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GIFT TAXES—Interest-Free Demand Loans Are Not Taxable Gifts—*Johnson v. United States**

Over a period of several years, taxpayer transferred substantial amounts of money to his adult son as loans that were repayable on demand and did not bear interest.[1] The Commissioner of Internal Revenue assessed and collected gift taxes on the theory that taxpayer had made gifts to his son of the *use* of the money loaned. The value of the gift was asserted to be 3½ per cent of the average unpaid balance as of the end of each of the taxable years involved.[2] In a suit to recover the gift taxes paid, the Federal District Court for the Northern District of Texas held for the taxpayer. An interest-free loan repayable on demand does not constitute a gift of the value of the use of the money loaned.

Section 2501 of the Internal Revenue Code of 1954 imposes a tax on the "transfer of property by gift."[3] "Gift" is not defined in the Code, but "transfers," which come within the meaning of the term gift, are expansively described in section 2511(a).[4] The value of a gift is determined according to the procedure outlined in section 2512,[5] wherein it is specifically noted that if a transfer takes the form of an exchange, the amount of the gift for tax purposes shall be the amount by which the value of the property surrendered exceeds the value of the property received. In enacting these sections, Congress sought to impose a tax on all transactions which, without regard to their formal characterizations, operate to pass property or property rights donatively to another. The congressional committees which reported the original bill expressly disclaimed an intent to specify all of the various types of transactions known to the common law which could be deemed to constitute a taxable event within the meaning of the statute.[6] Moreover, the Supreme Court, in con-

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* 254 F. Supp. 73 (N.D. Tex. 1966) [hereinafter referred to as principal case].

1. The facts have been simplified. The case involved loans by the taxpayer and his spouse to their son, daughter, and the daughter's husband. The average yearly balance of the son's outstanding loans was approximately $300,000. Similar balances for the daughter were $230,000 during the years involved. Principal case at 75-76.

2. The case involved tax years 1959-1962, inclusive. Plaintiffs stipulated however that they had made loans consistently, beginning sometime before the year 1952. Principal case at 74. In assigning a value to the right to use money, the Government selected the factor of 3½% from the regulations providing for the valuation of annuities, life estates, terms for years, remainders, and reversions, stating: "We think the use of 3½ per cent as the value of the use of the taxpayer's money was suitably conservative, and the taxpayers apparently agree since they have not disagreed with the amount of the gifts if such there were." Brief for Defendant, p. 17. See Treas. Reg. § 25.2512-5 (1958).

3. INT. REV. CODE OF 1954, § 2501.

4. INT. REV. CODE OF 1954, § 2511(a). See also Treas. Reg. §§ 25.2511-1(a) & (c) (1958).

5. INT. REV. CODE OF 1954, § 2512.

6. See H.R. REP. No. 708, 72d Cong., 1st Sess. 27-28 (1932):

> [T]he aim in framing this title has been to state with brevity and in general terms the provisions of a substantive character.

struing the gift tax provisions, has repeatedly emphasized that Congress was not concerned with refinements of title, but rather with the passage of control over economic benefits of property having exchangeable value and for which full value was not returned.[7] The fact that, with the exception of transactions made in the ordinary course of business, every completed inter vivos transfer for less than "adequate and full consideration in money or money's worth" is subject to the gift tax[8] indicates that, regardless of the form chosen, Congress intended that the gratuitous transfer to another of a valuable property right would be taxed as a gift *no later than* the point in time when the right conferred could no longer be recovered by the transferor.[9]

The transaction in the principal case in effect transferred the taxpayer's right to earn income on his capital to his son, and no value in "money or money's worth" was given for the receipt of this right. While admittedly the son did not receive any measurable benefit at the time the loan was transacted, he did receive possession of an income-producing asset belonging to another without either having the duty to account for the income therefrom or promising

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> 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 exchangeable value.
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> 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 (sec. 503) that, property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment.

The passage is repeated verbatim, S. REP. No. 665, 72d Cong., 1st Sess. 39 (1932). See also Treas. Reg. § 25.2512-8 (1958).

