1984

Interest Free Loans

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The 52nd anniversary of the modern federal gift tax was June 6, 1984: the effective date of the new tax rules applicable to interest-free and below-market interest loans. I.R.C. § 7872, as added by § 172 of the Tax Reform Act of 1984 (TRA).

Despite an express exception for seller loans arising from the sale of property and covered by revised § 483 or new § 1274, § 7872 is not by its terms limited to loans of money: an area highlighted on February 22, 1984, by the Supreme Court's opinion in *Dickman* that, in dictum, discussed the broader concept of transfers of the use of property generally.

At this stage, however, I do not believe new § 7872 will be expanded to impute income in cases of "loans" of property other than money; for example, an accommodation pledge of securities or the free use of facilities (e.g., the family car or vacation cottage). Nevertheless, the Conference Report makes clear that within § 7872—

> "It is intended that the term 'loan' be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans." Conf. Rep., H.R. 4170, 98th Cong., 2d Sess. 1018 (June 23, 1984) (herein "Conf. Rep.   ").

It is hard to predict, therefore, what money or credit transactions, no matter how innocent, will escape the reach of the new statute if they are thought to have any "significant effect on any Federal tax liability of the lender or the borrower." I.R.C. § 7872(c)(1)(E). For example, in their infancy split-dollar insurance programs were considered to be, in effect, interest-free loans from the premium payor (or cash value owner) to the insured (or death benefit owner). Whether these transactions now fall under the statute must await a further announcement from the Internal Revenue Service.

In establishing the new rules, the lawmakers insisted that "[n]o inference is intended with respect to the application of present law to any below-market loan outstanding prior to the effective date." Conf. Rep. 1023. What then is the proper income and gift tax treatment of interest-free and below-market interest loans for 1983 and prior years, and for the interim January 1-June 6, 1984 period?

I. *Pre-1984 Loans*

There have always been different rules for the tax treatment of demand loans and term loans. In general, the controversies have arisen in three types of loan transactions: family or gift loans, compensation-related loans and corporation-shareholder loans.

A. *Income Tax*

The government has consistently failed in its attempts, begun just 23 years ago, to impose income tax liability on borrowers in cases involving compensation-related and corporation-shareholder loans made interest-free or at below-market interest rates. In the gift loan area, questions have been raised about below-market loans to trusts under traditional assignment of income and Clifford trust principles (e.g., a demand loan to a trust is nothing more than a revocable transfer, so the argument goes); but, where a valid debtor-creditor relationship has been established, there are no reported income tax cases on either side.

B. *Gift Tax*

A low-interest term loan has always been recognized as a transfer of value from lender to borrower. In family cases, this has traditionally resulted in a reportable gift. *E.g., Blackburn* v. *Commissioner,* 20 T.C. 204 (1953). The only real controversy in the past was whether the gift tax applied to a demand loan, and this was resolved on February 22, 1984 by the Supreme Court's decision against the taxpayer in *Dickman* v. *Commissioner,* 465 U.S. , 79 L.Ed.2d 343, 84-1 USTC 13,560, 53 AFTR2d 148,627 (1984).

What has never been finally determined, however, is how to value low-interest loans for tax purposes; that is, whether to use a commercial rate after taking into consideration all the facts and circumstances (e.g., the credit-worthiness of the borrower), the local prime rate, the current tax deficiency rate, an average U. S. Treasury bill rate, or whatever.

Within a week after the *Dickman* decision, the government announced that it would insist on full retroactive effect. This placed in jeopardy all interest-free and low-interest demand loans made since June 6, 1932 "for less than an adequate and full consideration in money or money's worth." *See* I.R.C. § 2512(b); Treas. Reg. § 25.2511-1(g)(1) (donative intent is not essential).

Pressure was immediately directed at Congress from both taxpayers and their tax return preparers, using the same arguments already successfully pressed in the House for prospective-only treatment of net gifts after the Supreme Court's decision in *Diedrich* v. *Commissioner,* 457 U.S. 191 (1982). The net gift proponents won (TRA § 1026); the interest-free loan proponents lost.

