

Notes

The Safe-Harbor Interest Rates Under Section 483 of the Internal Revenue Code: A Gift Tax Trap

I. INTRODUCTION

The use of an inappropriate interest rate on certain deferred sales transactions can create unforeseen gift tax consequences for related parties. Where one party sells property to a related party and the purchase price of the property is to be paid in installments, the relevant concern is the interest rate used to calculate the installment payments. Two interest rates are possible: one is the market interest rate; the other is the interest rate provided by section 483¹ of the Internal Revenue Code of 1954 (Code), which applies to certain deferred sales transactions similar to the one described above.² If the parties use the lower of the two interest rates, which presumably is the section 483 interest rate, then the Internal Revenue Service (IRS) might assert, as it did in *Ballard v. Commissioner*,³ that a taxable gift has been made based on the difference between the market interest rate and the section 483 interest rate.

Section 483, enacted as part of the Revenue Act of 1964,⁴ applies to certain sales or exchanges of real or personal property in which the purchase price of the property is to be paid in installments.⁵ Section 483 imputes a certain rate of interest to such deferred sales transactions in which the parties do not charge at least the interest rate specified by section 483.⁶ The rate of interest imputed under section 483 is unquestionably imputed for income tax purposes to ensure that the seller will recognize (pay income tax on) an appropriate amount of interest income.⁷

¹All section numbers used in this Note refer to the INTERNAL REVENUE CODE OF 1954 as amended.

²See I.R.C. § 483 (Supp. III 1985).

³53 T.C.M. (CCH) 323 (1987). See *infra* text accompanying notes 42-55.

⁴Revenue Act of 1964, Pub. L. No. 88-272, § 224, 78 Stat. 19, 77-78; see also H.R. REP. NO. 749, 88th Cong., 2d Sess. 1, 72, reprinted in 1964 U.S. CODE CONG. & ADMIN. NEWS 1313, 1380 [hereinafter H.R. REP. NO. 749]; S. REP. NO. 830, 88th Cong., 2d Sess. 1, 101, reprinted in 1964 U.S. CODE CONG. & ADMIN. NEWS 1673, 1774 [hereinafter S. REP. NO. 830].

⁵I.R.C. § 483(c) (Supp. III 1985).

⁶*Id.* § 483(a)-(b).

⁷H.R. REP. NO. 749, *supra* note 4, at 1380; S. REP. NO. 830, *supra* note 4, at 1774-75.

The controversy surrounding section 483 is whether, for gift tax purposes, interest is imputed using section 483 interest rates or potentially higher market interest rates such that the seller is deemed to have made a taxable gift if he does not charge at least the *market* rate of interest. For example, a seller of property falling within the scope of section 483 may charge the appropriate rate of interest under section 483 for income tax purposes, but be deemed to have made a taxable gift for gift tax purposes based on the difference between the rate he charged under section 483 and the higher market rate of interest.⁸ Therefore, if a transaction falls within the scope of section 483, and the seller charges the appropriate section 483 rate of interest, the seller will not have any income tax problems but may unexpectedly be faced with gift tax problems.

This Note will address the issue of whether the interest rate imputed under section 483 for income tax purposes is also the appropriate rate to impute for gift tax purposes where section 483 applies to a transaction. This Note will also examine the evolution of section 483 as it relates to the discrepancy between section 483 interest rates and market interest rates.⁹

II. SECTION 483—HOW IT OPERATES

Section 483 requires that a deferred sale of property transaction include an appropriate amount of interest so that the seller of the property will recognize interest income instead of capital gain income.¹⁰ Congress did not see any reason why taxpayers should not report amounts as interest income merely because they did not contractually provide for it in the contract.¹¹ For example, suppose the taxpayer sells an asset with a basis and fair market value of \$1000 for \$1300 payable over ten years with no interest. Over the ten year period, the taxpayer would report \$300 [\$1300-\$1000] of capital gain income. If the taxpayer had sold the asset for its fair market value and had charged interest of \$300, the taxpayer would have recognized \$300 of ordinary interest income and no capital gain.¹²

⁸See *infra* text accompanying notes 36-41.

⁹Consequently, this Note will not discuss the original issue discount (OID) rules or section 7872 in any great detail. See *infra* text accompanying notes 194-206.

¹⁰H.R. REP. NO. 749, *supra* note 4, at 1381; S. REP. NO. 830, *supra* note 4, at 1775; 5 Fed. Taxes (P-H) ¶ 20,921 (1987). See *infra* note 70.

¹¹H.R. REP. NO. 749, *supra* note 4, at 1381; S. REP. NO. 830, *supra* note 4, at 1775.

¹²H.R. REP. NO. 749, *supra* note 4, at 1380; S. REP. NO. 830, *supra* note 4, at 1774-75.

Section 483(a)¹³ states that a portion of the amount of interest, which should have been specified in the contract but was not, will be allocated to each payment under a contract for the sale or exchange of property. Section 483(b)¹⁴ provides the method for calculating unstated interest, which is the total amount of interest that should have been specified in the contract but was not. Section 483(b) states that the sum of the payments that are due under the contract (not including interest payments) less the present value¹⁵ of all payments due under the contract (including interest payments) equals the total unstated interest.¹⁶ Section 483(c)¹⁷ specifies the payments to which section 483 applies: any payment

¹³I.R.C. § 483(a) (Supp. III 1985) provides:

§ 483. Interest on certain deferred payments

(a) Amount constituting interest

For purposes of this title, in the case of any payment—

(1) under any contract for the sale or exchange of any property, and

(2) to which this section applies,

there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

¹⁴*Id.* § 483(b) provides:

(b) Total unstated interest

For purposes of this section, the term “total unstated interest” means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of the preceding sentence, the present value of a payment shall be determined under the rules of section 1274(b)(2) using a discount rate equal to the applicable Federal rate determined under section 1274(d).

¹⁵The present value of an annuity of \$1 per period for n periods is determined by the formula:

$$1 - \frac{1}{(1 + k)^n}$$

k

where n = number of periods, and k = interest rate. L. LIPKIN, I. FEINSTEIN & L. DERRICK, ACCOUNTANT'S HANDBOOK OF FORMULAS AND TABLES 16 (P-H 2d ed. 1973).

¹⁶See Treas. Reg. § 1.483-1(c) (as amended in 1981); see also Carlson, *Income Tax Blue Law: Imputation of Interest Under Section 483*, 34 TAX L. REV. 187, 188 (1979).

¹⁷I.R.C. § 483(c) (Supp. III 1985), which provides in relevant part:

(c) Payments to which subsection (a) applies

(1) In general

Except as provided in subsection (d), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

under a contract for the sale or exchange of property where the payment is due more than six months later, where at least some payments under the contract are due more than a year later, and where there is unstated interest.¹⁸

Example 1.—The contract sales price is \$6000 with a payment of \$2000 to be received by the seller at the end of each year for three years with no interest. Assume interest under section 483 is to be imputed at a rate of six percent compounded annually. The total payment due under the contract is \$6000. The present value of all payments made under the contract at six percent interest would be $\$2000 \times 2.6730^{19} = \5346 . Total unstated interest would therefore be computed as follows:

Total payments	\$6000
Less:	
Present value	<u>\$5346</u>
Total unstated interest ²⁰	\$654

Thus, for income tax purposes, the total principal payments would be \$5346 and the total interest payments would be \$654.²¹ Instead of recognizing no ordinary interest income, the seller would recognize \$654 of ordinary interest income in accordance with section 483.²²

Example 2.—The contract sales price is \$6000 with a payment of \$2245 to be received by the seller at the end of each year for three years or a total of \$6735. The payments are computed using a six percent interest rate compounded annually. Thus, \$6000 would be principal and \$735 would be “stated interest.” Assuming that the section 483 interest rate is six percent compounded annually, unstated interest would be computed as follows:

Total payments	\$6000
Less:	
Present value [$\$2245 \times 2.6730 =$]	<u>\$6000</u>
Total unstated interest ²³	\$0

(A) under which some or all of the payments are due more than 1 year after the date of such sale or exchange, and

(B) under which there is total unstated interest.

(2) Treatment of other debt instruments

For purposes of this section, a debt instrument of the purchaser which is given in consideration for the sale or exchange of property shall not be treated as a payment, and any payment due under such debt instrument shall be treated as due under the contract for the sale or exchange.

¹⁸*Id.*

¹⁹The present value of an annuity of \$1 at the end of a year for three years using a six percent interest rate is \$2.6730. See *supra* note 15.

²⁰I.R.C. § 483(b) (Supp. III 1985).

²¹*Id.* § 483(a).

²²*Id.*

²³*Id.* § 483(b).

