Interest-Free Loans

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I. Introduction

The Deficit Reduction Act of 1984 has overturned years of established precedent and administrative practice in which interest-free loans were not treated as taxable transactions. Historically, interest-free loans provided a substantial advantage to individuals desirous of transferring assets to individuals with lower incomes. The transfer was with minimal or no adverse tax consequences.

Interest-free loans or below-market rate loans usually occur in three situations: (1) loans between family members; (2) loans between a corporation and an employee; and (3) loans between a corporation and a shareholder. The loans between family members occur either in the gift situation or in the transfer of assets for value between family members. Loans between a corporation and an employee are a form of employee benefit which became popular because of the necessity to encourage employees to remain with the corporation or to attract superior employees to the corporation. Loans between a corporation and shareholder were undertaken in order to avoid taxable income to the shareholder, or to alleviate the possibility of unreasonable amounts of compensation.

The tax planning aspects of interest-free loans provided numerous opportunities. The loans also afforded an opportunity to borrowers where conventional financing sources were unavailable.

From the inception of modern tax laws in 1913 until 1961, the government did not treat such loans as taxable events either by rule, regulation or litigation.

The courts have consistently determined that interest-free loans do not constitute taxable income to the borrower. On the other hand, such loans were held not to constitute income to the lender.

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The leading case of *J. Simpson Dean v. Commissioner*[1] and its progeny established judicial refusal to change the non-taxable status of interest-free loans. The court stated:

> We have heretofore given full force to interest-free loans for tax purposes, holding that they result in no interest deduction for the borrower . . . nor interest income to the lender . . . . We think it to be equally true that an interest-free loan results in no taxable gain to the borrower, and we hold that the Commissioner is not entitled to any increased deficiency based upon this issue.[2]

The courts consistently rejected the Internal Revenue Service's efforts to impose tax consequences until the *Dickman v. Commissioner*[3] case. The Supreme Court determined that an interest-free demand note is a taxable gift of the use of the money. The Supreme Court stated:

> A substantial no-interest loan from parent to child creates significant tax benefits for the lender quite apart from the economic advantages to the borrower. This is especially so when an individual in a high income tax bracket transfers income-producing property to an individual in a lower income tax bracket, thereby reducing the taxable income of the high-bracket taxpayer at the expense, ultimately, of all other taxpayers and the government. Subjecting interest-free loans to gift taxation minimizes the potential loss to the federal fisc generated by the use of such loans as an income tax avoidance mechanism for the transferor. Gift taxation of interest-free loans also effectuates Congress' desire to supplement the estate tax provisions. A gratuitous transfer of income-producing property may enable the transferor to avoid the future estate tax liability that would result if the earnings generated by the property—rent, interest, or dividends—became a part of the transferor's estate. Imposing the gift tax upon interest-free loans bolsters the estate tax by preventing the diminution of the transferor's estate in this fashion.[4]

This article examines the status of interest-free loans following *Dickman* and the enactment of certain provisions of the Deficit Reduction Act. First traced is the case law and statutory background of interest-free loans before these recent developments. An analysis and description of the new provisions follows this back-

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1. 35 T.C. 1083 (1961), *nonacq.*, 1973-2 C.B. 4.
2. *Id.* at 1090 (citing A. Backus, Jr. & Sons, 6 B.T.A. 590 (1928); Rainbow Gasoline Corp., 31 B.T.A. 1050 (1934); Howell Turpentine Co., 6 T.C. 364, *rev'd on another issue*, 162 F.2d 316 (5th Cir. 1946); D. Loveman & Son Export Corp., 34 T.C. 776 (1960); Combs Lumber Co., 41 B.T.A. 339 (1940); Society Brand Clothes, Inc., 18 T.C. 304 (1952); Brandtjen & Kluge, Inc., 34 T.C. 416 (1960)).
3. 690 F.2d 812 (11th Cir. 1982), *aff'd*, 104 S. Ct. 1086, *reh'g denied*, 104 S. Ct. 1932 (1984).
4. 104 S. Ct. at 1092.

ground. Finally, interest-free loans are examined from a tax planning aspect.

