de minimus exception to the tax treatment of both employer/employee and corporate/shareholder loans. The exception provides that these loans will not be subject to the statutory treatment on any day on which the aggregate loans between the parties do not exceed $10,000. This exception, however, does not apply to any loan that has the principal purpose of tax avoidance.

In determining the aggregate loans between lender and borrower, the Code treats a husband and wife as one person, so all loans between lender/spouse and borrower/spouse are aggregated. *Id.* § 7872(f)(7).

98. *See infra* note 106.

the deduction. Thus, the income tax is due in the first year, but the final dollars of deduction (and tax savings) are delayed until the loan terminates. Third, as in any tax deduction situation, a deduction is always more valuable to a higher bracket taxpayer. Deferring the interest deduction over the life of the loan may cause some of the deduction to come in lower bracket years when the earning potential of the taxpayer has declined.[99] Finally, the interest is deductible to the same extent as actual interest paid by a taxpayer on any loan. Thus, if a taxpayer does not itemize or if the deduction were disallowed under other Code provisions,[100] the taxpayer would lose the benefit of the deduction.[101]

The employer, however, benefits from such an arrangement. He or she is treated as having "paid compensation" to the employee in the year of the loan in an amount equal to the excess of the loan over the present value of the total principal and interest payments to be received under the loan.[102] The employer is thereby entitled to an "accelerated" deduction for the compensation deemed paid to the employee. At the same time, the employer realizes "income" in the amount of foregone interest, but only in the ratable yearly share which the employee is deemed to pay.

The following example illustrates the effects to the employer and the employee:

> The employer, on January 1, 1985, makes an interest-free loan of $100,000 to the employee, payable in fifteen years. Assume the current interest rate is 10%, compounded semi-annually.

Amount of Loan	$100,000
Less:	
1) Present value of principal repayment at 10%	23,138
2) Present value of actual interest payments at 10%	0
	$76,862

The $76,862 represents the original issue discount. As a result, the

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99. The taxpayer may not always be in a lower bracket in the later years of the loan, but this situation is more likely to occur with athletes who enjoy a relatively short career. Football players generally average only 3.6 high-earning career years. This analysis does not take into account the tax consequences that might result from a change in marital status. For an analysis of the impact of such a change, see Chapman, *Marriage Neutrality: An Old Idea Comes of Age*, 87 W. VA. L. REV. 335 (1984).

100. *See, e.g.*, I.R.C. §§ 162(d), 265 (1982).

101. H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 3, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1700.

102. *See supra* note 95.

parties will have the following consequences:[103]

103.

	Date	O.I.D.	Loan Balance	Total Interest For Year
Year 1	1/1		$23138.00	
	6/30	$1156.90	24294.90	
	12/31	1214.75	25509.05	$2371.65
Year 2	6/30	1275.44	26785.09	
	12/31	1339.21	28124.30	2614.65
Year 3	6/30	1406.17	29530.77	
	12/31	1476.48	31006.95	2882.65
Year 4	6/30	1550.31	32557.26	
	12/31	1627.82	34185.08	3178.13
Year 5	6/30	1709.21	35894.29	
	12/31	1794.67	37688.96	3503.88
Year 6	6/30	1884.41	39573.37	
	12/31	1978.63	41552.00	3863.04
Year 7	6/30	2077.56	43629.56	
	12/31	2181.44	45811.00	4259.00
Year 8	6/30	2290.51	48101.51	
	12/31	2405.03	50506.54	4696.54
Year 9	6/30	2525.28	53031.82	
	12/31	2651.55	55683.37	5176.83
Year 10	6/30	2784.13	58467.50	
	12/31	2923.33	61390.83	5707.46
Year 11	6/30	3069.50	64460.33	
	12/31	3222.97	67683.30	6292.47
Year 12	6/30	3384.12	71067.42	
	12/31	3553.33	74620.75	6937.45
Year 13	6/30	3731.00	78351.75	
	12/31	3917.55	82269.30	7649.35
Year 14	6/30	4113.42	86382.72	
	12/31	4319.09	90701.81	8432.51
Year 15	6/30	4535.05	95236.86	
	12/31	4761.80	99998.66	9296.85