Hence, in this example, section 483 would impute no additional ordinary interest income to the seller.²⁴

Example 3.—The same facts as in Example 2 apply except that the section 483 imputed rate is nine percent compounded annually, and only a six percent interest rate compounded annually is used to compute payments. Unstated interest would be computed as follows:

Total payments	\$6000
Less:	
Present value [$\$2245 \times 2.5313^{25} =$]	<u>\$5683</u>
Total unstated interest ²⁶	\$317

Therefore, unstated interest would be \$317,²⁷ stated interest would be \$735, and principal payments would be \$5683, for a total payment of principal and interest of \$6735. The seller would recognize an additional \$317 of ordinary interest income as a result of the application of section 483.²⁸

III. GIFT TAX PROBLEMS

A. Gift Transactions

Generally, a federal gift tax is imposed on all direct or indirect gift transfers.²⁹ When property is transferred for less than a full and adequate consideration in money or money's worth, the difference between the fair market value of the property and the value of the consideration will be subject to gift taxation.³⁰ However, the regulations prescribed by the Secretary of the Treasury provide that "a sale, exchange, or other transfer of property if made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."³¹ Therefore, if an insubstantial interest rate is charged on a deferred sales transaction, the transaction will be subject to gift taxation because there will be less than a full and adequate consideration received, unless the transaction is determined to have been "made in the ordinary course of business."³² The question of how substantial an interest rate must be is therefore of prime importance.

²⁴*Id.* § 483(a).

²⁵The present value of an annuity of \$1 at the end of a year for three years using a nine percent interest rate is \$2.5313. See *supra* note 15.

²⁶I.R.C. § 483(b) (Supp. III 1985).

²⁷*Id.*

²⁸*Id.* § 483(a).

²⁹I.R.C. § 2511(a) (1982).

³⁰*Id.* § 2512(b); Treas. Reg. § 25.2512-8 (1958).

³¹Treas. Reg. § 25.2512-8 (1958).

³²*Id.*

The Internal Revenue Service and courts generally presume that a transfer of property for less than fair market value made between closely related parties involves a gift,³³ where the parties are unrelated, however, generally no gift is found.³⁴ Courts also usually find that unrelated party transactions are "made in the ordinary course of business" and not subject to gift taxation.³⁵ Therefore, gift tax problems arise most often only if the parties are related and will probably not arise where unrelated parties enter into deferred sales transactions under section 483.

Example 4.—The contract sales price and fair market value of property transferred by the seller is \$6000 with a payment of \$2245 to be received by the seller at the end of each year for three years or a total of \$6735. The payments are computed using a six percent interest rate compounded annually. Thus, \$6000 would be principal and \$735 would be "stated interest." Assume that the section 483 interest rate is six percent and the market interest rate is nine percent both compounded annually. As in Example 2, unstated interest under section 483 would be zero, and section 483 would impute no additional ordinary interest income to the seller.³⁶ If section 483 interest rates are used to value the consideration received by the seller for gift tax purposes,³⁷ the gift would be computed as follows:

Fair market value of property	\$6000
Less:	
Value of consideration discounted using a six percent interest rate [$\$2245 \times 2.6730^{38} =$]	\$6000
Value of gift ³⁹	\$0

³³See, e.g., *Heringer v. Commissioner*, 235 F.2d 149, 151 (9th Cir. 1956) (the family context of a transfer of property without consideration by family members to a 100% family owned corporation created a presumption of a gift); *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 201 (1970) (presumption that a transfer of units in a voting trust to family members in exchange for promissory notes is a gift).

³⁴See, e.g., *Weller v. Commissioner*, 38 T.C. 790 (1962) (sale of a 2% interest in a partnership to an unrelated person for less than fair market value did not constitute a taxable gift); *Estate of Anderson v. Commissioner*, 8 T.C. 706 (1947) (value of stock transferred to unrelated parties was greater than consideration received, but transfers were made in the ordinary course of business and not subject to gift taxation).

³⁵See *Weller*, 38 T.C. at 806.

³⁶See *supra* text accompanying notes 23-24.

³⁷See *Joyce & Del Cotto, Interest-Free Loans: The Odyssey of a Misnomer*, 35 TAX L. REV. 459, 463 (1980) (no reason exists why section 483 would not apply where *A* intends to make a gift to *B* of a portion of the goods transferred; unstated interest under section 483 is also the amount of the gift).

³⁸See *supra* note 19.

³⁹I.R.C. § 2512(b) (1982); Treas. Reg. § 25.2512-8 (1958).

However, if market interest rates are used to value the consideration received by the seller for gift tax purposes, the gift would be computed as follows:

Fair market value of property	\$6000
Less:	
Value of consideration discounted using a nine percent interest rate [\$2245 × 2.5313 ⁴⁰ =]	\$5683
Value of gift ⁴¹	\$317

Thus, even if the section 483 interest rate is used to calculate the payments to be received by the seller, a taxable gift will be computed if a higher market interest rate should have been used to value the consideration received by the seller for gift tax purposes.

B. Ballard v. Commissioner

Ballard v. Commissioner,⁴² a recently decided United States Tax Court case, illustrates the inequities that result when section 483 applies to a transaction and when market interest rates are used to compute a taxable gift because related parties are involved. In *Ballard*, the taxpayer sold her farm to her three children in June 1981 under a deferred sales contract where the principal amount of the payments was \$386,000. The rate used to discount the payments was six percent simple interest, the minimum or "safe-harbor" rate⁴³ prescribed by section 483 in June 1981.⁴⁴ Because the present value of the payments using a six percent interest rate was also \$386,000, there was no unstated interest and no additional interest income to recognize.⁴⁵

The taxpayer, who relied upon the section 483 rate for gift tax purposes as well as income tax purposes, contended that the six percent rate under section 483 should be applicable for gift tax purposes as well as income tax purposes.⁴⁶ In structuring the transaction, the taxpayer made the following calculation:

⁴⁰See *supra* note 25.

⁴¹I.R.C. § 2512(b) (1982); Treas. Reg. § 25.2512-8 (1958).

⁴²53 T.C.M. (CCH) 323 (1987).

⁴³The phrase "safe-harbor" rate refers to the lowest interest rate that can be used in structuring a deferred sales transaction without section 483 imputing a higher rate.

⁴⁴Treas. Reg. § 1.483-1(d)(1)(ii)(B) (as amended by T.D. 7394, 1976-1 C.B. 135).

⁴⁵I.R.C. § 483(b) (1976).

⁴⁶*Ballard*, 53 T.C.M. (CCH) at 324.

Fair market value of farm	\$570,000 ⁴⁷
Less:	
Value of consideration discounted using a six percent interest rate	<u>\$386,000⁴⁸</u>
Value of gift ⁴⁹	\$184,000

The taxpayer filed a gift tax return, but calculated that she owed no gift tax after available credits and exclusions.⁵⁰

The IRS contended that for gift tax purposes, the taxpayer should have used the market interest rate on the date of transfer—eighteen percent.⁵¹ The present value of the payments due under the contract discounted at an eighteen percent rate was not \$386,000, but approximately \$134,000.⁵² As a result, the IRS calculated the value of the gift as follows:

Fair market value of farm	\$570,000
Less:	
Value of consideration discounted using an eighteen percent interest rate	<u>\$134,000</u>
Value of gift ⁵³	\$436,000

The taxpayer would then owe, after exclusions and credits, a staggering \$84,000 gift tax liability instead of no gift tax liability.⁵⁴ The United States Tax Court held in favor of the IRS.⁵⁵

C. Consequences of Failing to File a Gift Tax Return

There is no statute of limitations for assessing gift tax when no gift tax return is filed.⁵⁶ In the *Ballard* case, the taxpayer filed a gift tax return. Thus, it was upon audit of the gift tax return that the IRS

⁴⁷*Id.* at 323.

⁴⁸*Id.*

⁴⁹I.R.C. § 2512(b) (1976); Treas. Reg. § 25.2512-8 (1958).

⁵⁰Total exclusions were \$9000 because there were three donees. *See* I.R.C. § 2503(b) (1976) (in 1981, there was a \$3000 exclusion per donee per year from the taxable gift). Hence, the taxable gift was reduced by \$9000 from \$184,000 to \$175,000. The gift tax liability on \$175,000 in 1981 was approximately \$47,000. *Id.* § 2001(c). The gift tax liability was then reduced by the unified credit against gift tax, which in 1981 was \$47,000. *Id.* § 2505(b). Therefore, the taxpayer calculated that she owed no gift tax.

⁵¹*Ballard*, 53 T.C.M. (CCH) at 324.

⁵²*Id.*

⁵³I.R.C. § 2512(b) (1976); Treas. Reg. § 25.2512-8 (1958).

⁵⁴*Ballard*, 53 T.C.M. (CCH) at 324; *see also* I.R.C. §§ 2001(c), 2502(a), 2503(b), 2505 (1976).

⁵⁵*Ballard*, 53 T.C.M. (CCH) at 327.

⁵⁶I.R.C. § 6501(c)(3) (1982).

determined a gift tax deficiency. Other taxpayers may have structured transactions similar to the one in *Ballard* except that these other taxpayers, who relied on section 483 rates for gift tax purposes, structured their transactions so that they computed no gift tax liability. Consequently, they would have filed no gift tax returns. If the IRS determines anytime in the future that in fact a gift was made at the time of the transactions because market interest rates that exceeded section 483 interest rates should have been used, the IRS will thus be able to assess the tax at that future time because no statute of limitations applies to unfiled tax returns.⁵⁷ It would be quite a shock for taxpayers to expect no gift tax liability and then be informed years later that they owe a substantial amount of gift taxes, interest, and penalties.