II. Case Law Prior to *Dickman*

A. *The Income Tax Issue*

The basic issues involved with interest-free loans in the income tax context are (1) whether income can be imputed to the borrower on the receipt of the benefits from the loan; and (2) whether income can be assessed to the lender in making a bona fide interest-free loan. The Internal Revenue Service has consistently argued that there is a tax consequence both to the borrower and to the lender. The courts have held to the contrary in stating that interest-free loans do not give rise to income tax. The Tax Court has held that where the interest accrued on a loan is deductible it is unnecessary to impose a tax on the borrower equal to the economic value of the loan. Any imputed income to the borrower from the loan would be offset by a corresponding deduction for the imputed interest on the loan. In *J. Simpson Dean v. Commissioner*, the court stated:

> Here, on the other hand, had petitioners borrowed the funds in question on interest-bearing notes, their payment of interest would have been fully deductible by them under section 163, I.R.C. 1954. Not only would they not be charged with the additional income in controversy herein, but they would have a deduction equal to that very amount.[5]

The court's reasoning was contrary to the Internal Revenue Service position that the taxpayer realized economic benefit from the interest-free use of funds borrowed by the taxpayer from a family-controlled corporation. While the Tax Court entertained the argument of the Internal Revenue Service, the court concluded that any economic benefit would be offset by a corresponding deduction.

It is ironic that for a twelve-year period after *Dean* the Internal Revenue Service did not indicate acquiescence or non-acquiesence. Thereafter, the Commissioner applied a non-acquiesence to the *Dean* decision.[6] Subsequent decisions were also supportive of the taxpayer's position that interest-free loans do not result in taxable gain to the borrower. As recently as 1983 in *Hardee v. United*

5. 35 T.C. at 1090.
6. 1973-2 C.B. 4.

States[7] the United States Court of Appeals for the Federal Circuit stated that the law was settled as to the applicable tax imposed on interest-free loans. The court in *Hardee* stated that a majority shareholder's borrowed funds from a controlled corporation were not taxable income especially where the prior decisions of five circuit courts over a number of years had been consistent. In addition, to overturn the settled tax law in this particular area of interest-free loans would create uncertainty and uneven application of the tax laws:

> As we stated above, however, the accepted interpretation of tax law supporting the *Dean* holding does not depend on the ability of a borrower to have structured a loan transaction in which interest is paid in such a way as to "wash out" his interest payments in order to attain the benefit of a non-taxed, interest-free loan. Rather, the accepted interpretation of the definition of taxable income does not encompass the benefit of such an interest-free loan in the first place. Thus, it is immaterial that no statutory authority exists for imputing a deduction for imputed interest payments, or that no statutory authority authorizes equal treatment for economically equivalent transactions when one of those transactions depends on the ability to deduct interest payments.[8]

There were no rulings by the Internal Revenue Service during this span of years to challenge the settled judicial authority.

B. *The Gift Tax Issue*

Concurrent with the income tax question of interest-free loans, the Internal Revenue Service raised the possibility that a loan without interest constituted a taxable gift from the lender to the borrower. This was especially true in demand loans. Despite the expansive language of Treasury Regulation 25.2512-8, which provides that the gift tax embraces dispositions of property "to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor . . ."[9] the courts construed the statute narrowly to exclude interest-free demand loans. Such loans were recognized to be temporary transfers lacking donative intent since they were potentially due for payment at the whim of the lender.

