ACTEC Law Journal

Volume 42 | Number 1 Article 19

3-1-2016

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Description of the Case

The Dickmans were successful farmers and produce packagers in Florida. Paul and Esther Dickman, their son Lyle, Lyle's wife and Lyle's children owned Artesian Farm, Inc. Mr. and Mrs. Dickman made substantial loans to Lyle and Artesian Farm on an interest-free, demand basis.[1]

Mr. Dickman's death in 1976 brought the loans to the attention of the I.R.S. The I.R.S. treated the loans as taxable gifts of the value of the use of the loaned funds. It established that value by using the interest rates applicable under section 6621 to the underpayment of tax in the years the loans were outstanding.[2] The I.R.S. issued notices of gift tax deficiency to Mr. Dickman's estate and to his widow individually. The Eleventh Circuit agreed with the I.R.S.[3]

The Supreme Court granted certiorari to resolve a conflict between the Eleventh and Seventh Circuits.[4] The Seventh Circuit had sided with the taxpayer on the interest-free loan issue four years earlier in *Crown v. Commissioner*.[5] In *Dickman*, the Court resolved the circuit split by agreeing with the Eleventh Circuit, concluding that the right to use money is a property interest, that the gratuitous transfer of that right is a property transfer within the meaning of section 2501(a)(1), and that the gift tax value of that transfer is the reasonable value of the right to use the loaned funds.[6]

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1 Dickman v. Comm'r, 465 U.S. 330, 332 (1984).

2 *Id.*

3 Dickman v. Comm'r, 690 F.2d 812, 819-20 (11th Cir. 1982).

4 Dickman v. Comm'r, 459 U.S. 1199 (1983).

5 585 F.2d 234, 234-35 (7th Cir. 1978).

6 *Dickman*, 465 U.S. at 340-45.

WHAT HAS CHANGED SINCE *DICKMAN*?

Within a few months after *Dickman*, Congress enacted section 7872.[7] This section provided a framework for answering any valuation questions for most future interest-free and below-market demand loans that are gift loans.[8]

A demand loan is a below-market loan if interest on the loan is calculated at a rate lower than the applicable federal rate.[9] A loan is a gift loan if the lender's forgoing of interest is in the nature of a gift.[10] "Forgone interest" is the amount of interest that would have been charged on a demand loan if the lender had charged the applicable federal rate.[11] Section 7872 treats the "forgone" interest on a demand gift loan as a gift to the borrower from the lender of the amount of the forgone interest followed by a deemed payment of the interest amount to the lender as interest on the last day of each calendar year.[12] The applicable federal rate is the federal short-term rate determined under section 1274(d).[13]

The Joint Committee on Taxation's explanation of section 7872 states that the section is intended to supersede *Dickman*'s treatment of the amount of the gift attributable to an interest-free loan as the reasonable value of the loan by providing an objective set of rules for determining gift tax value.[14] Value is determined without regard to the actual fair market value of the note issued by the lender. The value of an impecunious child's unsecured demand note is determined in the same manner as that of a wealthy child's secured demand note.

Section 7872 applies to most, but not all, below-market loans. Subsection (f)(7) treats married spouses as one person. Presumably this means that section 7872 does not apply to interspousal loans. Subsection (c)(3) specifically excepts gift loans between individuals if the amount outstanding between the individuals is not more than $10,000. If a below-market loan is not covered by section 7872, it is unclear how

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7 Section 7872 is effective for term loans made after June 6, 1984 and for demand loans outstanding after that date. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 172(a), 98 Stat. 494.

8 Section 7872 also provides a set of rules for the gift tax treatment of below-market term loans and the income tax treatment of all below-market loans, subjects beyond the scope of this short commentary.

9 I.R.C. § 7872(e)(1).

10 § 7872(f)(3).

11 § 7872(e)(2).

12 § 7872(a).

13 § 7872(f)(2).