Year of	Employer		Employee	
Loan	Income	Deduction	Income	Deduction
1	$2,371.65	$76,862	$76,862	$2,371.65
2	2,614.65			2,614.65
3	2,882.65			2,882.65
4	3,178.13			3,178.13
5	3,503.88			3,503.88
6	3,863.04			3,863.04
7	4,259.00			4,259.00
8	4,695.54			4,695.54
9	5,176.83			5,176.83
10	5,707.46			5,707.46
11	6,292.47			6,292.47
12	6,937.45			6,937.45
13	7,648.55			7,648.55
14	8,432.51			8,432.51
15	9,296.85			9,296.85

Section 7872 therefore maintains the tax exempt status of below market demand loans, since both the employer and the employee possess an income/deduction "wash" in most settings. However, the legislation significantly alters the tax implications of below market term loans by providing employers with a tax benefit and by imposing upon employees a meaningful tax disincentive. The statute clearly favors demand loans over term loans. Although this provision succeeds in taxing the heretofore more prevalent form of below market loan, the encouragement of demand loans represents a poor and potentially biased economic judgment. Demand loans are often vehicles for significant tax abuse because parties frequently employ a demand loan format as a sham when they have no actual intention of repaying the loan. Taxpayers could also avoid the remedial effects of section 7872 by structuring the below market loan as a demand loan with a separate understanding that it will be repaid only at a certain time—in effect a tax-free term loan. Demand loans also favor lenders, since the transaction is risk-free for them—if they need the money back or become disenchanted with the borrower for any reason, they can simply demand repayment of the principal. Finally, term loans are better vehicles for borrowers legitimately in need of investment capital, as the conditions of interest and repayment are established and predictable.[104] The 1984 legislation therefore encourages use of the most economically inefficient type of below market loan and may penalize the unwary borrower.

104. *See* TERM LOAN HANDBOOK 37-45, 143-51 (J. McCann ed. 1983) (ABA Comm. on Developments in Bus. Fin., Sec. Corp., Banking and Bus. Law).

Congress produced this result by engrafting the different valuation formulas for demand and term loans created by the judiciary in the gift tax context upon the income tax.[105] The assessment of the demand loan gift tax liability on an annual basis provided no incentive favoring demand over term loans, since a substantially equivalent gift tax was imposed on both types of loans. The income tax, unlike the gift tax, possesses an annual deduction for the payment of certain types of interest.[106] An annual valuation of income in the salary or dividend setting therefore results in the demand loan retaining its tax exempt status. Section 7872 fails to attain significant tax neutrality by providing substantial incentives for the demand loan rather than the term loan. This lack of neutrality is more harmful where the favored transaction is less economically efficient.

Congress should have subjected demand loans to a meaningful income tax rather than to the illusory tax treatment in section 7872. One method would tax demand loans in a manner similar to the treatment presently applied to revocable trusts[107] or anticipatory assignments of income from income-producing property.[108] Thus, the lender would be required to report as income each year the excess of any income actually earned from the loan proceeds over the actual interest charged on the loan. This would provide a disincentive to employers making demand loans to employees as part of compensation packages.

An alternative method would impute a statutory "term" for all demand loans and would value them accordingly. For example, all demand loans could initially be treated as a five-year term loan for valuation purposes. The tax treatment could parallel the tax treatment of any five-year term loan.[109] Any demand loan outstanding after five years could be treated as a new five-year term loan and valued accordingly. Either of these alternatives would impose a

105. *See supra* notes 41-42, 67 and accompanying text.

106. I.R.C. § 163 (1982).

107. Except as provided in §§ 671-678, when the settlor has created a revocable trust, the income each year is charged to the settlor of the trust regardless of who has been designated as the income beneficiary. *See generally* I.R.C. §§ 641-643 (1982). Thus, the settlor of the trust retains the income tax liability, and if the income is paid to a beneficiary other than the settlor, he or she is also subject to the gift tax.

108. When a taxpayer has made an anticipatory assignment of income from income-producing property, the assignment successfully shifts the income to the assignee but fails to shift the income tax liability from the taxpayer. In order to successfully shift both the income and the income tax liability to the assignee, the taxpayer must transfer ownership of the income-producing property. *See* Helvering v. Horst, 311 U.S. 112, 118 (1940).

109. *See supra* notes 95, 104, and accompanying text.

meaningful tax consequence upon the use of below market demand loans. The income tax, like the gift tax currently in effect in section 7872, would then treat both demand and term loans in a substantially equivalent manner. This tax neutrality would mean that true economic benefits rather than tax avoidance considerations would dictate the choice of the term or demand loan format if a below market loan were still valuable to the parties.