IV. CONTRAST BETWEEN SECTION 483 AND LOAN TRANSACTIONS

Section 483 applies to *sales or exchanges* of property under a deferred-payment contract⁵⁸ and to payments due under debt instruments given in consideration for the *sale or exchange* of property.⁵⁹ In other words, section 483 does not apply to pure loans where there is no sale or exchange of property.

A term loan is a loan that will remain outstanding for a *fixed* term.⁶⁰ That is, the borrower receives the right to use the money for a certain period of time.⁶¹ A term loan is treated as a below-market loan if the amount of the loan exceeds the present value of all payments due under the loan.⁶² This is similar to the way unstated interest is computed under section 483.⁶³ Payments made under section 483 are actually in the nature of payments under a term loan because the payments occur for a fixed term.⁶⁴ In contrast to a term loan, a demand loan remains outstanding not for a fixed term but only until the lender demands repayment.⁶⁵

Although the *Ballard* case is the first to address the gift tax ramifications of below-market interest deferred sales transactions that fall under section 483, there are cases that have addressed the gift tax

⁵⁷*Id.*

⁵⁸I.R.C. § 483(c)(1) (Supp. III 1985). See *supra* text accompanying notes 17-18.

⁵⁹I.R.C. § 483(c)(2) (Supp. III 1985). See *supra* text accompanying notes 17-18.

⁶⁰Breitbard, Mattachione & Hasting, *Interest-Free Loans: The Battle Continues*, 42 INST. ON FED. TAX'N §§ 53.01, 53.02[3] (1984).

⁶¹Joyce & Del Cotto, *supra* note 37, at 459.

⁶²I.R.C. § 7872(e)(1)(B) (Supp. III 1985); Hartigan, *New Law Introduces Major Income and Gift Tax Consequences for Interest-Free Loans*, 13 TAX'N FOR LAW. 116, 118 (1984).

⁶³See I.R.C. § 483(b) (Supp. III 1985). See *supra* text accompanying notes 14-16.

⁶⁴See I.R.C. § 483(a) (Supp. III 1985). See *supra* text accompanying note 13.

⁶⁵Breitbard, Mattachione & Hasting, *supra* note 60, at § 53.02[3].

ramifications of below-market interest demand and term loans.⁶⁶ Because section 483 does not concern below-market loans, the cases relating to below-market demand and term loans did not resolve the issue presented in *Ballard*.

V. IRS POSITION

In 1975, the IRS first addressed the gift and estate tax ramifications of section 483 in internally created General Counsel Memorandum (GCM) 36,355.⁶⁷ In its memorandum, the IRS initially stated, "By its terms, this section [483] applies to the entire Code, Title 26 of the United States Code."⁶⁸ The IRS continued, "The statute is unambiguous on its face, however, and its provisions clearly extend to all parts of the Code, including the estate and gift tax provisions."⁶⁹ The IRS position against the use of section 483 rates for estate and gift tax purposes is based on the fact that section 483 is a remedial measure designed only to prevent the seller of property from converting what would otherwise be ordinary interest income into capital gain income.⁷⁰ The IRS also stated:

The remedy imposed by Code § 483 is to treat part of the amount stated to be principal as interest for purposes of the Federal Income tax. . . . Thus, while Code § 483 is by its terms applicable to the entirety of Title 26, it is actually directed at Subtitle A [the income tax subtitle] of Title 26.⁷¹

⁶⁶At first, courts held that below-market demand loans created no gift tax consequences. See *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966); *Crown v. Commissioner*, 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978). The IRS, however, maintained that such demand loans did carry gift tax consequences. Rev. Rul. 73-61, 1973-1 C.B. 408, 409. The United States Supreme Court resolved the issue in *Dickman v. Commissioner*, 465 U.S. 330 (1984), *aff'g* 690 F.2d 812 (11th Cir. 1982), holding that below-market demand loans do create gifts of the reasonable value of the use of the money lent. *Id.* at 344. The dissenting opinion in *Dickman*, however, indicated that the complexity of the gift tax computation imposes a heavy burden on taxpayers who conscientiously try to adhere to the Code. *Id.* at 347 (Powell, J., dissenting).

Below-market term loans were not quite as controversial as below-market demand loans. The IRS view is that below-market term loans involve gift tax ramifications. Rev. Rul. 73-61, 1973-1 C.B. 408, 409. The court in *Estate of Berkman v. Commissioner*, 38 T.C.M. (CCH) 183 (1979), agreed with this position, holding that below-market term loans not made at arm's length involve gifts of the difference between the fair market value of the property and the fair market value of the consideration received by the donor. *Id.* at 186.

⁶⁷Gen. Couns. Mem. 36,355 (Aug. 4, 1975). GCM's are not to be relied upon or otherwise cited as precedent by taxpayers. *Id.*

⁶⁸*Id.*

⁶⁹*Id.*

⁷⁰*Id.* Capital gain income is still distinct from ordinary income even after the Tax Reform Act of 1986 became effective because capital losses are deductible only to the extent of capital gain income plus \$3000 of ordinary income. See I.R.C. § 1211(b) (1982).

⁷¹Gen. Couns. Mem. 36,355 (Aug. 4, 1975).

In short, the IRS asserted that section 483 should apply only for income and not gift tax purposes. However, the IRS contradicted itself by asserting that section 483 applies to the entire Code while simultaneously arguing that it applies only to the income tax subtitle.

The IRS also cited *Blackburn v. Commissioner*⁷² in GCM 36,355. In this case, the taxpayer sold property having a fair market value of \$245,000 to related parties in exchange for a note with a face amount of approximately \$173,000. The taxpayer contended that the amount of the gift was the difference between the fair market value of the property and the face amount of the note. The note bore interest at a rate of two and one-quarter percent payable in monthly installments of \$600 over a period of thirty-four years and six months. Similarly to the way unstated interest is computed under section 483, the IRS discounted the note at a four percent interest rate (the usual rate of interest charged on such transactions at that time) to determine the value of the consideration, which turned out to be approximately \$135,000. The IRS therefore computed the gift to be the difference between \$245,000 and \$135,000 instead of \$245,000 and \$173,000, as the taxpayer contended. In other words, the difference in the present value of the note using a two and one-quarter percent interest rate and a four percent interest rate amounted to a \$38,000 [\$173,000 - \$135,000] increase in the taxable gift. The United States Tax Court held for the IRS.⁷³ Thus, the IRS asserted in this GCM that market interest rates are to be used in determining the gift tax consequences of deferred sales transactions as they were in *Blackburn*.⁷⁴ The *Blackburn* case was decided in 1953; section 483 was not promulgated until 1964.⁷⁵ In 1953, there was no section 483 rate that could have been imputed. Therefore, *Blackburn* should not be determinative of the issue presented in *Ballard*.

However the court in *Ballard* relied heavily on *Blackburn*, asserting that the basic valuation principle followed in *Blackburn* was not affected by section 483.⁷⁶ The court noted that if valuation of a note for gift tax purposes could be accomplished using section 483 instead of market interest rates, then Congress specifically would have mentioned such a use in the legislative history to section 483.⁷⁷ However, Congress may not have anticipated such a problem. What Congress did anticipate was that the rate under section 483 would "reflect the going rate of interest."⁷⁸

⁷²20 T.C. 204 (1953).

⁷³*Id.* at 207.

⁷⁴Gen. Couns. Mem. 36,355 (Aug. 4, 1975).

⁷⁵See Revenue Act of 1964, Pub. L. No. 88-272, § 224, 78 Stat. 19, 77-78.

⁷⁶53 T.C.M. (CCH) 323, 326-27 (1987).

⁷⁷*Id.* at 327.

⁷⁸H.R. REP. No. 749, *supra* note 4, at 1381; S. REP. No. 830, *supra* note 4, at 1775. See *infra* text accompanying notes 147-48.

The controversy in *Ballard* arose only because of the eventual discrepancy between section 483 and market interest rates. Furthermore, while Congress may not have mentioned specifically the use of section 483 for gift tax valuation purposes in the 1964 legislative history of the section, Congress did suggest the use of section 483 for valuation purposes in the 1981 legislative history of the section.⁷⁹

The IRS specifically addressed the issue of the section 483 rate of interest also being a "safe-harbor" rate of interest for purposes of the gift tax subtitle in another internally created document—Private Letter Ruling (PLR) 77-46-002.⁸⁰ The IRS adopted a similar stance in this PLR to that it had previously taken in the GCM.⁸¹ In this PLR, the IRS stated that the "fair market value of property is not affected by its designation for income tax purposes."⁸² In other words, the designation of a portion of the payments as interest or principal under section 483 is not relevant to the determination of whether a gift was made for purposes of the gift tax subtitle. The IRS position is that the fair market value of the consideration received by the seller should always be determined using market interest rates for gift tax purposes.⁸³ Section 483 merely mandates what portion of the payments is treated as interest for income tax purposes.⁸⁴ It is section 2512⁸⁵ and not section 483, the IRS maintained, that determines how large the total payments must be regardless of what portion of the payments section 483 designates as interest.⁸⁶

By 1984 the IRS position toward section 483 had changed as indicated in two more internally created memoranda, which suggests the weakness of its position in the first two memoranda. In Technical Advice Memorandum (TAM) 85-05-005,⁸⁷ the issue was whether a note should be valued by reference to its face value instead of its fair market value

⁷⁹See *infra* text accompanying notes 164-70.