In *Crown v. Commissioner*,[10] the court rejected the Internal Revenue Service's attempt to impose a gift tax on interest imputed to

7. 708 F.2d 661 (Fed. Cir. 1983).
8. *Id.* at 665.
9. Treas. Reg. § 25.2512-8 (1958).
10. 585 F.2d 234 (7th Cir. 1978).

intra-family interest-free loans. The Seventh Circuit Court of Appeals held that no taxable gift occurred where the lender gave money to his children and other close family members through demand loans. The recipient of the loan had no legally protected interest. The court reasoned that no property right was transferred by the loan, and also cited theoretical and practical problems of valuation, since the value of the right to repayment at the time the loan is extended is "unknown and unknowable." In prior decisions such as *Johnson v. United States*,[11] it was held that where there is no contractual agreement to pay interest the borrower has no legal duty to pay interest on the loan. Any contrary decision in support of the government's position would constitute judicial legislation:

> The time has not yet come when a parent must suddenly deal at arm's length with his children when they finish their education and start out in life. There is no legal requirement, express or implied, to charge them interest on money advanced to them at that stage, whether it be to open a law office and hang out a shingle, to go into the oil business on a substantial scale, or to begin life on their own in some other way. The fact that the Johnsons were financially able to make substantial loans to their children does not change the principle involved. It is to the credit of the entire family that children of those wealthy parents had the judgment to use their money in such a way that they were able to repay almost the entire loans during their father's lifetime.[12]

III. Taxable Gifts from Interest-Free Demand Loans and Term Loans

In *Dickman v. Commissioner*,[13] the Eleventh Circuit Court of Appeals held that taxable gifts do arise from interest-free demand loans. The Internal Revenue Service claimed a gift tax on the reasonable value of the use of the money lent to the borrower. Where an interest-free demand loan is made to a child or to a closely held family corporation, the court reasoned that a gift occurred which is subject to tax. In construing the language of the gift tax statute, the court held that Congress intended to reach any gratuitous transfer of an interest in property as a gift.

In contrast to the *Crown* case, the court reasoned that the use of valuable property was a legally protected property interest that produced a measurable economic benefit capable of being taxed. The tax was imposed because the value of the interest could be

11. 254 F. Supp. 73 (N.D. Tex. 1966).
12. *Id.* at 77.
13. 690 F.2d 812 (11th Cir. 1982), *aff'd*, 104 S. Ct. 1086 (1984).

determined by reference to current interest rates. The Supreme Court affirmed the Eleventh Circuit and held that the gratuitous transfer is subject to gift tax.

Interest-free or below-market term loans as distinguished from demand loans have been treated as taxable gifts.[14] Term loans have consistently been valued by the courts at their fair market value based on the rate of interest charged. Any term loan below current interest rates was subject to gift tax:

> While the petitioner contends that the transfers were arm's-length transactions, the evidence in the record simply does not support its position. Even though the decedent may have had a profit motive in making these transfers because the interest rate on the notes was higher than he was earning on his money otherwise, this factor alone does not mean that the transfers were made at arm's length. There are other factors here which must be considered. To begin with, the decedent was over 75 years old when he began making these transfers in exchange for notes due in 20 years. In addition, the decedent took no security on these notes. Moreover, the notes did not require any principal payments until maturity. Finally, the transferees, the decedent's daughter and son-in-law, were the natural objects of his bounty. In his will, the decedent directed that all his property be divided equally between his two daughters. As a result, Barbara Given was bequeathed one half of the notes on which she was a debtor. Taking all these factors into account, we conclude that the petitioner has failed to meet its burden of proof that the transfers were at arm's length and free of donative intent.[15]

IV. The Deficit Reduction Act of 1984

The Deficit Reduction Act reclassified interest-free and below-market loans. Such loans were defined by Congress as arm's-length transactions where the lender is deemed to have made a loan to the borrower in exchange for an agreement requiring payment of interest at a statutorily established rate. The non-interest charge or below-market interest is taxable income to the lender and is deductible by the borrower to the extent that the borrower itemizes deductions. This is true if: (1) the borrower itemizes deductions; and (2) the interest deduction does not exceed investment interest limitations. The statute further differentiates between a gift, compensation or a dividend. The differentiation is based upon the relationship of the borrower and the lender.