B. *New Legislation*

The Tax Reform Act of 1986[110] substantially impacts upon the deductibility of below market loans in two separate areas—tax rates and interest deduction availability.

The new legislation lowers the maximum tax rate to 28% by 1988.[111] This reduction imposes an additional penalty on term borrowers. For taxpayers who received below market loans prior to 1987, the income generated by the foregone interest calculation in the year in which the loan was issued very likely was taxed at 50%.[112] On the other hand, the deductions for interest that is disbursed over the life of the loan will probably be taken against 28% of income.[113] A taxpayer will lose $.22 on each dollar of deduction because of the change in the rate schedules.

The new legislation also eliminates the deduction for consumer interest, with the exception of interest on a principal residence and possibly a second residence.[114] The interest deduction on the purchase of other consumer products, such as cars, boats, and any items of personal use, is abolished. Additionally, the new legislation expands the scope of the interest limitation and generally restricts deductibility of investment interest.[115] As a result, the taxpayer in the below market loan situation could face restricted deductions or, at the worst, no deduction for his or her "deemed interest expense." A borrower of either a demand or term loan would therefore have income from the loan without any offsetting deductions. Such a result significantly increases the tax disadvantages for either type of below market loan. Further, the borrower actually controls interest deductibility by investing the principal in a qualifying (e.g., princi-

110. Pub. L. No. 99-514, 100 Stat. 2085 (1986), *reprinted in* 1986 U.S. CODE CONG. & AD. NEWS Special Tax Pamphlet.

111. *Id.* § 101(a)(1) (amending I.R.C. § 1).

112. I.R.C. § 1 (1982).

113. Tax Reform Act of 1986 § 1. *But see id.* § 1(g) for imposition of 5% surtax.

114. Tax Reform Act of 1986 § 511(h) (amending I.R.C. § 163).

115. *Id.* at § 511(d) (amending I.R.C. § 163(d)).

pal residence) or a non-qualifying (e.g., car or boat) transaction. An uninformed choice could have severe tax consequences to the unwary taxpayer.

C. *Below Market Loans in the Professional Sports Industry*

The professional sports industry has utilized below market loans as part of a total financial package for many of its highest paid athletes.[116] Sports contracts therefore provide a vehicle for examining the modern use of below market loans as compensation. These contracts are also excellent examples for illustrating how the statutory provisions alter the economic utility of such loans. Finally, below market loans in the sports industry frequently involve an understanding between the parties regarding repayment. Contractual conditions which alter the obligation to repay will have significant income tax ramifications.

1. *The Effect of Section 7872*

The most commonly utilized form of below market loan in the professional sports industry, the term loan, has been most affected by the changes in the tax laws.[117] For example, a team loans its first round draft pick $400,000 interest free to be repaid fifteen years from the date he or she executes the promissory note with the club. Under the law prior to the Tax Reform Act of 1984, the employer, at the time of the loan, did not receive a deduction for the principal amount of the loan since it was not considered a salary or business expense, but rather a commercial investment.[118] Similarly, the athlete received the face amount of the loan tax free because the money was not considered income but instead was treated as the incurring of indebtedness. The arrangement had no significant economic benefit for the team aside from any negotiation advantages which it may have acquired in structuring the financial package. The player,

116. J. WEISTANT & C. LOWELL, THE LAW OF SPORTS 848-49 (1979). In professional football, 46 veteran National Football League (NFL) players negotiated loans in 1983 with an average value of $109,000, and 96 veteran NFL players negotiated loans in 1984 with an average value of $249,166. Five of the 28 players chosen in the first round of the 1983 NFL draft negotiated loans with an average value of $248,000, and 19 of 28 players chosen in the first round of the 1984 draft negotiated loans with an average value of $514,000. Additional loans were generated through later rounds of each draft. NAT'L FOOTBALL LEAGUE PLAYER'S ASS'N, 1983 DRAFT COMPENSATION BREAKDOWN (Feb. 1984); 1984 *Salary Survey*, LAWDIBLE, Feb./Mar. 1985, at 1-2, 3 (AFL-CIO Legal Dept., Fed'n of Prof. Athletes). Among the players chosen in the first round of the 1985 draft, the average loan had a value of $452,499. 1985 *Draft Compensation by Round*, LAWDIBLE, Feb. 1986.