⁸⁰Priv. Ltr. Rul. 77-46-002 (July 29, 1977). As with GCM's, PLR's are not to be used or cited as precedent. *Id.*; see also I.R.C. § 6110(j)(3) (1982).

⁸¹See *supra* text accompanying notes 68-71.

⁸²Priv. Ltr. Rul. 77-46-002 (July 29, 1977).

⁸³*Id.*

⁸⁴*Id.*

⁸⁵I.R.C. § 2512 (1982), which provides in relevant part:

§ 2512. Valuation of gifts

(a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

⁸⁶Priv. Ltr. Rul. 77-46-002 (July 29, 1977).

⁸⁷Tech. Adv. Mem. 85-05-005 (Sept. 27, 1984). This TAM is not to be relied upon or cited as precedent by taxpayers. I.R.C. § 6110(j)(3) (1982).

using prevailing market interest rates for purposes of section 301, which concerns distributions to a shareholder by a corporation. The taxpayer argued that no discount can be made for the discrepancy in interest rates when the "safe-harbor" rate of section 483 is met.⁸⁸ The ruling stated that section 483 applies for all purposes of the Code.⁸⁹ The ruling further stated that section 483 appears to proceed from the assumption that the parties are dealing at arm's length.⁹⁰ When the parties are unrelated, it can be assumed that market forces determined the sale price and interest rate and that there is thus no other component such as a gift.⁹¹ It can be argued, the ruling continued, that it is necessary to use prevailing market rates to determine whether related party transactions have a gift component.⁹² However, the ruling contended that the principal objection to this argument is that there is no evidence that there is a related party exception to section 483.⁹³ In other words, there is no indication that related parties should face gift taxation, as a result of the application of section 483, where unrelated parties would not. The ruling further contended that section 483(b) was designed to afford taxpayers "a degree of certainty in structuring their transactions. Related taxpayers need certainty as much as unrelated taxpayers, and . . . there is no evidence that Congress intended to impose a greater burden on them."⁹⁴ The ruling concluded with the language that "the 'safe-harbor' rate of section 483 governs in sales of property for all purposes of the code."⁹⁵ Therefore, notes bearing interest at the section 483 prescribed "test rate"⁹⁶ should have a fair market value equal to their face value.⁹⁷

In GCM 39,331,⁹⁸ the issue was whether the section 483 rate rather than the prevailing market rate was the appropriate rate to use in valuing a note given in exchange for property in a related party transaction. The memo quoted the same arguments used in TAM 85-05-005.⁹⁹ The GCM then discussed *Caruth v. United States*,¹⁰⁰ in which the issue was

⁸⁸Tech. Adv. Mem. 85-05-005 (Sept. 27, 1984).

⁸⁹*Id.*

⁹⁰*Id.*

⁹¹*Id.* See *supra* text accompanying notes 33-35 and *infra* text accompanying notes 172-76.

⁹²Tech. Adv. Mem. 85-05-005 (Sept. 27, 1984).

⁹³*Id.*

⁹⁴*Id.*

⁹⁵*Id.*

⁹⁶"Test rate" can be used interchangeably with "safe-harbor" rate. See *supra* note 43.

⁹⁷Tech. Adv. Mem. 85-05-005 (Sept. 27, 1984).

⁹⁸Gen. Couns. Mem. 39,331 (Jan. 23, 1985). This GCM is not to be relied upon or cited as precedent by taxpayers. *Id.*

⁹⁹See *supra* text accompanying notes 89-94.

¹⁰⁰411 F. Supp. 604 (N.D. Tex. 1976), *rev'd on other grounds*, 566 F.2d 901 (5th Cir. 1978).

whether the present value of non-interest bearing notes calculated in accordance with section 483 rates was to be treated as the fair market value for purposes of determining the "amount realized" under section 1001.¹⁰¹ The court looked to the interplay between the Code and the income tax regulations prescribed by the Secretary of the Treasury in order to reach its decision.¹⁰² The court held the present value of the non-interest bearing notes for section 483 purposes to be the fair market value of the notes for purposes of determining the amount realized under section 1001(b).¹⁰³ Although the Fifth Circuit did not reach this issue, it did express its difficulty with the trial court's holding. The Fifth Circuit noted that there was no indication that Congress intended to amend section 1001 by adopting section 483.¹⁰⁴ Likewise, the court in *Ballard* expressed difficulty with a similar argument in the *Ballard* case.¹⁰⁵ The court in *Ballard* stated that the "legislative history under section 483 gives no indication that Congress intended to amend the general principles of section 2512 by its adoption of section 483."¹⁰⁶

While the 1964 legislative history of section 483 does not specifically state that section 483 is an exception to section 2512,¹⁰⁷ section 483 appears to be such an exception.¹⁰⁸ It certainly is not clear. Furthermore, doubtful situations are to be construed in the taxpayer's favor.¹⁰⁹ Also, the 1981 legislative history of section 483 does suggest that section 483 may be an exception to section 2512.¹¹⁰ As the trial court in *Caruth* reasoned, the present value of the notes for section 483 purposes should be the fair market value of the notes for gift tax purposes. That is, the present value of the notes should be determined using section 483 rates even for gift tax purposes if section 483 applies to the transaction.

VI. TAXPAYER POSITION

A. Statutory Construction

The wording of a statute is very important in determining its meaning because the starting point for construction of a statute is the language

¹⁰¹*Id.* Section 1001 describes the determination of the amount of and recognition of gain or loss on sales transactions. See I.R.C. § 1001 (1982 & Supp. III 1985).

¹⁰²*Caruth*, 411 F. Supp. at 607.

¹⁰³*Id.* at 608.

¹⁰⁴*Caruth*, 566 F.2d at 905.

¹⁰⁵See *supra* text accompanying notes 42-55.

¹⁰⁶53 T.C.M. (CCH) 323, 326 (1987).

¹⁰⁷See *supra* note 30 and accompanying text.

¹⁰⁸See *supra* text accompanying notes 78-79 and *infra* text accompanying notes 152-53.

¹⁰⁹See *infra* text accompanying note 127.

¹¹⁰See *infra* text accompanying notes 164-70.

of the statute itself.¹¹¹ As a result, the wording of section 483 should be examined carefully. Where a statute is clear on its face, unequivocal evidence of legislative purpose is required to override the plain meaning of the words used in the statute.¹¹² Furthermore, words are to be given their ordinary meaning unless intent to the contrary is shown.¹¹³

Congress has amended section 483 three times in the last five years,¹¹⁴ but each time it has retained the same introduction—"For purposes of this title . . ."¹¹⁵ Section 483(a) states that "[f]or purposes of this *title*," payments to which this section applies shall be divided into interest and principal.¹¹⁶ The word "title" refers to Title 26 of the United States Code (U.S.C.) in which the Internal Revenue Code of 1954 (Code) is codified.¹¹⁷ The Code is broken down into subtitles, chapters, subchapters, parts, sections, and subsections. The word title therefore includes the gift tax portion of the Code, Subtitle B, Chapter 12.¹¹⁸ Furthermore, the regulations prescribed by the Secretary of the Treasury (Treasury Regulations) provide that interest imputed under section 483 constitutes interest for all purposes of the Code.¹¹⁹ Despite the fact that section 483 is in the income tax subtitle, Subtitle A, the plain language of section 483 states that it applies for purposes of this "title"¹²⁰—not for purposes of this "subtitle."¹²¹ There are several code sections in the income tax subtitle that begin with the words "[f]or purposes of this subtitle . . ."¹²² Presumably, the application of these sections would

¹¹¹*See, e.g.,* Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980); United States v. W.M. Webb, Inc., 402 F.2d 956, 959 (5th Cir. 1968), *rev'd on other grounds*, 397 U.S. 179 (1969); United States v. Northumberland Ins. Co., 521 F. Supp. 70, 76 (D.N.J. 1981).

¹¹²*See, e.g.,* Ken-Rad Tube & Lamp Corp. v. Commissioner, 180 F.2d 940, 942 (6th Cir. 1950); Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33, 36 (6th Cir. 1945); Huntsberry v. Commissioner, 83 T.C. 742, 747-48 (1984).

¹¹³*See, e.g.,* Perrin v. United States, 444 U.S. 37, 42 (1979); Hanover Bank v. Commissioner, 369 U.S. 672, 687 (1961); Crane v. Commissioner, 331 U.S. 1, 6 (1946); United States v. Brown Wood Preserving Co., 275 F.2d 525, 528 (6th Cir. 1960); William Powell Co. v. United States, 524 F. Supp. 841, 845 (S.D. Ohio 1981); Greer v. United States, 269 F. Supp. 801, 803 (E.D. Tenn. 1967), *aff'd*, 408 F.2d 631 (6th Cir. 1969).

¹¹⁴*See infra* notes 154, 184, 207 and accompanying text.