14 STAFF OF THE JOINT COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 529 (Comm. Print 1984).

it should be treated for gift tax purposes. So long as the lender is a United States citizen, the marital deduction should protect demand loans to the lender's spouse from the gift tax.[15] In theory, the I.R.S. could attempt to impose the *Dickman* rationale on loans of less than $10,000. Such an approach would be inconsistent with the policy, if not the letter, of section 7872, and there is no indication that the I.R.S. intends to take this position.

Strength of the Court's Analysis

The technical basis for the Supreme Court's *Dickman* decision seems sound. The imposition of a gift tax requires only that a transfer of property[16] be made for less than an adequate consideration in money or money's worth.[17] In order for the Supreme Court to conclude that the Dickmans' demand loans were subject to gift tax, it had to determine that the making of a demand loan is a transfer of property and that, when made on an interest free basis, is made for inadequate consideration in money or money's worth.

The Court considered the first requirement satisfied because, in its view, the revocable right to use valuable property, such as money, is a property interest, analogous to the use of real property under a tenancy at will.[18]

The second requirement was more difficult. Arguably, the value of the note issued by the borrower is equal to the amount of the loan because the lender can take back the funds at any time by demanding repayment. The Court treated this requirement as satisfied by characterizing a demand loan as an incomplete transfer, one over which the transferor had not yet relinquished dominion and control.[19] As the loan remains outstanding, the borrower "enjoys" the property within the meaning of Treasury Regulation section 25.2511-2(f), under which the enjoyment "operates to free . . . the . . . enjoyment from the [donor's] power and constitutes a gift of . . . [the] enjoyment."[20]

Importance of the Decision

Loans as an Estate Planning Technique. Intra-family loans are an important planning technique. To the extent the borrower is able to

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15 I.R.C. § 2523(a). Section 2523(i) disallows the marital deduction for transfers to spouses who are not U.S. citizens. Query whether the non-deductible terminable interest rule of section 2523(b) exposes an interest free interspousal term loan to gift tax?

16 § 2501(a)(1).

17 § 2512(b).

18 Dickman v. Comm'r, 465 U.S. 330, 337-38 (1984).

19 *Id.* at 338 n.7; *see* Treas. Reg. § 25-2511-2(b).

20 Treas. Reg. § 25-2511-2(f).

invest funds to achieve an investment return higher than the interest rate charged on the loan, assets are shifted on a gift-tax-free basis from the lender to the borrower. The chances of the strategy succeeding are enhanced if the loan is interest-free.

Although *Dickman* took away some of the advantage of intra-family loans, the prompt enactment of section 7872 gave clear guidance as to how the technique could be used without gift tax risk. Section 7872 eliminated the uncertainty as to how the borrower's note would be valued. If the interest rate is the federal short-term interest rate, the note's value is face value. If there is no interest, the amount of the gift is limited to the forgone interest.

When section 7872 was enacted, the applicable federal rate for short term loans was 10.78%.[21] Average prime rates were about 13%.[22] If a borrower could achieve a return equal to or better than prime, the loan would make good estate planning sense. Of course, if the lender knew that the loan would enable the borrower to make an investment, say in a family business with better than average expected growth potential, the loan would be even more attractive.

In August, 2016, the applicable federal rate for short term loans was only .56%.[23] In this environment, interest-free loans are a powerful estate planning tool.[24]

Application to Non-Cash Loans. The *Dickman* decision, section 7872 and the legislative history left open the question of how to treat loans of tangible property. Thirty-two years later, there has been no guidance on this point. The Court did characterize the grant by a parent to a child of the rent-free, indefinite use of commercial property as a transfer of a valuable property right.[25] But it also said that it assumed that the I.R.S. would not tax traditional familial transactions such as giving adult children the use of cars and vacation cottages. Additionally, the authority it cited in support of its conclusion that the right to use property was an interest in property dealt with the right to use property "to the exclusion of others."[26] Perhaps so long as the use right granted to a child is simply the right to share property with his or her parent and not the exclusive right to use it, the right does not rise to the dignity of a

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21 *Applicable Federal Rates for 1984*, EVANS-LEGAL.COM, http://evans-legal.com/dan/afr84.html (last visited Nov. 30, 2016).