117. *See supra* notes 95-104 and accompanying text.

118. Treas. Reg. § 1.162-7 (1958).

on the other hand, received a large sum of money at signing which was considered tax free.

Under the new statute, the tax implications for both parties have changed considerably. Since the employer is considered as having paid compensation to the employee in an amount equal to the excess of the face amount of the loan over the present value of the loan, the club receives a deduction of $307,449 in the year of signing.[119] This deduction is in effect "recaptured" over the fifteen-year term of the loan, because the team is required to report as income each year the interest attributed to it by the statute (in this example, $20,497). For the athlete, the tax situation is reversed. The employee is now charged with $307,449 in taxable income in the year of signing. He or she will eventually be made whole after the loan has run its term because the new law allows an annual interest deduction (again, $20,497). However, the team procures a significant financial advantage, and the player receives a significant financial disadvantage, given the present value dollar effect in the year of signing. The transaction is even more disadvantageous for the player if the annual interest deduction is lost by commiting the principal to investments which do not qualify for the interest deduction.[120]

The legislation therefore encourages players who wish to utilize below market loans as part of their compensation package to structure the loans as demand loans or some variant which avoids the imputed interest calculation.[121] These alternatives effectively discourage the use of below market loans, since the demand loan

119. This is the original issue discount on a $400,000 interest free loan for 15 years using a 10% applicable rate. *See supra* notes 96, 104, and accompanying text for the method used to calculate the original issue discount.

120. I.R.C. § 265(2) (1982); Tax Reform Act of 1986 § 511(h).

121. A variant on this "straight" interest-free loan is a loan from the team at a near-market rate of interest. The club then builds into the player's athletic contract an easily earned reporting or performance bonus in an amount equal to the yearly interest charge.

This produces a loan which in effect is interest free. The club reports the interest as income but receives a corresponding deduction for the payment of the bonus to its employee. The player reports the reporting or performance bonus as income but receives an equivalent deduction for his or her interest expense payment to the team. Structuring the loan in this manner allows both parties to avoid the attributed interest rate mandated by the new statute. The relevant numbers are completely in the control of the drafting parties. However, since the player's interest payment is an obligation, separate from his or her athletic contract, the player must insure that he or she receives the appropriate bonus for each year the loan is outstanding. The player therefore must either take a short-term loan or accept a longer-term athletic contract. In addition, if the player could have negotiated the identical reporting or performance bonus without the inclusion of the loan as part of the package, the loan is not truly interest free.

places an already vulnerable athlete under more managerial control. Unfortunately, many players continue to use the term loan format and to ignore the impact of section 7872 by treating the loan as tax free.[122] The Service will deter this practice as it audits and penalizes taxpayers for disregarding the statute. In the professional sports context, the elimination of borrowing will ultimately benefit athletes economically, given the significant non-tax disadvantages to the borrowing player.[123]

2. *Terms of Repayment*

Athletes have frequently employed below market loans in a contractual structure where the intent to repay the loan is illusory. Such transactions reveal that, as a compensation substitute, the below market loan possesses no real economic value aside from its potential tax-avoidance benefit. A popular variant of the below market loan is the use of a player's deferred compensation payout or of an easily met performance bonus (most typically reporting to training camp) to repay the principal when due.[124] This type of transaction begins with the establishment of a below market term loan, e.g., $500,000 loaned interest free to the player from team funds, repayable in fifteen years. As an additional but contractually separate part of the player's financial package, the team agrees to pay the athlete a sum of money equal to the face amount of the loan as a signing bonus or salary, but the player defers receipt of that income until the date the loan is due to be repaid, e.g., a $500,000 signing bonus to be paid to the player fifteen years from the date of signing. If the loan is short term, the repayment schedule may correspond to a series of reporting bonuses which begin each year of the player's athletic contracts, e.g., a player receives a $500,000 loan

122. *See supra* note 115 and accompanying text.

123. Aside from the tax consequences, the loan's economic value to the player lies in the yearly rate of return he or she can generate from investing it or in the after-tax worth of the interest expense saved by not having to buy a conventional loan to acquire property (e.g., a house). The loan arrangement is potentially disastrous for the player if he or she fails to invest the proceeds in an asset which retains or increases its value until the repayment period. For example, if the loan is used to pay an agent's fee, to buy a depreciating asset (e.g., a car) or to invest in a speculative opportunity which fails, the athlete may be "cash poor" at the time of repayment. The player could therefore become insolvent at a poor economic time—the last years of the playing career or the lower income non-sports years following the player's athletic retirement. Many players also seem to believe that the team does not actually expect the loan to be repaid. This illusion will probably be shattered as teams sue players for principal amounts due and owing. *See NFC Report*, USA Today, Aug. 25, 1986, at 8C, col. 7.