7. Almost without exception the cases construing the gift tax rely in whole or in part on the decision in Burnet v. Guggenheim, 288 U.S. 280 (1933). See also Commisioner v. Wemyss, 324 U.S. 303, 306-07 (1945); Robinette v. Helvering, 318 U.S. 184, 187 (1943); Smith v. Shaughnessy, 318 U.S. 176, 180 (1943); Estate of Sanford v. Commissioner, 308 U.S. 39, 43 (1939); *cf.* Corliss v. Bowers, 281 U.S. 376, 378 (1930).

8. The exclusion for transactions in the ordinary course of business is contained in Treas. Reg. § 25.2512-8 (1958). This language of "adequate and full consideration in money or money's worth" has been relied upon as an additional ground to support the assertion that Congress intended to impose the tax in any case where the parties to a transfer do not deal *as if* they were strangers. Commissioner v. Wemyss, 324 U.S. 303 (1945). For this purpose, "ordinary course of business" is defined by the regulations as "a transaction which is bona fide, at arm's length, and free from any donative intent" and is somewhat broader than the "ordinary course of business" concept of § 162. 5 MERTENS, FEDERAL GIFT & ESTATE TAXATION § 34.19 (1959). See also Rosenthal v. Commissioner, 205 F.2d 505 (2d Cir. 1953).

9. See note 6 *supra*. That the tax was intended to apply to continuing interests as well as to outright and absolute gifts is evidenced by the following statement appearing in the committee reports. Note, however, that the illustration was offered by way of example and not as a limitation.

> For example . . . (7) where A creates a revocable trust naming B as beneficiary, a gift to B of the corpus is effected when A relinquishes the power to revoke or the power is otherwise terminated in B's favor (the income payments to B in the interim being gifts from A in the calendar years when received).

H.R. REP. No. 708, 72d Cong., 1st Sess. 28 (1932); S. REP. No. 665, 72d Cong., 1st Sess. 40 (1932).

to give value for the right to use the asset. So long as taxpayer permitted his son to retain possession of that asset (by refraining from exercising his right to demand payment), the son was in a position to realize upon the income rights which attached to the transferred capital.[10] Although it may be said that the benefit thus conferred upon the son was subtle and elusive, the complexity of any particular arrangement ought not to determine the applicability of the tax laws.[11]

An analogy may be made to a transaction which, at least in a family setting, is substantially equivalent to the transaction involved in the principal case. Assume that a father gives his son $100,000 in exchange for the son's promise to repay that amount in five years and that the parties mutually agree that the loan will not bear interest. Unless the transaction is one in the ordinary course of business,[12] the Internal Revenue Service is bound to examine the exchange in order to determine whether any part of it constitutes the making of a gift.[13] Even assuming that there is no question of the son's ability to repay the loan at maturity,[14] a present promise to pay $100,000 at the end of five years is patently not worth $100,000 at the time of the promise. Presumably, under section 2512(b), the father will be deemed to have made a gift of the difference between $100,000 and the present value of the promise to pay $100,000 at the end of five years.[15] Admittedly, the trans-

10. The passage of a taxable benefit does not depend upon enrichment resulting to the donee by reason of the transfer. Treas. Reg. § 25.2511-2(a) (1958). Thus, the argument that the borrower might not realize upon the potential right to earn income from the possession of capital is seemingly misdirected.

11. See, *e.g.*, Smith v. Shaughnessy, 318 U.S. 176, 180 (1943).

12. Nothing herein should be taken to suggest that family members cannot deal at arm's length. The fact is that on occasion they do. The argument is only that absent a showing that the transaction being considered is in fact arm's length—that is, an ordinary business exchange—the transaction is generally presumed to be one of gift and therefore subject to "special scrutiny." See, *e.g.*, Harris v. Commissioner, 340 U.S. 106 (1950); Commissioner v. Tower, 327 U.S. 280, 291 (1946); Helvering v. Clifford, 309 U.S. 331, 335 (1940).

13. INT. REV. CODE OF 1954, § 2512(b). The value to be used for purposes of comparison are the present values of the respective property interests exchanged. Treas. Reg. § 25.2512-1 (1958), as amended, T.D. 682, 1965-2 CUM. BULL. 367; *cf.* Treas. Reg. §§ 25.2512-4 & -5 (1958). See also G. H. Blackburn, 20 T.C. 204 (1953).