Unquestionably persuasive to the legislators was the Internal Revenue Service's announcement on May 11, 1984 of an amnesty for what it deemed to be non-abusive gift situations, establishing a uniform valuation standard and a generous reporting exception for pre-1984 taxpayer compliance. IRS Announcement 84-60, 1984-23 I.R.B. 58 (June 4, 1984). Technically, the announcement applies only to interest-free demand loans (obviously, the great bulk of gift loans), but the same principles may also be applied to low-interest demand loans. A Revenue Procedure was promised, but at this writing has not been published.

If the unused annual gift tax exclusion(s) or the new IRS administrative reporting exception does not apply, a lender's interest-free loans outstanding in 1981, 1982 or 1983 are subject to gift taxes and future bracket creep, as are his interest-free loans for any other open gift tax year (i.e., any period since June 6, 1932 in which a gift tax return was not filed, or any quarter or year within the last 6 years for which a gift tax return was filed but the value of the omitted gifts exceeds 25% of the total amount of gifts stated in the return).

The announced valuation standard is remarkable in its simplicity, especially when compared with the new rules under § 7872. The value of the pre-1984 gift element inherent in interest-free demand loans can be determined by applying simple annual interest derived from the lesser of (a) the statutory rate for refunds and deficiencies or (b) the annual average rate for three month Treasury bills. On this basis (and without the even more favorable administrative reporting exception described below), a lender's per donee safe harbor over the last ten years would compute as follows, just using his annual exclusion(s) (assuming no other reportable gifts that year):

Year	Applicable Interest Rate	Annual Exclusion(s)	Average Loan Balance
1983	8.6%	$10/20,000	$116,279/232,558
1982	10.6%	$10/20,000	$94,339/188,679
1981	12.0%	$3/6,000	$25,000/50,000 *
1980	11.5%	$3/6,000	$26,086/52,173 *
1979	6.0%	$3/6,000	$50,000/100,000
1978	6.1%	$3/6,000	$49,180/98,360 *
1977	5.2%	$3/6,000	$57,692/115,384
1976	4.9%	$3/6,000	$61,224/122,448
1975	5.8%	$3/6,000	$51,724/103,448
1974	6.0%	$3/6,000	$50,000/100,000

*But see the special $50,000/100,000 exception described below.

Further, the IRS announcement relieves a married couple from any obligation to file a gift tax return if the previously unused balance of their annual per donee exclusions would absorb the computed value of their interest-free demand loans to that donee/borrower.

Even if the lender should fail the traditional test under the simplified valuation rule (as might be the case in 6 out of the last 10 years above, if there had been even modest additional gifts from the donor/lender to the donee/borrower), most non-abusive interest-free loans will be sheltered under the new administrative reporting exception. Announcement 84-60 states that no pre-1984 gift tax reporting is required if the average annual outstanding balance of interest-free demand loans made by a single taxpayer to a single donee does not total, in the aggregate, more than $50,000 each year. If the donor was married at the time, interest-free demand loans aggregating $100,000 per donee becomes the cliff over which the lender must fall before being faced with pre-1984 gift tax reporting. Loans made to a trust or other entity (for example, the Dickmans' closely-held corporation) are deemed made proportionately to the individuals who have a beneficial "present interest in the loan proceeds or the income attributable to the loan proceeds."

If a taxpayer falls within the $50,000 ($100,000, if married) per donee administrative reporting exception, then he can completely disregard the fact that other gifts were made to the same donee that year, taxable or not; and, as important as any other feature, he does not have to worry about the cumulative effect of his interest-free gift loans on his future gift or estate tax rates. If his interest-free demand loans total $50,001/100,001 in any year, however, he gets no mercy, and must run the gauntlet with his available annual exclusion(s) and with only the comfort of the simplified applicable interest rates.