The types of loans covered by section 172 of the Deficit Reduc-

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14. *See, e.g.*, Estate of Meyer B. Berkman, 38 T.C.M. (CCH) 183 (1979); Blackburn v. Commissioner, 20 T.C. 204 (1953).

15. Estate of Meyer B. Berkman, 38 T.C.M. (CCH) at 186.

tion Act are:

1. *Gift Loans.* These loans occur regardless of the relationship between the borrower and the lender.

2. *Compensation-Related Loans.* These occur between an employer and employee or an independent contractor and the end party requiring services.

3. *Corporation-Shareholder Loans.*

4. *Tax Avoidance Loans.* A loan where the primary purpose is tax avoidance.

5. *Other loans* which are not specifically designated in the regulations but have a significant effect on the tax liability of either borrower or the lender.[16]

The amount of the imputed interest is the difference between the interest that the lender charges, if any, and the rates prescribed by the IRS under section 1274.[17] The prescribed rate is based on the interest rate paid by the government to borrow money on the open market. The first determination of applicable federal rates was announced on September 30, 1984 and applied as of January 1, 1985. For periods prior to 1985, the applicable rate was ten percent per annum, compounded semi-annually. The Internal Revenue Service on February 20, 1985 issued a Revenue Ruling establishing the interest rates for March, 1985. The rates are an alternative method of imputing interest when the interest rates in the statute are higher than those of the Revenue Ruling.[18]

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16. *See* Deficit Reduction Act of 1984, § 172, 98 Stat. 699 (codified at 26 U.S.C.A. § 7872 (West Supp. 1985)).

17. *See id.* § 41 (codified at 26 U.S.C.A. § 1274 (West Supp. 1985)).

18. Rev. Rul. 85-21, I.R.B. 1985-9. Pursuant to section 1.1274-6T of the Temporary Income Tax Regulations, the federal short-term, mid-term, and long-term applicable federal rates (AFR) for the month of March, 1985 computed under the alternate method are as follows:

		Annual	Semiannual	Quarterly	Monthly
			Short-Term		
	AFR	9.77%	9.54%	9.43%	9.36%
110%	AFR	10.77%	10.49%	10.36%	10.27%
120%	AFR	11.78%	11.45%	11.29%	11.19%
			Mid-Term		
	AFR	11.30%	11.00%	10.85%	10.76%
110%	AFR	12.47%	12.10%	11.92%	11.81%
120%	AFR	13.64%	13.20%	12.99%	12.85%
			Long-Term		
	AFR	11.72%	11.40%	11.24%	11.14%
110%	AFR	12.93%	12.54%	12.35%	12.22%
120%	AFR	14.15%	13.68%	13.45%	13.31%

A. *Income Tax Treatment*

All gift loans, whether term or demand, receive the same income tax treatment. The borrower is treated as having paid a designated market rate of interest to the lender. The lender is treated as having received the imputed interest for each day that the loan is outstanding, making the amount includable in income. Imputed interest is treated as having been paid to the lender on the last day of the taxable year.

B. *Gift Tax Treatment*

Gift tax treatment on gift demand loans is applied to the value of the imputed interest imposed on the principal of the loan, and is treated as having been made to the borrower on the last day of the calendar year. The lender is deemed to have made a taxable gift to the borrower equal to the amount of the interest; the borrower in turn is deemed to have made an interest payment to the lender. The deemed annual payment is the amount of interest that would accrue on the loan during each calendar year, using applicable federal rates less actual interest paid. The deemed accrued rate will vary according to changes in federal rates over the life of the loan.