14. Absent a finding that the son is able to repay at maturity, there would arguably be a gift at the time of the loan of the full amount transferred. Selsor R. Haygood, 42 T.C. 936 (1964); Minnie E. Deal, 29 T.C. 730 (1958).

15. The question was raised in the principal case in the government's brief. Brief for Defendant, pp. 16-17 & n.13. The government takes this question as settled, on authority of Lockard v. Commissioner, 166 F.2d 409 (1st Cir. 1948), which held that a beneficiary's irrevocable right to receive the income of a short-term trust constituted a taxable gift in the year the property was transferred to the trust. G. H. Blackburn, 20 T.C. 204 (1953), is the strongest authority for the proposition that the transaction of a term loan at less than fair market interest is a gift. In that case, the Tax Court upheld the Commissioner's assertion of a gift on the ground that the fair market value of the secured note given by the transferees was only $134,538.30. While the note carried a face amount of $172,517.65, it required interest payments of only 2¼%. The

action in the principal case can be distinguished from the hypothetical in that the former loan is repayable *on demand.* However, the court held that no gift had been made at the time of the loan, *or at any time thereafter,* which suggests the somewhat suspicious rule that interest-free *term* loans are subject to gift taxation under section 2512(b), while interest-free demand loans are not. The distinction between term and demand obligation may be valid in the market, but it clearly is inappropriate where the lender and the borrower are not dealing at arm's length.[16] In all probability, a father who wishes to transfer a property right to his son through the use of an interest-free loan will be unconcerned with whether the loan is technically repayable at a definite time, or alternatively, on demand. In fact, it would appear that where the desire and ability to give are strongest, so too will be the tendency to loan interest-free money on a demand basis. If one form will result in the imposition of the gift tax whereas the other will not, surely the parties will adopt the latter. Previous characterizations of gift and non-gift transactions have not rested on a distinction so slender as that suggested here, and therefore if the transaction of a term loan at less than fair market interest constitutes a gift transfer, so should the transaction of a demand loan.

The form utilized in the principal case may also be compared with the revocable trust of cash. Both may be employed to confer upon another the continuing, but defeasible, right to enjoy the income from the taxpayer's donated capital.[17] The beneficiary of the revocable trust is deemed to receive a separate gift each calendar year as distributions of income are made by the trustee.[18] However,

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reduction of the fair market value of the note was occasioned by the court's finding that notes of similar character required interest payments of at least 4%.

16. The transaction of a demand loan has not been viewed as an economic device to pass wealth. This conclusion is based on the assumption that a lender dealing at arm's length will demand interest commensurate with the value of the benefit conferred—the right to use capital. Where the parties to the loan are related, the assumption may or may not be warranted and the absence of an obligation to pay interest (or some other consideration in lieu thereof) would seem to indicate that a gift is intended. When a transaction taking the form of a demand loan does not conform to the economic assumptions for which it has been recognized, there is no reason to give religious adherence to the form.

17. The taxpayer's capital is "donated" in the case of the interest-free demand loan in the sense that the taxpayer has not exacted from his borrower payment for the benefit which has been conferred. Few taxpayers would be so foolish as to argue that they would loan money to all comers on these terms, yet that seems precisely the standard which Congress had in mind when related taxpayers purport to deal at arm's length. See Commissioner v. Wemyss, 324 U.S. 303, 306 (1945); Treas. Reg. § 25.2512-1 (1958), as amended, T.D. 6826, 1965-2 CUM. BULL. 367; Treas. Reg. § 25.-2512-8 (1958); *cf.* Treas. Reg. § 25.2512-4 (1958).