¹¹⁵*Compare* I.R.C. § 483(a) (Supp. III 1985) *with* I.R.C. § 483(a) (Supp. II 1984) *and* I.R.C. § 483(a) (1982) *and* I.R.C. § 483(a) (1976).

¹¹⁶I.R.C. § 483(a) (Supp. III 1985) (emphasis added). *See supra* text accompanying note 13.

¹¹⁷26 U.S.C. §§ 1-9602 (1982 & Supp. III 1985).

¹¹⁸*Id.* §§ 2501-2524.

¹¹⁹Treas. Reg. § 1.483-2(a)(1)(i) (1966); *see also* Carlson, *supra* note 16, at 192-93.

¹²⁰I.R.C. § 483(a) (Supp. III 1985).

¹²¹*See supra* note 13 and *infra* text accompanying note 122.

¹²²*See, e.g.,* I.R.C. §§ 62-65, 152, 1221-1223 (1982 & Supp. III 1985).

be limited to Subtitle A. Section 7872,¹²³ for example, which is in Subtitle F, also begins with the words “[f]or purposes of this title”¹²⁴ and is not limited to the particular section, chapter or even subtitle in which it is found. For instance, section 7872(d)(2) makes a reference to the application of section 7872 for purposes of Chapter 12, which is in Subtitle B.¹²⁵ Merely because section 483 is in the income tax subtitle does not mean that it cannot apply to the gift tax subtitle. The Code itself provides that no inference, implication, or presumption of legislative construction shall be made or drawn by reason of the location of any particular section.¹²⁶

In ambiguous situations, courts have held that the taxpayer is entitled to the benefit of the doubt.¹²⁷ Therefore, taxpayers who rely on the language in section 483, which states that it applies for purposes of this title, and structure their tax transactions to avoid incurring a gift tax should be given the benefit of the doubt if these words in the statute are found to be ambiguous.

The following two cases demonstrate that courts have applied section 483 to other Code sections. In *Robinson v. Commissioner*,¹²⁸ the issue was whether section 483 applied to section 453(b),¹²⁹ a provision concerning installment sales. The court reasoned that section 483 applies to section 453(b) because the provisions of section 483 are to apply “for purpose[s] of this title.”¹³⁰ The court stated that “inherent in the issue presented is the question of the scope of section 483, and specifically the question of whether it applies in the determination of the selling price under section 453(b)(2).”¹³¹ This language indicates that the court looked at the scope in a *general* sense as well as a specific sense. So, there is no reason for inferring that the court meant anything except that section 483 should apply for *all* purposes of Title 26—including gift tax purposes. In affirming this decision, the Eighth Circuit stated, “Even though § 483 does not specifically refer to § 453, the former provision is applicable to § 453 because § 483 is couched in the comprehensive and unambiguous language that it is to apply for ‘purposes

¹²³See *infra* text accompanying notes 196-206.

¹²⁴I.R.C. § 7872(a)(1) (Supp. III 1985).

¹²⁵See *id.* § 7872(d)(2).

¹²⁶I.R.C. § 7806(b) (1982).

¹²⁷See, e.g., *Old Colony R. v. Commissioner*, 284 U.S. 552, 561 (1932); *Ransburg Corp. v. Commissioner*, 621 F.2d 264, 268 (7th Cir. 1980); *Busse v. Commissioner*, 479 F.2d 1147, 1151 (7th Cir. 1973); *Charles Leich & Co. v. United States*, 210 F.2d 901, 907 (7th Cir. 1954).

¹²⁸54 T.C. 772 (1970), *aff'd*, 439 F.2d 767 (8th Cir. 1971).

¹²⁹54 T.C. at 778.

¹³⁰*Id.*

¹³¹*Id.*

of this title' (the Internal Revenue Code, Title 26).''¹³² Nowhere in this opinion is there any indication that section 483 should be limited to income tax purposes of the Code even though section 453, as well as section 483, is in the income tax subtitle.

Citing *Robinson*, the court in *Rose v. Commissioner*,¹³³ stated that Congress, in passing the Revenue Act of 1964,¹³⁴ intended section 483 to "be applied retroactively not only to the types of transactions expressly contemplated therein, but 'for all purposes of the Code.'"¹³⁵ If section 483 is to be applied retroactively for all purposes of the Code, then it should also be applied prospectively for all purposes of the Code. That is, there is no reason why the application of section 483 to other parts of the Code should be limited to a retroactive application.

The court in *Ballard* agreed with the taxpayer that section 483 is not restricted to Subtitle A of the Code.¹³⁶ However, the court disagreed with the taxpayer's argument that section 483 applied for valuation purposes, asserting that section 483 had nothing to do with valuation purposes.¹³⁷ The court noted that the purpose of section 483 is to recharacterize portions of payments on deferred sales transactions as interest payments.¹³⁸ However, when a portion of a payment is recharacterized as interest, that necessarily leaves a smaller portion to be characterized as principal. Therefore, in essence, section 483 acts to devalue the payments being made on an installment contract. If the language in section 483 is being misinterpreted by taxpayers, Congress could clarify the section by simply changing the word "title" to "subtitle" in section 483(a). Construction should not be substituted for legislation.¹³⁹

B. Discrepancy Between Section 483 and Market Interest Rates in the 1980's

The origin of the controversy regarding section 483 is the discrepancy between the section 483 interest rate and market interest rate. This problem began prior to the enactment of amendments to section 483 in the 1980's. Even during periods where the section 483 and market interest rate are approximately the same, and hence the issue of which

¹³²*Robinson*, 439 F.2d at 768.

¹³³55 T.C. 28 (1970).

¹³⁴Revenue Act of 1964, Pub. L. No. 88-272, § 224, 78 Stat. 19.

¹³⁵*Rose*, 55 T.C. at 31. The court discussed retroactive application of section 483 because that was the specific issue in the case. *See id.* at 28.

¹³⁶53 T.C.M. (CCH) 323, 326 (1987).

¹³⁷*Id.*

¹³⁸*Id.*

¹³⁹*See, e.g., United States v. Missouri Pac. R.R.*, 278 U.S. 269, 278 (1929); *Busse v. Commissioner*, 479 F.2d 1147, 1151 (7th Cir. 1973).

rate to use in currently structuring a deferred sales transaction becomes insignificant, the IRS still may be able to challenge currently the issue of which rate should have been used in a previously structured deferred sales transaction.¹⁴⁰

1. *Pre-1982.*—Section 483, as it existed before 1982,¹⁴¹ stated that the present value of payments should be determined as of the date of the sale or exchange by discounting the payments at the rate provided in the regulations prescribed by the Secretary of the Treasury.¹⁴² Section 483 originally provided for “test” or “safe-harbor” rates by which the IRS would measure whether interest needed to be imputed.¹⁴³ In other words, if the taxpayer charged at least the test rate, no interest would be imputed.¹⁴⁴ By 1981, the test rate under section 483 was six percent,¹⁴⁵

¹⁴⁰See *supra* text accompanying notes 56-57.

¹⁴¹I.R.C. § 483(a)-(b) (1976), which provides:
§ 483. Interest on certain deferred payments
(a) Amounts constituting interest

For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) Total unstated interest

For purposes of this section, the term “total unstated interest” means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

¹⁴²*Id.* § 483(b).

¹⁴³H.R. REP. NO. 749, *supra* note 4, at 1382; S. REP. NO. 830, *supra* note 4, at 1776; Treas. Reg. § 1.483-1(d) (as amended in 1981). See *supra* note 43.

¹⁴⁴Before July 24, 1975, the test rate was 4% per annum simple interest, and the imputed rate was 5% per annum compounded semiannually. Treas. Reg. § 1.483-1(d)(1)(ii)(A) (T.D. 6873, 1966-1 C.B. 101); Treas. Reg. § 1.483-1(c)(2)(ii)(A) (T.D. 6873, 1966-1 C.B. 101). From July 23, 1975 to July 1, 1981, the test rate was 6% simple interest, and the imputed rate was 7% compounded semiannually. Treas. Reg. § 1.483-1(d)(1)(ii)(B) (as amended by T.D. 7394, 1976-1 C.B. 135); Treas. Reg. § 1.483-1(c)(2)(ii)(B) (as amended by T.D. 7394, 1976-1 C.B. 135). After July 1, 1981, the test rate under section 483 was 9% simple interest, and the imputed rate was 10% compounded semiannually. Treas. Reg. § 1.483-1(d)(1)(ii)(C) (as amended by T.D. 7781, 1981-2 C.B. 123); Treas. Reg. § 1.483-1(c)(2)(ii)(C) (as amended by T.D. 7781, 1981-2 C.B. 122).

¹⁴⁵Treas. Reg. § 1.483-1(d)(1)(ii)(B) (as amended by T.D. 7394, 1976-1 C.B. 135).

and the market interest rate was into the double digits;¹⁴⁶ there was a wide margin between the section 483 and market rate.