Gift tax on gift term loans is computed by subtracting from the amount of the loan the present value of all principal and uncharged interest payments due as determined by Internal Revenue Service rates. The lender is treated as making a gift on the date the loan is made. The borrower is treated as re-transferring to the lender the amount of interest that would have accrued on an annual basis. Such amounts are not subject to witholding under Chapter 24 of the Internal Revenue Code.

A husband and wife are treated as one person for purposes of all gift loans. The amount of imputed interest is determined by the aggregate amount of loans outstanding between the borrower and the lender. The imputed interest rules do not apply for any day if the amount of outstanding gift loans between individuals does not exceed $10,000. There are no income or gift taxes imposed on the loans between a borrower and a lender (including a spouse) if the aggregate balance of all loans between the parties is $10,000 or less, provided that the loans are not attributable to purchasing or carrying income-producing assets.[19]

If loans not in excess of $100,000 are made without a primary

19. 26 U.S.C.A. § 7872 (West Supp. 1985).

tax avoidance purpose, no interest is imputed to a borrower (and spouse) if the borrower has net investment income of $1,000 or less. Net investment income means interest, dividends, rent and the like. In practice, the imputed interest is not burdensome. For example, parents may lend a child (and spouse) $100,000 with no stated interest, but neither of them would be burdened by imputed interest:

Child's Net Investment Income	Interest Rate	Imputed Interest Deductible by Child	Interest Income Reported by Parents	Gift by Parents
$1,000	12%	0	0	0
$2,000	12%	$2,000	$2,000	$12,000
$3,000	12%	$3,000	$3,000	$12,000

The major impact is that the child (and spouse) cannot claim the imputed interest of $12,000 but are limited to the net investment income amount as a deduction.[20]

The statute defines net investment income as investment income minus investment expenses.[21] Investment income includes rent, interest, dividends, royalties, short-term capital gain and any gain on the sale of depreciable or mineral property recaptured as ordinary income. Investment expenses include deductions for business expenses, bad debts, depreciation, amortizable bond premiums, production of income expenses, and cost depletion. If the net investment income is greater than $1,000, interest will be imputed but will be limited to the net investment income.

For any day that the aggregate amount owed by the borrower to the lender exceeds $100,000, interest and expenses will be imputed on the entire amount of the loan outstanding, not merely the amount in excess of $100,000.

C. *Treatment of Non-Gift Loans*

Non-gift interest-free or low-interest loans include corporation-shareholder loans, compensation-related loans and any other loan determined by the Internal Revenue Service to be made for the purpose of tax avoidance or impacting on the tax liability of the lender or borrower.

On non-gift term loans the amount of imputed interest is equal

20. *Id.* § 7872(d)(1)(A), (E).

21. Staff of Joint Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 536.

to the amount of the loan minus the present value of all principal and interest payments due under the loan. The lender is treated as transferring and the borrower as receiving the excess of the amount loaned over the present value of the payments required by the terms of the loan. This excess is considered received and includable in income on the date the loan is made or on the first date that I.R.C. section 7872 applies. The excess is treated as Original Issue Discount (OID), as if it were re-transferred to the lender over the life of the loan under the OID rules for a debt issued after July 1, 1982.[22] Under OID rules, the lender is deemed to receive interest at a constant yield to maturity over the life of the loan, while the borrower may deduct this interest to the same extent as if it were actually paid. The deemed original issue discount is in addition to any actual OID on the loan:

> The issue price of an obligation is the stated principal amount unless there is inadequate stated interest. The adequacy of the interest element in a transaction is determined by comparing the debt instrument's stated principal amount to the "testing amount"—the amount determined by discounting, at a rate equal to 110 percent of the applicable Federal rate, all payments due under the instrument. An instrument contains adequate stated interest if the stated principal amount is less than the testing amount.
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> If a debt instrument does not contain adequate stated interest, section 1274 deems the principal amount (and the issue price) of the instrument to be the "imputed principal amount." The imputed principal amount is the amount determined by discounting all payments due under the instrument using a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually.
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> Section 1273, which replaces section 1232(b)(1) of prior law, provides that the amount of original issue discount is the difference between the issue price of an instrument and its stated redemption price at maturity. Although the issue price of an instrument issued for nontraded property for purposes of section 1273 is generally either the stated principal amount or the imputed principal amount, in certain "potentially abusive situations" neither of these amounts may determine the issue price, as discussed below.[23]