18. Treas. Reg. § 25.2511-2(f) (1958) provides in part:

The receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself) during the interim between the making of the initial transfer and the relinquishment or

according to the holding in the principal case, the recipient of an interest-free loan will not be deemed to have received any taxable gift in any of the years during which the loan was allowed to remain outstanding. It is suggested that since both the revocable trust and the demand loan afford a means by which a taxpayer can transfer gratuitously the enjoyment of capital, and since refinements of title are not to control the incidence of the gift tax,[19] the result in the principal case is highly questionable. Indeed, since the interest-free demand loan accomplishes purposes equivalent in substance to both the revocable trust and the interest-free term loan described above, imposition of the tax would seem to follow from the bare requirement of consistent application of the gift tax.

It might be argued that if a transaction is to constitute a taxable gift, it must qualify as such at the time of the transaction. Admittedly, the gift tax is an excise levied upon the donor's act of making an absolute transfer[20] and it cannot be levied on a defeasible transfer or the transfer of a mere expectancy. Since the right accorded the borrower of an interest-free demand loan (the free use of capital at the will of the lender) can have only prospective value, the negotiation of such a loan is thus not a completed transfer for purposes of the gift tax. In such a case, if the tax is to apply, it can be only

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> termination of the power operates to free such income or other enjoyment from the power, and constitutes a gift of such income or of such other enjoyment taxable as of the calendar year of its receipt.

The substance of this rule was originally contained in a regulation (itself limited to the revocable trust) adopted to implement the gift tax enacted in 1924. See Burnet v. Guggenheim, 288 U.S. 280, 283 (1933). Congress incorporated that regulation (continuing to limit its application to revocable trusts) into the Revenue Act of 1932, ch. 209, § 501(c), 47 Stat. 245:

> (c) The tax shall not apply to a transfer of property in trust where the power to revest in the donor title to such property is vested in the donor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such property or the income therefrom, but the relinquishment or termination of such power (other than by the donor's death) shall be considered to be a transfer by the donor by gift of the property subject to such power, and any payment of the income therefrom to a beneficiary other than the donor shall be considered to be a transfer by the donor of such income by gift.

This section was repealed by the Congress after the Supreme Court suggested in *Burnet v. Guggenheim* that the principles contained therein were already a part of the law. Revenue Act of 1934, ch. 277, § 511, 48 Stat. 758; see H.R. REP. No. 704, 73d Cong., 2d Sess. 40 (1934); S. REP. No. 558, 73d Cong., 2d Sess. 50 (1934), both of which state: "This section repeals section 501(c) of the Revenue Act of 1932, since the principle expressed in that section is now a fundamental part of the law by virtue of the Supreme Court's decision in the *Guggenheim* case (288 U.S. 280)." Despite these developments, the rule was successfully challenged in Estate of Mead, 41 B.T.A. 424 (1940), *appeal dismissed*, 116 F.2d 278, *nonacq.*, 1942-1 CUM. BULL. 27. The rule was reaffirmed in Commissioner v. Warner, 127 F.2d 913, 916 (9th Cir. 1942), *reversing* 42 B.T.A. 954 (1940). The Board of Tax Appeals expressly repudiated the departure of *Mead* in Leonard A. Yerkes, 47 B.T.A. 433 (1942).

19. See authorities cited *supra* note 7.

20. Burnet v. Guggenheim, 288 U.S. 280 (1933); Treas. Reg. § 25.2511-2(a) (1958). See also Bradford v. Commissioner, 34 T.C. 1051 (1960); Estate of Koert Bartman, 10 T.C. 1073 (1948); Estate of Sanford v. Commissioner, 308 U.S. 39, 44 (1939).