124. *See, e.g., Wallets Opened for USFL Talent*, The Sporting News, Aug. 25, 1986, at 42, col. 4.

at the time of signing the contract which must be repaid in installments of $100,000 two years from the date of the loan, $150,000 three years from the date of the loan, and $250,000 four years from the date of the loan. The player's athletic contracts contain reporting bonuses of $100,000 before he or she begins the third season, $150,000 before the fourth season, and $250,000 before the fifth season.

This agreement, particularly the longer term loan secured by deferred compensation, is fraught with peril for the player. The below market term loan would be subject to the present value tax result mandated by the new statute and discussed previously.[125] If the player or agent is unaware of the effect of section 7872, he or she will improperly assess the economic value of the below market loan and the entire compensation package. This oversight will eventually result in the payment of past due tax, interest, and penalties to the Service.[126] However, this tax is not imposed merely upon the use of the money, or foregone interest. These types of below market loans also subject the player to economic and tax difficulties for the principal amount.

The shorter term loan will be repaid during the heart of the athlete's prime earning years, and the athlete is therefore less likely to be cash poor at that time. In both situations, however, the player carries a significant tax liability with no corresponding offsetting liquid income. At the time the loan is due to be repaid, the team engages in a purely paper transaction which records the loan as paid in full, credits the player with an income payment in the amount of the deferred compensation, and takes a deduction for the team in the same amount.[127] The club notifies the player of the player's receipt of income equal to the face amount of the loan.[128] However, he or she receives no actual cash from the team at that time and must therefore satisfy the tax liability from other liquid assets. For example, a player does not report income on the $500,000 loan received at the time of signing the contract. Fifteen years from that date (the repayment year), the club notifies the player that the loan has been repaid and credits the player with receipt of $500,000 of income. In year fifteen, the player receives no actual monies from the team, but, assuming a 28% tax bracket, the player now owes the

125. *See supra* notes 104, 115, 118-20, and accompanying text.

126. *See infra* note 132 and accompanying text.

127. Treas. Reg. § 1.162-1 (1959).

128. I.R.C. § 451(a) (1954).

government $140,000.[129] If the player has invested the original $500,000 wisely or is still playing and earning a high salary, the scheme has some economic value to the player, and his or her financial posture is healthy. However, as more frequently happens, if the player has engaged in an undisciplined investment plan or has indulged in a lavish lifestyle and now generates a lower income from a non-athletic career, the transaction is a financial nightmare for the player. The scheme which the athlete believed would result in tax-free income has merely deferred tax liability to a time when the player is less able to pay it. The athlete's prospects are even more bleak if a substantial portion of the tax-free money received at the time of signing was used to pay the fee of the agent who structured the package.

This type of below market loan structure also disadvantages the player in the tax liability on the principal amount. In this type of arrangement, the player's failure to report income in the year of loan receipt may violate the constructive receipt of income doctrine for deferred compensation.[130] The player actually receives in the year of signing all the money which for tax reporting purposes will be "deferred." This transaction on its face may be a sham and a fraud on the Service.[131] Constructive receipt of deferred funds occurs if the money is "credited to his account, set apart for him, or otherwise made available so that he may draw upon it."[132] Even if the loan and deferred compensation are drafted as contractually independent transactions, the Service may rather easily pierce through to the economic reality of the contracts where the amounts and years were identical. If the Service successfully took this position, the player would owe unpaid taxes, interest charges, and penalties based on the principal amount of the loan.[133]

Occasionally a club will relieve a player from the obligation to repay a negotiated loan. This forgiveness can occur during the life of the loan or at the date of actual repayment. The team may be motivated by a desire to alleviate some financial problems of its former players, but the forgiveness is more often the product of the club's negotiating a new financial package with the player or reworking or renegotiating an existing contractual arrangement. If

129. Tax Reform Act of 1986 § 1.

130. Treas. Reg. § 1.451-2 (1979).

131. Gregory v. Helvering, 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935).

132. Treas. Reg. § 1.451-2 (1979).

133. Treas. Reg. § 1.6661-1 (1985).

the team forgives the indebtedness, the taxable event is the forgiveness.[134] At that point, the club is entitled to a deduction for the face value of the amount forgiven as a payment to an employee. At the same time, the player has imputed income equivalent to the forgiven amount. The player's tax liability, depending on the bracket and year, will most likely equal 28% of the face amount of the loan.