On non-gift demand loans the borrower is treated as having paid interest to the lender and as having received an identical amount from the lender (wage, dividend, or other payment depending on the nature of the transaction). While the borrower may deduct the imputed interest payment, he must include it in income as wage,

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22. 26 U.S.C.A. § 1272 (West Supp. 1985).
23. Staff of Joint Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984 115.

dividend or other payment. Employment tax witholding and information reporting are required as if the deemed payments were actual payments; however, no income tax witholding is required.

Interest-free and low-interest loans, both compensation-related and corporation-shareholder, are exempt from the imputation of interest and expenses if the aggregate amount on any day is $10,000 or less, unless a primary purpose of the loan is tax avoidance. Below-market loans with a business purpose are not subject to the provisions of the statute. Sales of property that provide for deferred payments, including unstated interest, are not within the scope of the statute. They are governed by the existing provisions relating specifically to such transactions.

Congress has extended the original interest discount rules to apply to all transactions under $2,000,000.[24] As long as the interest rate is nine percent on any transaction under $2,000,000 prior to July 1, 1985, there will be no imputed interest. If the interest rate is less than nine percent or is not stated at nine percent, or if the interest rate unstated or at a reduced rate is less than 110% of the applicable federal interest rate, interest will be imputed at 120% of the federal interest rate.

The new law applies to term loans made after June 6, 1984. The Deficit Reduction Act also applies to demand loans outstanding after June 6, 1984, but not to demand loans outstanding on June 6, 1984 that were repaid prior to September 16, 1984 (the 60th day after the date of enactment). The new rules do not apply to any loan made to nursing homes and continuing care facilities by residents of those facilities if payments were made prior to June 6, 1984.[25]

On November 1, 1984 the Internal Revenue Service issue Revenue Ruling 84-163. The Service stated:

> Recently enacted legislation (H.R. 5361) will affect sales or exchanges of property (other than new section 38 property) occurring from January 1 through June 30, 1985. This legislation establishes a testing rate (in lieu of 110 percent of the applicable federal rate) of 9 percent for such sales or exchanges *to the extent the stated principal amounts of all debt instru-*

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24. P.L. 98-612, 98 Stat. 3182, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS, amended section 44(b) of the Tax Reform Act of 1984. This amendment delayed implementation of the new imputed interest rates from January 1, 1984 to June 30, 1985, with respect to principal loans below $2,000,000.

25. The discretion of the Internal Revenue Service is invoked by the Conference Report accompanying the Act which states that no inference is intended respecting treatment of these payments after June 5, 1984. Any loan that is renegotiated, extended, or revised after June 6, 1984 is treated as a new loan.

ments arising from the same transaction do not exceed $2 million.[26]

Senator Robert Dole, Senate Majority Leader, in a letter to Assistant Treasury Secretary for Tax Policy Ronald Pearlman, expressed disapproval of one aspect of Revenue Ruling 84-163: "In my view the Congress did not intend the principal amount of otherwise exempt assumed loans to be aggregated with new debt for purposes of this temporary relief measure."[27]

V. Tax Planning After the Deficit Reduction Act

A. *Family Loans*

Intra-family interest-free loans may still be viable. A parent may make interest-free loans to a child, child's trustee or custodian to be invested for future college expenses; however, the amount of the loan will be limited to $10,000. Since a husband and wife are treated as one taxpayer under the statute, separate loans by each spouse will not increase the limitation. The use of an interest-free loan, as a substitute for a ten-year Clifford trust in order to accumulate savings for college education expenses has been restricted by the new law. Clifford trusts, spousal remainder trusts, and outright gifts will often be preferred as intra-family income shifting techniques.[28] Interest-free loans may still be advantageous where the borrower is in a higher income tax bracket than the lender. For example, if the lender is a corporation and the borrower an individual, both of whom are taxed at the highest current rate, the lender will be taxed on the imputed interest at forty-six percent, but the borrower will be able to deduct that interest against income taxed at fifty percent, resulting in a clear advantage.