In enacting section 483, Congress stated that “[i]t is anticipated that any rate specified by the Secretary of the Treasury or his delegate will reflect the going rate of interest and will not be higher than the rate at which a person . . . could be expected to borrow money from a bank.”¹⁴⁷ Congress then stated that a rate of five percent was appropriate at that time—1964.¹⁴⁸ Congress seemed more concerned about the section 483 interest rate specified by the Secretary being too high than it did about the rate being too low. There would be no gift tax quandary if the Secretary had kept interest rates under section 483 at the “going” rate of interest. In other words, there would be no controversy if the section 483 rate and the market rate of interest were the same. Five percent may have been an appropriate rate in 1964, but the test and imputed rates of six and seven percent certainly did not “reflect the going rate of interest” in 1981. In discussing the Economic Recovery Tax Act (ERTA)¹⁴⁹ amendments to section 483, Senator Melcher, sponsor of one of the amendments, stated:

[T]his amendment deals with imputed interest rates, which is a term that the IRS uses when they wish to make certain, under section 483 of the Codes, that there will be a proper interest rate on the sale of realty. By “proper” I mean an interest rate that they think is realistic.¹⁵⁰

Because Congress gave the Secretary the power to change the interest rate under section 483 to keep it “realistic,”¹⁵¹ one can presume that the IRS believed that the section 483 rate was “realistic” or else it would have changed it. By not updating the interest rate under section 483 to reflect the market rate of interest, it appeared as though section 483 were a special exception to the requirement of charging the market rate of interest in order to avoid making a taxable gift. That is, it is easy to see why taxpayers could have thought that if a transaction fell under section 483, then all they needed to charge was the section 483 rate, a rate the IRS had the power to change¹⁵² and a rate Congress had anticipated would be “realistic.”¹⁵³ Because of the variance between

¹⁴⁶See, e.g., N.Y. Times, June 2, 1981, at D11, col. 6.

¹⁴⁷H.R. REP. NO. 749, *supra* note 4, at 1381; S. REP. NO. 830, *supra* note 4, at 1775.

¹⁴⁸H.R. REP. NO. 749, *supra* note 4, at 1381; S. REP. NO. 830, *supra* note 4, at 1775.

¹⁴⁹See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 126, 95 Stat. 172, 202.

¹⁵⁰127 CONG. REC. 17,805 (1981).

¹⁵¹I.R.C. § 483(b) (1976).

¹⁵²*Id.*

¹⁵³127 CONG. REC. 17,805 (1981).

the section 483 rate of interest and the market rate of interest, a "tax trap" was created for sellers in property transactions that fell under section 483. That is, taxpayers whose transactions fell under section 483 could logically rely on the section 483 rate of interest as a "safe-harbor" rate for "all purposes of the Code" and yet later be told that they should have used the market rate of interest instead.

2. *After ERTA.*—Section 483 was amended by the Economic Recovery Tax Act (ERTA) of 1981.¹⁵⁴ In 1981, Congress, under ERTA, added subsection (g) [now (e)] to section 483.¹⁵⁵ Section 483(g) [now (e)] limited the maximum interest rate used in determining total unstated interest to seven percent compounded semiannually in the case of a "qualified sale."¹⁵⁶ Qualified sale means a sale or exchange of land to a family member.¹⁵⁷ The section 483(g) [now (e)] rate does not apply to qualified sales that exceed \$500,000.¹⁵⁸ If the \$500,000 limit is exceeded during the calendar year, the lower rate is available only as to the first sales or exchanges up to that limit.¹⁵⁹ The Senate amendment provided

¹⁵⁴Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 126, 95 Stat. 172, 202; see also S. REP. NO. 144, 97th Cong., 1st Sess. 1, reprinted in 1981 U.S. CODE CONG. & ADMIN. NEWS 105.

¹⁵⁵I.R.C. § 483(g) (1982), which provides in relevant part:

(g) Maximum rate of interest on certain transfers of land between related parties

(1) In General

In the case of any qualified sale, the maximum interest rate used in determining the total unstated interest rate under the regulations under subsection (b) shall not exceed 7 percent, compounded semiannually.

(2) Qualified Sale

For purposes of this subsection, the term 'qualified sale' means any sale or exchange of land by an individual to a member of such individual's family (within the meaning of section 267(c)(4)).

(3) \$500,000 Limitation

Paragraph (1) shall not apply to any qualified sale between individuals made during any calendar year to the extent that the sales price for such sale (when added to the aggregate sales price for prior qualified sales between such individuals during the calendar year) exceeds \$500,000.

¹⁵⁶*Id.* § 483(g)(1).

¹⁵⁷*Id.* § 483(g)(2).

¹⁵⁸*Id.* § 483(g)(3).

¹⁵⁹H.R. CONF. REP. NO. 215, 97th Cong., 1st Sess. 281, reprinted in 1981 U.S. CODE CONG. & ADMIN. NEWS 285, 370 [hereinafter H.R. CONF. REP. NO. 215]; 51 Fed. Reg. 12,024 (1986). For example, if property is sold during the calendar year for \$400,000, the 7% interest rate would be applicable. If more property is later sold during the same calendar year for \$150,000, the 7% interest rate would not be applicable to the \$150,000 sale because the \$500,000 limitation would have been exceeded. See Prop. Treas. Reg. § 1.483-4(b)(2)(iv), 51 Fed. Reg. 12,044 (1986). However, the parties can structure a sale with two debt instruments. One can have a \$100,000 face amount and the other a \$50,000 face amount. The 7% rate would apply to the \$400,000 and \$100,000 instruments but not to the \$50,000 face amount. The \$500,000 limitation would not have been exceeded

that the seven percent rate be applied to sales of non-depreciable property for less than \$2 million.¹⁶⁰ The special seven percent rate was established in reaction to the 1981 increase in the section 483 test and imputed interest rates.¹⁶¹ The Conference Agreement adopted section 483(g) [now (e)] from the Senate Amendment.¹⁶² By providing a lower rate of interest for related parties under section 483(g) [now (e)] than for unrelated parties whose transactions fall under section 483, Congress intentionally widened the gap between the section 483 and market rate of interest where related parties are concerned. This does one of two things: either it further evidences that a tax trap has been created under section 483 that needs to be remedied, or it clarifies that section 483 rates really are to be applied for *all* purposes of the Code. If Congress anticipated the section 483 rate to be “realistic,”¹⁶³ then by adjusting it under section 483(g) [now (e)], Congress may have set what it considered to be a “realistic” rate for related parties whose transactions fall under section 483, or Congress may have wanted to provide a “tax break” to related parties. In either case, no higher interest rate should be applied to a related party transaction falling under section 483 for any purpose under the Code because Congress has already provided either a “realistic” rate or a rate with a “tax break” in mind for related parties.

a. Legislative History.—Senators’ comments during discussion of the amendment are indicative of how they viewed section 483 transactions. The Senate amendment was primarily concerned with an excessive, imputed interest rate on sales of farms and small businesses.¹⁶⁴ Senator Melcher remarked that “it is vitally important that we hold these rates down, particularly in the sale of family farms, family ranches, and small businesses”¹⁶⁵ Senator Boschwitz commented that “[t]his amendment is a reasonable compromise to relieve the burdens the regulations impose on family farms and small businesses.”¹⁶⁶ Senator Grassley said:

One of the tools for assessability of younger generations to continue the family farming operation has been the lower rate of interest that mothers or fathers have been willing to give to their sons and daughters in helping to start this family farm operation or small business.

by the total of the first \$400,000 instrument and the second \$100,000 instrument. *See* 51 Fed. Reg. 12,024 (1986).

¹⁶⁰H.R. CONF. REP. NO. 215, *supra* note 159, at 370.

¹⁶¹*Id.* *See supra* note 144.

¹⁶²H.R. CONF. REP. NO. 215, *supra* note 159, at 370.

¹⁶³*See* 127 CONG. REC. 17,805 (1981).

¹⁶⁴*Id.*

¹⁶⁵*Id.*

¹⁶⁶*Id.* at 17,806.

This intergenerational loan or gift is not ever in the vein of trying to pull something fast on the Government. This is a very open approach of one generation willing to forgo some income just because of the desire to see the family farm continue within the family from one generation to the other.¹⁶⁷

These comments indicate an intent to enable farmers, small businessmen, and their families to structure their deferred sales transactions with lower interest rates. Senator Grassley even recognized the possibility of a gift, but his comments do not suggest that the transaction should be subject to gift taxation. The purpose of the lower interest rate is to enable farmers and small businessmen to keep the property in the family without their children incurring high interest rates—"one generation willing to forgo some income."¹⁶⁸ It is unlikely that Senator Grassley contemplated that the generation "willing to forgo some income" must also be willing to incur a financially devastating gift tax on the difference between the safe-harbor interest rate under section 483 and the current market rate of interest.

Senator Jepsen commented:

When the time comes for a child to get started in business or farming, he or she cannot afford 20-percent interest rates and the enormous initial capital expenditures. So, a father and mother give the child a break: A low-interest loan and a deferred payment schedule. This does two things: It helps the young person when such help is critical and allows parents to pass on their property to their offspring without incurring the confiscatory rates of present estate taxation.¹⁶⁹

Senator Jepsen's comments do not suggest that parents would escape being subject to estate taxation only at the expense of being subject to gift taxation. Otherwise, that would defeat Senator Jepsen's philosophy of making it easier for parents to transfer the property to their offspring.