22 *Prime Rate History*, FEDPRIMERATE.COM, http://www.fedprimerate.com/wall_street_journal_prime_rate_history.htm (last visited Nov. 30, 2016).

23 Rev. Rul. 2016-11, 2016-19 I.R.B. 717.

24 See Steven R. Akers & Philip J. Hayes, *Estate Planning Issues With Intra-Family Loans and Notes*, 38 ACTEC L.J. 51, 56 (2012) for an excellent discussion of the issues involved in intra-family loans.

25 Dickman v. Comm'r, 465 U.S. 330, 336-37 (1984).

26 *Id.* at 336; Passailaigue v. United States, 224 F.Supp. 682, 686 (M.D. Ga. 1963).

property right or is of such negligible value that its taxation is impractical.

The gift tax system relies on self-assessment for its operation, particularly in the case of undocumented transactions such as loans of tangible personal property. Until the I.R.S. addresses these matters, most taxpayers are likely to assume that they have no responsibility to report the value of loans of tangible property on their gift tax returns.

Risks of Reliance on Decisions When the I.R.S. Disagrees. The Supreme Court's decision in *Dickman* applied to the Dickmans and to all other taxpayers who had relied on the failure of the I.R.S. to challenge interest-free demand loans as well as the I.R.S.'s initial losses when it finally decided to challenge them.

During the first forty years of the gift tax,[27] the I.R.S. did not take the position that interest-free demand loans were taxable gifts. When it finally took this position in *Johnson v. United States*, in 1966,[28] it lost and waited six years before announcing its disagreement.[29] In 1977 and in 1978 it lost the issue in the Tax Court[30] and in the Seventh Circuit in *Crown v. Commissioner*.[31]

The Supreme Court in *Dickman* showed no sympathy for taxpayers who relied on the earlier administrative practice of the I.R.S. It reaffirmed statements made in prior decisions that "the Commissioner may change an earlier interpretation of the law, even if such a change is made retroactive. . . ."[32]

The retroactivity of the *Dickman* decision had draconian consequences for those taxpayers who had not reported their interest-free demand loans.[33] The I.R.S. took the position that these taxpayers were obligated to report their interest-free demand loans as gifts no matter how long ago they were made.[34] Not only did it publish a chart listing the interest rates taxpayers were required to use for the years starting as far back as 1939, it advised taxpayers with unreported interest-free de-

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27 Revenue Act of 1924, Pub. L. No. 68-176, ch. 234, § 300, 43 Stat. 253, 303-04, 313 (1925).

28 254 F. Supp. 73, 77 (N.D. Tex. 1966).

29 The I.R.S. announced disagreement with *Johnson* in Rev. Rul. 73-61, 1973-1 C.B. 73.

30 Crown v. Comm'r, 67 T.C. 1060, 1064 (1977).

31 Crown v. Comm'r, 585 F. 2d 234, 241 (7th Cir. 1978).

32 Dickman v. Comm'r, 465 U.S. 330, 343 (1984).

33 *See* Cohen v. Comm'r, 910 F. 2d 422, 423-28 (7th Cir. 1990) (requiring taxpayers to calculate gift tax on more than $69 million dollars' worth of gifts based on interest rates prescribed by Rev. Proc. 85-46 between 6% and 12%).

34 Rev. Proc. 85-46, 1985-2 CB 507, 508.

mand loans from earlier periods to obtain the appropriate interest rates by writing to the Associate Chief Counsel.[35]

The consequences of the retroactive application of *Dickman* are a reminder of the risk of reliance on prior administrative practices of the I.R.S. even if case law supports the taxpayer position.

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[35] *Id.* at 509.