after continued possession of the principal and the passage of time have combined to accord the borrower an interest capable of actuarial valuation. The question becomes at what point or points in time can it be said that a taxable interest has been "transferred" by the lender. The problem may be illustrated by again comparing the interest-free demand loan with the interest-free term loan. Suppose that a taxpayer makes two loans of equal amount on January 1, 1967: one repayable on demand to his son, the other repayable on December 31, 1967, to his daughter. Both loans are bona fide[21] but neither carries interest. The loan to the daughter is a complete and taxable transfer on January 1, 1967, the date of its negotiation,[22] whereas the loan to the son is not a completed transfer and therefore not taxable at the time it is made. Now suppose that the son repays his loan on December 31, 1967, the same day repayment is made by the daughter. Both borrowers have enjoyed the use of their father's capital for a period of one year. No doubt the *value* of the right to use money on a demand basis is somewhat less than the value of the right to use the same amount of money for a fixed period. However, that does not bear on the *completeness* of the transfer effected by the father in these two hypothetical transactions. In each case, by the close of the year, the father has irrevocably conferred a valuable right during calendar year 1967. For purposes of reporting taxable gifts transferred during 1967, it would appear irrelevant that in one case the extent of the gift was fixed on the first day of the year, while in the other the extent of the gift could not be finally determined until the last day of that year. Moreover, it should be clear that the extent of the interest passed from father to son during 1967 does not depend upon the fact that the loan was repaid before the close of that year.[23] Even if the loan were not repaid on December 31, 1967, but rather was allowed to remain outstanding into 1968, that cannot affect the *extent* of the benefit conferred *during* 1967. So long as the benefit derived cannot be recalled by the father, the transfer to the son is in effect complete.[24]

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21. That is, both borrower and lender intend that the principal amount will be repaid according to the terms of the loan.

22. See note 15 *supra* summarizing the case of G. H. Blackburn, 20 T.C. 204 (1953), apparently the only case to consider the question to date. Note that in that case the court upheld the Commissioner's assertion of gift tax deficiency to the extent of the discrepancy between the rate of interest actually payable by the borrower (2¼%) and the rate that would have been demanded in the open market for similarly secured notes (4%). To the extent that the *Blackburn* case is followed, it is authority for taxing both interest-free and low-interest *term* loans as transactions involving a taxable gift.

23. Where the property right being considered is the interest-free use of the lender's capital on a demand basis, the benefit commences upon the transfer of the money and continues, day by day, until the loan is repaid.

24. It should be noted that an argument that the transfer was incomplete with respect to any past period would presuppose that the lender has a legal right to payment for a period between negotiation of the loan and demand. This argument

No doubt it would be easier to await repayment of the son's loan and to determine the extent of the benefit for the whole period of the loan, but Congress intended the tax to be levied annually.[25] Therefore, if the tax is to apply to interest-free demand loans at all, it appears that it must apply no later than the close of any year during which such a loan is made, and be valued according to the length of time the loan was outstanding during that year.[26] Any other construction would introduce hopeless inconsistencies into the application of the gift tax.[27]

It remains to assign a value to the benefit which results from the interest-free use of money. When the right to be valued is the use of money for a fixed period, the measure has generally been the rate of interest for similar obligations in the local market.[28] When the right at issue is the use of money for an indefinite period, the value should therefore be set at the rate of interest that prevails for similar demand obligations. Absent a reliable market for demand obligations, it will be necessary to use some other, more readily determined, interest factor (such as, for example, the average prime rate during the period or the average bank rate on one-year

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would conflict with the basic contention, necessary to the lender's case, that there is a *loan* which the law will recognize as interest-free. Further, it would presumably result in finding that the lender had forgiven legally owing interest payments. Note the district court's seeming preoccupation with this analysis in the principal case at 77.

25. INT. REV. CODE OF 1954, § 2501. Treas. Reg. §§ 25.2511-2(a)-(f) (1958). See also the legislative history to the Revenue Act of 1932 in S. REP. No. 665, 72d Cong., 1st Sess. 40-41 (1932), stating: "For a more effective administration and to secure prompt collection of the revenues, the bill provides that the tax shall be collected annually."

26. There is no direct authority for this type of gift tax treatment save that which may be drawn from the broad language used by the congressional committees in 1932 in introducing the original bill embodying the present gift tax law. See excerpts from H.R. REP. No. 708, 72d Cong., 1st Sess. 28 (1932); S. REP. No. 665, 72d Cong., 1st Sess. 40 (1932), quoted *supra* notes 6, 9. The only situation there envisioned by Congress wherein a transferee would receive the revocable right to enjoy the income from the transferor's donated capital was in connection with the trust. The committee reports specifically provided for the imposition of the tax on income payments actually made to a beneficiary without regard to the fact that the income interest (as distinguished from payments of income) is revocable. There is no reason to suppose that the congressional committees intended to limit the tax on interests received or enjoyed in connection with defeasible transfers to trusts, but, on the other hand, the courts have not had occasion (before the principal case) to deal with such interests outside of the trust area. The third sentence of Treas. Reg. § 25.2511-2(f) (1958), obviously contemplates imposition of tax on benefits received under non-trusted revocable transfers, but apparently it has not been employed outside of the trust framework:

> The receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself) during the interim between the making of the initial transfer and the relinquishment or termination of the power operates to free such income or other enjoyment from the power, and constitutes a gift of such income or of such other enjoyment taxable as of the calendar year of its receipt.

This language was rejected without comment by the court in the principal case.

27. The inconsistency of taxing term loans as gifts while allowing demand loans to go untaxed has already been noted. See note 16 *supra* and accompanying text.

28. G. H. Blackburn, 20 T.C. 204 (1953).

obligations).[29] Reference can perhaps be made to section 483, which was added to the income tax provisions of the Code by the Revenue Act of 1964.[30] That section attributes interest to payments made under certain contracts for the sale or exchange of property when payment is deferred and interest is either unstated or fixed at an unreasonably low rate. Pursuant to the current Treasury Regulations, a deferred payment contract which does not provide for at least four per cent simple interest will be deemed, in effect, to require payment of five per cent interest compounded semiannually.[31] Stated simply, section 483 *imputes* interest to transactions which would normally require payment of interest, without regard to the fact that the parties to the contract have expressly agreed that no interest will be paid.[32] Although income tax provisions are not often used

29. In J. Simpson Dean, 35 T.C. 1083 (1961), the Commissioner attacked the transaction of an interest-free loan to principal shareholders, claiming that such a loan constituted income or a dividend. To value the benefit, the Commissioner initially used the legal rate of interest. Before trial, however, the current prime interest rate was substituted. The court did not reach the valuational question. See Comment, 33 U. Chi. L. Rev. 346 (1966).

30. Revenue Act of 1964, 78 Stat. 19. Permanent regulations were promulgated in T.D. 6873, 1966-1 Cum. Bull. 101.

31. Treas. Reg. §§ 1.483-1(c)(2), -1(d)(2) (1966).

32. Section 483 was designed to prevent a seller from converting interest income into capital gains. See § 483(f)(3). Consider the application of § 483 to cases in which the absence of interest charges is explained by the generosity of the seller rather than by the so-called "time-price differential." A loan unassociated with a transfer of property other than cash would probably not be considered a "sale or exchange of property" within § 483 and therefore § 483 probably does not apply to the facts of the principal case. Consider however the application of § 483 to a transfer of property in exchange for interest-free or low interest notes, as in G. H. Blackburn, 20 T.C. 204 (1953). See Treas. Reg. § 1.483-1(b)(6), examples (4) & (6) (1966). The provisions of § 483 seem to apply unless the *taxpayer* argues that he has made a gift of interest. The transfer of property (not excluded by § 483(f)(3)) having a fair market value of $100,000 may be from a father to his son in exchange for the son's interest-free note for $100,000. If § 483 applies, the father will be forced to recognize interest income, the son would be allowed a § 163(a) interest deduction, and the father will suffer an unrecognizable loss, § 267(a). To illustrate, assume such a transfer is made and that the father's basis in the property is $100,000, payment on the note being made in full four years after the sale:

(a) Sum of payments to which § 483 applies	$100,000
(b) Value of $100,000 due 4 years from date of sale, Treas. Reg. § 1.483-1(g), Table I (1966), 45-51 mos: .82075	82,075
Total unstated interest	$ 17,925
To the father the payment consists of:	
(1) Return of capital	$ 82,075
(2) Interest income	17,925
Total payment	$100,000

The father will have an unrecognizable loss, § 267(a), of $17,925 and the son will be allowed an interest deduction, § 163(a), of $17,925. It is difficult to conclude that this result was intended or contemplated by the Congress in enacting § 483, but the statute does not seem to afford an "out." If interest were stated at 4%, taxpayer could utilize the § 2503(b) exclusion and report a taxable gift of $1,000 per year by forgiving annual interest payments. See also Int. Rev. Code of 1954, § 163(b), imputing interest for purposes of deduction of 6% on the average unpaid balance under certain contracts for the purchase of personal property or educational services.