The Senator's comments do not in any way suggest that section 483 transactions, where the section 483 rate of interest has been used, should be subject to gift taxation. Furthermore, the General Explanation of the Economic Recovery Tax Act of 1981 regarding section 483(g) [now (e)] indicates that an undue burden would be placed on sales of land between related parties if the lower rate of interest under section 483(g) [now (e)] were not enacted.¹⁷⁰

¹⁶⁷*Id.*

¹⁶⁸*Id.*

¹⁶⁹*Id.*

¹⁷⁰JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 60 (1981).

b. Related Party Transactions.—As discussed previously, a gift tax will not be imposed on all transactions in which the value of the consideration is less than the fair market value of the property.¹⁷¹ Where the transaction is a genuine business transaction, in contrast to a family type transaction, generally no gift will be found.¹⁷² Intra-family transfers have always prompted special scrutiny by courts, in regard to determining if a gift has been made, precisely because a genuine business transaction cannot usually be found.¹⁷³ A close look at the transaction is unavoidable.¹⁷⁴ However, gift tax will not be imposed on arm's length transactions that have a bona fide business objective and involve no element of donative intent.¹⁷⁵ Furthermore, it is not an essential requirement in such transactions that the property be transferred for a full and adequate consideration in money or money's worth in order to preserve the legitimate business character of the property transfer.¹⁷⁶ Bad bargains and sales for less than a full and adequate consideration are commonplace in the business world; the tax law does not insist that such transactions necessarily involve gift transfers.¹⁷⁷ Moreover, a family transaction may be treated as one "in the ordinary course of business" if each of the parenthetical criteria in Treasury Regulation section 25.2512-8¹⁷⁸ is fully met.¹⁷⁹ A taxpayer's reliance on the section 483 rate of interest could show that there was no intent to make a gift and thus render the transaction free of any donative intent, bona fide, and one made at arm's length. In other words, by relying on section 483 rates, the taxpayer is not merely charging a "low" rate of interest, but instead is intentionally complying with section 483 of the Internal Revenue Code. Gifts have not always been found in transactions between related parties where there is no donative intent even where less than a full and adequate consideration is received.¹⁸⁰

¹⁷¹See *supra* text accompanying notes 29-35.

¹⁷²See, e.g., *Estate of Anderson v. Commissioner*, 8 T.C. 706, 720 (1947).

¹⁷³See, e.g., *Fehrs v. United States*, 620 F.2d 255, 260 (Ct. Cl. 1980) (taxpayer's transfer of shares of stock to a newly created corporation wholly owned by taxpayer's daughters was in part a gift by taxpayer to corporation to the extent of the excess of fair market value of the transferred shares of stock over consideration received); *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 201 (1970).

¹⁷⁴See, e.g., *Fehrs*, 620 F.2d at 260.

¹⁷⁵*Id.*

¹⁷⁶*Id.*

¹⁷⁷*Id.*; *Estate of Anderson*, 8 T.C. at 720.

¹⁷⁸See *supra* text accompanying note 31.

¹⁷⁹*Estate of Berkman v. Commissioner*, 38 T.C.M. (CCH) 183, 185-86 (1979).

¹⁸⁰See *Messing v. Commissioner*, 48 T.C. 502, 511-12 (1967) (no gift was found where a father sold stock to his son at a price below its worth because there was held to be no donative intent).

Essentially, unrelated parties whose transactions fall under section 483 and who use section 483 rates when market rates are higher would be unlikely to face gift tax problems. This will be true even if market rates and not section 483 rates apply for gift tax purposes because unrelated party transactions will generally not be subject to gift taxation.¹⁸¹ It is only related party transactions that are normally subject to gift taxation.¹⁸² It is inconsistent to allow unrelated parties to succeed in charging the section 483 rate without incurring any gift tax, while forcing related parties to meet the market rate of interest in order to avoid gift taxation when both parties' transactions fall under section 483. This is especially so because section 483(g) [now (e)] was created, which provides a special *lower* rate of interest for related party transactions.¹⁸³ It misleads taxpayers, defeats reliance expectations, and is inconsistent with legislative intent for the IRS to maintain that related taxpayers must charge the section 483 interest rate for income tax purposes but must charge the higher market interest rate to avoid gift taxation. Nowhere in section 483(g) [now (e)] or anywhere else in section 483 is it mentioned that imputation of interest is limited to income tax purposes.

3. *1984 Amendments.*—Section 483 was again amended by the Deficit Reduction Act of 1984.¹⁸⁴ Congress recognized that the safe-harbor and imputed interest rates under section 483 did not represent economic rates of interest for three reasons.¹⁸⁵ First, section 483 rates had not kept up with market rates.¹⁸⁶ Second, test rates under section 483 did not use compounding features.¹⁸⁷ Third, use of a single rate for all obligations failed to recognize that lenders typically demand different rates of return on investments depending upon the term of the loan.¹⁸⁸ In other words, Congress recognized that the section 483 rates were not as high as market rates of interest; until 1984, Congress chose to do nothing about the disparity. There is no reason why the seller should suffer merely because the section 483 rates were not adjusted to market rates. Again, it appears that section 483 is an exception to the rule that a below-market interest rate deferred payment transaction between related parties involves a gift.

The Deficit Reduction Act provides that the new rates under section 483 vary according to the maturity of the obligations and that the rates

¹⁸¹See *supra* text accompanying note 34.

¹⁸²See *supra* text accompanying note 33.

¹⁸³I.R.C. § 483(g)(1) (1982). See *supra* note 155.

¹⁸⁴Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 41, 98 Stat. 494, 553-55; see also H.R. REP. NO. 432, 98th Cong., 2d Sess., pt. 2, 1, reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 697 [hereinafter H.R. REP. NO. 432].

¹⁸⁵H.R. REP. NO. 432, *supra* note 184, at 908.

¹⁸⁶*Id.*

¹⁸⁷*Id.*

¹⁸⁸*Id.*

be adjusted at six-month intervals.¹⁸⁹ The new rates are determined under section 1274(d).¹⁹⁰ Section 1274(d) rates are the applicable federal rates (AFR), which consist of a short term rate (term not over three years), a mid-term rate (term over three years but not over nine years), and a long term rate (term over nine years).¹⁹¹ The applicable federal rate is determined by the Secretary of the Treasury based on the average market yield on outstanding marketable obligations of the United States.¹⁹²

Congress, recognizing that interest rates under section 483 had not kept up with market rates, changed the section 483 rates to approximate more closely the market rates. However, Congress retained the special lower rate for related party transactions under section 483(g), redesignated as section 483(f)¹⁹³ [presently section 483(e)]. It is not clear why Congress changed the interest rates under section 483, with regard to gift tax consequences. It could be that Congress changed the section 483 rates for income tax purposes only; that is, that section 483 rates never were meant to be applied for gift tax purposes. In the alternative, it is tenable that for gift tax purposes, Congress wanted to close the discrepancy in rates, providing only section 483(f) [now (e)] as an exception.

Section 483 was severely curtailed by the 1984 Act so that it applies only to transactions excepted from the original issue discount (OID) rules.¹⁹⁴ Section 483 now applies only to a sale or exchange of a farm if the sales price does not exceed \$1 million, sales of a principal residence, sales involving total payments of \$250,000 or less, and qualified sales of land under section 483.¹⁹⁵

4. *Section 7872.*—Section 7872 was enacted in 1984.¹⁹⁶ The enactment of section 7872 further shows Congress' intent that when section 483 applies, no other Code section will impute a higher rate of interest to the transaction. Section 7872 is the legislative response to *Dickman v. Commissioner*.¹⁹⁷ This section deals with the treatment of loans with

¹⁸⁹*Id.* at 913.

¹⁹⁰I.R.C. § 483(b) (Supp. III 1985).

¹⁹¹*Id.* § 1274(d)(1)(A).

¹⁹²*Id.* § 1274(d)(1)(C).

¹⁹³See I.R.C. § 483(f) (Supp. II 1984).

¹⁹⁴The principal of the original issue discount rules (§§ 1271-1275) is very similar to unstated interest under I.R.C. § 483. Where a transaction falls under the OID rules, the law discounts all payments due by a minimum interest rate so that OID may be computed. OID is taxable as interest income to the holder of the debt instrument. 8 Fed. Taxes (P-H) ¶ 32,923 (1987).

¹⁹⁵See I.R.C. § 1274(c)(3) (Supp. III 1985); H.R. REP. No. 432, *supra* note 184, at 913; Prop. Treas. Reg. § 1.483-1(c), 51 Fed. Reg. 12,038-39 (1986); *see also id.* at 12,023.

¹⁹⁶Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 172, 98 Stat. 494, 699. *See also* H.R. REP. No. 432, *supra* note 184, at 1017.