A different type of problem is posed when the contract contains a conditional forgiveness clause. A typical agreement establishes an interest-free loan for a term equivalent to the length of the player's athletic contract. The agreement further states that the loan will be forgiven if the player complies with a certain condition before the repayment date. The most frequent condition is the execution of an additional athletic financial package with the team. As noted above, the team receives a deduction, and the player is charged with income in the face amount of the loan at the time the loan is forgiven. If the provision is a valid condition and not a sham (i.e., if the player will certainly fulfill it), the transaction will have no other tax consequences aside from the present value calculation discussed previously.[135]

The seriousness of these types of problems have not yet been fully appreciated by members of the professional sports industry. Most large financial packages for athletes began to be structured during 1979 and 1980,[136] with the below market loan as a compensation tool being introduced even later. Therefore, most of the below market loans have yet to come due for repayment. In all probability, many of the tax years in which these packages were negotiated have not yet come under Service audit scrutiny.[137] In earlier years, when athletes were making much less money and exotic compensation schemes were unknown, the Service had little incentive to devote significant resources to investigating athletes. However, given the publicity accorded large financial player packages and the questionable nature of some compensation arrangements, difficulties between players and the Service will inevitably occur in the near future.

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134. Treas. Reg. § 1.61-12 (1954).

135. *See supra* notes 104, 115, 118-20, and accompanying text.

136. Large player compensation packages are generally attributable to greater bargaining leverage by labor, both collectively and individually, and to increased income available to sports management from the broadcast industry. *See* Closius, *Not at the Behest of Nonlabor Groups: A Revised Prognosis for a Maturing Sports Industry*, 25 B.C.L. REV. 341 (1983).

137. I.R.C. § 6501 provides that the statute of limitations for the assessment of tax is generally three years from the filing of the return. Thus, for example, returns filed in 1984 for tax year 1983 are open to Service review until at least 1987.

III. CONCLUSION

Below market loans had been utilized as substitutes for salaries, dividends, and gifts. In these settings, however, the transactions possessed no independent economic value as loans but merely employed the loan format as a tax-avoidance device. Lower court opinions encouraged the use of this technique by failing to perceive the true nature of the exchange of wealth merely because the transfer was labelled a loan. Use of the below market loan as a salary substitute was the most abusive practice. As exemplified by professional sports contracts, many compensation packages were structured so that the loan either was not intended to be repaid or was to be cancelled by an accounting adjustment. These transactions had no economic utility as a loan but merely adopted that form in an effort to compensate or to transfer wealth without subjecting the exchange to taxation. In professional sports, the desire to obtain immediate tax benefits often led players to include below market loans in their compensation packages when, in fact, such loans were detrimental to their long-term financial security. Subjecting the exchange to tax would therefore restore the integrity of the tax structure and limit the below market loan to those situations in which the borrowing exhibits independent economic value to the parties.

The Supreme Court in *Dickman* subjected both demand and term loans in the intrafamilial setting to the gift tax. Congress subjected all below market loans, according to their factual setting, to the appropriate income or gift tax. However, by applying the different valuation formulas for term and demand loans endorsed by the Supreme Court in the gift tax context to the income tax setting, Congress favored the use of demand loans as a salary substitute by leaving them effectively tax free while imposing a heavy tax burden on the term borrower. This bias resulted because the income tax, unlike the gift tax, allows an interest deduction which produces a tax wash in an annual assessment of gain as opposed to the meaningful gift tax liability generated by a yearly computation. This result encourages the use of a loan type which is least economically efficient and most likely to be a sham transaction. Congress should have achieved tax neutrality by subjecting both kinds of loans to a meaningful income tax consequence. This result can be produced by subjecting demand loans to current income tax. Congress can achieve this goal by ascribing the borrower's below market benefit to the lender or by statutorily imputing a term of years to all demand loans. This final reform would eliminate a significant tax-

avoidance device and would ultimately protect unwary borrowers from the disadvantageous economic effects which frequently accompany below market loans.