in connection with gift tax cases, when the gift tax question involves the rate of interest which the market demands, it would seem that the regulations to section 483 are, at least, an administrative pronouncement of which the court should take cognizance. Whatever interest factor is selected should bear some reasonable relation to the market existing during the period over which the right was enjoyed.[33] Moreover, a taxpayer who objects to the rate selected by the government should be permitted to prove that the use of a lower interest rate would be more reasonable. In the principal case, the government chose to value the right at 3½ per cent per annum, selecting that figure from the regulations dealing with the valuation of annuities, life estates, terms for years, remainders, and reversions.[34] Since these regulations are designed to allow determination of the present value of a right to be enjoyed in the future, it might be argued that the figure is not applicable to the valuation of a right enjoyed in the calendar year concluded at the time the return is filed. If this was an error, however, the taxpayer was not heard to complain that the rate selected was too low. No doubt a regulation on point would aid a court in resolving this question, but the absence of such a regulation should not prevent a court from setting the value of the benefit to be taxed.

As a practical matter, the question does not seem to be whether interest-free intra-family loans will be brought within the taxing statutes, but rather by what means and in what manner. If, on the basis of the decision in the principal case, demand loans will escape the gift tax entirely, then it may be expected that they will become a common vehicle for avoidance of tax.[35] A substantial benefit may thus be passed from the lender to the borrower by the use of no-interest or low-interest loans. When the parties are closely related, the integrity of the gift tax seems to require that "fair market interest" be imputed to the transaction and in this regard it should be irrelevant (except for determining the tax period during which the gift is to be reported) that the loan is payable on demand or on a date certain.[36]

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33. See, *e.g.*, Camp v. Commissioner, 195 F.2d 999, 1004 (1st Cir. 1952); Commissioner v. Marshall, 125 F.2d 943, 945-47 (2d Cir. 1942).

34. Treas. Reg. § 25.2512-5 (1958).

35. *But see* INT. REV. CODE OF 1954, § 2503(b), allowing a single taxpayer an exclusion from the gift tax, per donee. Using the 3½% factor urged by the government in the principal case, this exclusion could be employed by a taxpayer to allow, free from gift tax, interest-free loans somewhat in excess of $85,000 per donee-borrower, and so long as the statutory exclusion were not used for other purposes, only those loans exceeding $85,000 per donee would be subject to the gift tax.

36. The Government will not appeal the decision in the principal case. 2 CCH 1966 FED. EST. & GIFT TAX REP. 9006.

The interest-free loan (whether term or demand) raises some interesting income tax questions. In the principal case, the facts demonstrate that taxpayer succeeded in splitting his income with his children. Throughout the four years in question the

taxpayer's loans exceeded $500,000. Assuming an interest rate of 4%, the taxpayer escaped income taxes on $20,000 per year. Admittedly the taxpayer could leave his capital idle, but little reason appears to suppose that the $500,000 did remain idle. Indeed, the opinion of the district court suggests that the money was profitably invested by the borrowers. Principal case at 77. The income-shifting potential of interest-free loans has not been attacked by the Service, and it is doubtful that there is existing doctrine sufficient to meet the threat. A Note, 25 J. TAX. 358 (1966), recognizes the issue, and suggests that it belongs to the field of imputed income. The issue is perhaps more easily understood by reference to Code provisions charging the grantor with the income of short term and revocable trusts. See INT. REV. CODE OF 1954, §§ 673(a), 676(a). These provisions are designed to prevent the use of the trust device to transfer the income potential of a settlor's capital except where the settlor also passes an interest in the corpus sufficient to justify separate income treatment to the beneficiary. The result in the principal case at least suggests that a taxpayer can successfully split income with members of his family by surrendering no more than the immediate possession of his cash—by an interest-free demand loan. If the policies which led to the enactment of §§ 673 and 676 are viable, then those same policies would suggest that the reasoning of the principal case cannot be expected to endure.