¹⁹⁷465 U.S. 330 (1984), *aff'g* 690 F.2d 812 (11th Cir. 1982). *See supra* note 66.

below-market interest rates.¹⁹⁸ Section 7872 generally treats below-market gift loans as bearing fair market value interest, and treats the lender as making a gift to the borrower.¹⁹⁹ A gift loan is defined in section 7872 as a below-market loan where the forgone interest is in the nature of a gift.²⁰⁰ The computation of the amount treated as having been transferred from the lender to the borrower under section 7872 is similar to the computation of unstated interest under section 483.²⁰¹ As in section 1274(d), the rate used under section 7872 is the applicable federal rate.²⁰²

Section 7872 does not apply to any loan to which section 483 or 1274 applies.²⁰³ However, section 7872, and not section 483, will apply to below-market loans that are gift loans under section 7872 *and* are debt instruments described in section 1275(b), which concerns transactions involving personal use property.²⁰⁴ Section 7872 is the Code section that Congress drafted specifically to address the treatment of loans with below-market interest including gift tax ramifications.²⁰⁵ Congress not only did not provide for an imputed rate of interest for gift tax purposes under section 7872 to apply to section 483 transactions, but, on the contrary, Congress also specifically exempted section 483 transactions from the general scope of section 7872.²⁰⁶

5. *Present-Day Section 483.*—Section 483 was further amended by the 1985 Simplification of Interest Rules.²⁰⁷ Section 483(f), which provided the special rate for certain related party transactions, was redesignated as section 483(e).²⁰⁸ Simultaneously, Congress lowered the seven percent rate under section 483(e) to six percent to apply to transactions occurring after June 30, 1985.²⁰⁹ When section 483 was first enacted, Congress

¹⁹⁸See I.R.C. § 7872 (Supp. III 1985).

¹⁹⁹Orbach, Fireman & Levenson, *Planning for Tax Advantages Under Proposed Below-Market Loan Regs.*, 64 J. TAX'N 144, 144 (1986).

²⁰⁰I.R.C. § 7872(f)(3) (Supp. III 1985).

²⁰¹See *id.* §§ 483(b), 7872(b)(1). A gift loan that is also a term loan is computed in this fashion. *Id.* § 7872(d)(2). See *supra* text accompanying notes 14-16.

²⁰²I.R.C. § 7872(f)(1) (Supp. III 1985). See *supra* text accompanying notes 189-92.

²⁰³I.R.C. § 7872(f)(8) (Supp. III 1985); Willbanks, *Interest-Free Loans Are No Longer Free: Tax Consequences of Gift Loans*, 47 MONT. L. REV. 39, 60-61 (1986).

²⁰⁴Prop. Treas. Reg. § 1.7872-2(a)(2), 50 Fed. Reg. 33,557 (1985); see also Prop. Treas. Reg. § 1.483-1(c)(3)(iii), 51 Fed. Reg. 12,039 (1986); 51 Fed. Reg. 12,023 (1986); Orbach, Fireman & Levenson, *supra* note 199, at 145. Personal use property is defined as property substantially all of the use of which is not in connection with a trade or business of the taxpayer. I.R.C. § 1275(b)(3) (Supp. III 1985).

²⁰⁵See I.R.C. § 7872 (Supp. III 1985).

²⁰⁶*Id.* § 7872(f)(8).

²⁰⁷Simplification of Imputed Interest Rules, Pub. L. No. 99-121, § 102, 99 Stat. 505, 508; see also S. REP. NO. 83, 99th Cong., 1st Sess. 1, reprinted in 1985 U.S. CODE CONG. & ADMIN. NEWS 407 [hereinafter S. REP. No. 83].

²⁰⁸See I.R.C. § 483(e) (Supp. III 1985).

²⁰⁹*Id.*; see also Prop. Treas. Reg. § 1.483-4(b)(2), 51 Fed. Reg. 12,044 (1986).

had provided for a test or safe-harbor rate of interest and a one percent higher imputed rate of interest.²¹⁰ However, Congress concluded in 1985 that the higher imputation provided often acted as a penalty for uninformed taxpayers.²¹¹ Knowledgeable taxpayers would always avoid the higher imputation rate by providing for stated interest at the applicable test rate.²¹² Accordingly, the Committee bill eliminated the higher imputation rate.²¹³

a. Proposed Treasury Regulations.—The rates used under section 483 were again modified by the 1986 Proposed Treasury Regulations to be the lower of: (1) the applicable federal rate (based on the appropriate compounding period), or (2) nine percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.²¹⁴ This retains the problem of the appropriate rate to charge for gift tax purposes if the market rate exceeds nine percent. In that case, even if market rates and the AFR are approximately the same, the section 483 rate will still be lower than the market rate because the section 483 rate will be nine percent.²¹⁵ Also, the section 483(e) rate for related party transactions is only six percent.²¹⁶

The proposed regulations attempt to solve the section 483-market interest rate dilemma but are less than clear. The proposed regulations provide that in a related party transaction where the consideration furnished by the buyer to the seller consists of one or more debt instruments, the value of such debt instrument which has adequately stated interest under Proposed Regulation section 1.483-2 shall be its issue price.²¹⁷ A contract generally provides for adequate stated interest under Proposed Regulation section 1.483-2 if it calls for interest at least equal to the test rate of interest.²¹⁸ The value of such debt instrument described above issued under a contract to which section 483 applies shall be the amount described in Proposed Regulation section 1.483-3(a)(2)(i).²¹⁹ Such amount is the sum of the present values of the deferred payments and the present values of interest payments due under the contract.²²⁰ Thus, it appears that under these proposed regulations, if the parties are related and

²¹⁰H.R. REP. No. 749, *supra* note 4, at 1382; S. REP. No. 830, *supra* note 4, at 1776.

²¹¹S. REP. No. 83, *supra* note 207, at 420.

²¹²*Id.*

²¹³*Id.*

²¹⁴Prop. Treas. Reg. § 1.483-4(a)(1)-(2), 51 Fed. Reg. 12,043 (1986).

²¹⁵*Id.*

²¹⁶I.R.C. § 483(e) (Supp. III 1985).

²¹⁷Prop. Treas. Reg. § 1.1012-2(b)(1), 51 Fed. Reg. 12,047 (1986).

²¹⁸*Id.* § 1.483-2(a), 51 Fed. Reg. 12,039 (1986).

²¹⁹*Id.* § 1.1012-2(b)(2), 51 Fed. Reg. 12,047 (1986).

²²⁰*Id.* § 1.483-3(a)(2)(i), 51 Fed. Reg. 12,043 (1986).

charge the appropriate section 483 rate, then the value of the consideration will be the issue price. If the issue price is the fair market value, there will be no gift.²²¹

b. Movement Toward Reform.—At an annual meeting in Orlando, Florida, the Board of Regents of the American College of Probate Counsel (ACPC) adopted the recommendation of the Estate and Gift Tax Committee that the safe-harbor provisions in section 483 be carried over to Chapter 12 (gift tax) of the Internal Revenue Code.²²² The ACPC noted that the interplay among Proposed Regulation sections 25.2512-8, 1.1012-2(b)(1) and 1.483-4(b)(2) *appears* to cure the section 483(e) bargain sale problems for gift tax purposes.²²³ If this is so, non-section 483(e) transactions would also likely be safe for gift tax purposes because the section 483(e) rate is even lower than the rate under non-section 483(e) transactions. However, three different regulations need to be examined even to come to a tentative conclusion, which at best suggests that the area is confusing. Also, the word “appears” is the key word in the ACPC’s conclusion, which again suggests that the area is confusing. In *Ballard*, the court suggested that section 7872 probably prevents a case similar to *Ballard* from arising in the future.²²⁴ Even the court is not sure.

Even if these Proposed Treasury Regulations are adopted and do solve the section 483-market interest rate “tax trap” so that the issue does not occur in currently structured transactions, the resolution of this issue as presented in *Ballard*²²⁵ is still very important. This is because the IRS still may be able to challenge currently the issue of which rate should have been used in a past deferred sales transaction.²²⁶

VII: CONCLUSION

Although the legislative history, regulations, recent IRS rulings, and the Code sections themselves indicate that a gift tax problem does not arise when the section 483 rate of interest is used in deferred sales transactions, this area of the law is confusing, especially when early IRS rulings and the court in *Ballard* indicated that section 483 applies for income tax purposes only. What Congress needs to do is to clarify section 483, either spelling out the fact that section 483 applies for all purposes of the Code “including gift and estate tax purposes,” or specifying that section 483 applies “for income tax purposes only.” In

²²¹See *supra* text accompanying note 30.

²²²Horsley, *Some More Taxing Problems*, 12 PROB. NOTES 87, 88 (1986).

²²³*Id.* at 89.

²²⁴53 T.C.M. (CCH) 323, 327 (1987).

²²⁵See *supra* text accompanying notes 42-55.

²²⁶See *supra* text accompanying notes 56-57.

other words, Congress should provide for a gift tax safe-harbor rate, or specify that there is only an income tax safe-harbor rate. This clarification would bring greater certainty to the area and eliminate the "tax trap" into which taxpayers may otherwise fall. As for taxpayers who may have relied on section 483 to structure their transactions in the past, it would be terribly inequitable to apply retroactively an amendment that section 483 applies for income tax purposes only, because there was never any definite indication in the past that section 483 applied for income tax purposes only. If at all, the indication was that section 483 applied for gift as well as income tax purposes.

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