Compensatory loans will still be viable as fringe benefits. If the employee is able to use the imputed interest deduction, it may be assumed that the imputed income will be fully offset by the deduction. The employer will recognize interest income, but will also receive an offsetting deduction for compensation treated as paid to the employee. If the employee's regular wages and compensation exceed the wage base for Social Security Tax, no employment tax would be payable. The tax liability on the imputed interest income

26. Rev. Rul. 84-163, 1984-47 I.R.B. 25 (emphasis added).

27. *Tax Administration: Dole Requests Treasury Guidance on Imputed Interest Provisions*, Daily Tax Report (BNA) No. 4, at G-3-5 (January 7, 1985).

28. *See* Braun v. Commissioner, 48 T.C.M. (CCH) 210 (1984), where trust income was held taxable to the grantor. The duty to support is extended to tuition, room and board for a private high school, college and post-graduate education.

will almost always be a lesser financial burden on the employee than the after-tax cost of paying the market rate interest on a loan.

Caution must be exercised in corporation-shareholder loans. The Internal Revenue Service is likely to treat the imputed payment to the shareholder as a non-deductible dividend rather than as deductible compensation. The Internal Revenue Service might challenge the deduction as constituting unreasonably excessive compensation. An interest-free loan could increase retirement benefits where an employer makes compensatory no-interest loans to key employees. The new rules on retirement benefits are computed on the basis of total compensation. The employer should review the impact of the new rules before making such loans. Where the interest on a loan is forgiven on an annual basis, the substance of the overall transaction may be the economic equivalent of a below-market loan and should be treated as such.

Short term trusts provide a viable alternative method of shifting income to family members.

B. *Clifford Trust*

The trust must last no less than a term extending beyond the lesser of the life of the income beneficiary or ten years and one day. The transfers to a Clifford trust are measured by the above criteria as each individual transfer occurs. Transfers to a Clifford trust are subject to the restrictions applicable to obligations of support of beneficiaries by the creator of the trust.[29] A gift tax is imposed on the income interest transferred.

C. *Spousal Remainder Trust*

One spouse funds the trust for the income beneficiary with the corpus transferred to the other spouse at the end of the designated period of time. This period may be less than the ten years and one day required for a Clifford trust. The legal title passes to the spouse at the end of a designated period, thus the change in ownership eliminates a need for a prescribed time period.[30]

VI. Conclusion

The Deficit Reduction Act of 1984 has substantially reduced the

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29. Helvering v. Clifford, 309 U.S. 331 (1940).

30. *Braun*, 48 T.C.M. (CCH) at 213. The obligation of support may apply to adult children.

availability of interest-free loans as a tax planning tool. There are still opportunities to employ interest-free loans in family transactions and employer-employee loans. Loans of $10,000 or less, aggregate loans of $100,000 under prescribed restrictions and loans between higher and lower bracket taxpayers are still viable methods for tax planning.

To shift large amounts of income to lower brackets, tax planners must now revert to the Clifford trust and the spousal remainder trust. When the income shift occurs, the transferor of the assets loses the dominion of the assets, together with the immediate accessibility of the assets to satisfy a financial crisis. Especially in the spousal remainder trust, the dominion over the assets is forever lost. The loss of ownership is balanced against the reduction in taxable income. The favorable income tax results outweigh the lack of dominion. These trusts will be used frequently as a consequence of the Deficit Reduction Act.