C. *Estate Tax*

For estate tax purposes, § 20.2031-4 of the Regulations has always allowed an executor to establish a lower market value for any indebtedness held. In the case of an interest-free demand note, this value was presumptively its face amount unless it had become uncollectible. For term loans, an appropriate date-of-death or alternate value discount could be applied reflecting the then current interest rates in the community.

The real problem in the estate tax area, however, is the potential for prior gift tax liabilities (tax, interest and penalty) and, more importantly, bracket creep for all years after 1976 when the gift and estate tax were integrated. Not only will a conscientious executor be faced with a potential review for family loans back to June 6, 1932, but also with a significantly higher estate tax bracket for the present if any post-1976 over-$50,000 (or $100,000, as the case may be) loans are discovered.

II. *1984 Loans to June 7, 1984*

New § 7872 applies only to loans made after June 6, 1984. This includes pre-June 7, 1984 demand loans that are not repaid before September 16, 1984, and pre-June 7, 1984 term loans that are renegotiated, extended or revised after June 6, 1984. Thus, the pre-1984 income, gift and estate tax rules still apply to loans made or outstanding during the period January 1, 1984 to June 7, 1984.

By its terms, the special administrative reporting requirements for gift taxes (e.g., the $50,000/$100,000 interest-free demand loan exception) do *not* apply during 1984, unless blessed with an extension of administrative grace in a further announcement this year. The preparation of 1984 gift tax returns, therefore, will have to deal with an as yet unconfirmed interest rate applicable to gift loans outstanding during the period January 1-June 6, 1984; or to the payoff date before September 16, 1984, for demand loans repaid during that grace period.

Although recently announced Rev. Rul. 84-163 (November 19, 1984) offers interest rates for 1984 for purposes of new § 1274, it does not by its terms approve the use for gift tax purposes of 10%, compounded semiannually, for the January 1, 1984 to June 30, 1984 timeframe. Absent further clarification by the Service, however, this rate would seem to be the one to use.

III. *Post-June 6, 1984 Loans*

The value of a loan of money must now be determined by reference to the market interest rate established by the Code. Specifically excluded are loans arising from sales of property, but only if covered by amended § 483 and new § 1274 of the Code (i.e., most seller-financed property sales). I.R.C. § 7872(f)(8).

For the period June 7, 1984 to December 31, 1984, the Act establishes 10%, compounded semiannually, as the interest rate to be used. TRA § 172(c)(4). Even this favorable rate appears to be higher than Announcement 84-60's use of the annual average rate for three month Treasury bills, applied as simple interest, but is lower than the 10.50% "applicable Federal Rate" (semiannual compounding) for demand loans for the period July 1, 1984 to December 31, 1984, established in Rev. Rul. 84-163.

A. *Valuation*

Valuing a demand loan now involves a computation of "foregone interest." I.R.C. § 7872(a); § 7872(e)(2). Stated as simply as possible, interest on an outstanding demand loan is deemed to accrue on December 31 of each year, apparently compounded semiannually at "the applicable Federal rate" announced by the Secretary during the prior year's October (effective January 1) and the year's April (effective July 1), based on the average market yield (during the April-September and October-March timeframes) of marketable U.S. obligations with remaining maturities of 3 years or less.

For example, if an employer makes a $100,000 advance to an employee during 1986, with 5% interest payable annually, and the applicable Federal rate for demand loans happens to be 12% for the entire year, the amount of "foregone interest" for 1986 would be:

Loan amount	$100,000	
January 1 - June 30		
(181/365 x 12%)	5,951	$ 5,951
	$105,951	
July 1 - December 31		
(184/365 x 12%)		+ 6,409
Total interest		$12,360
Interest payable (5%)		- 5,000
Foregone interest		$ 7,360

[Note: There is currently some dispute as to whether the value of *demand* loans in 1985 and subsequent years must be computed using semiannual compound interest. This writer has been assured by a member of the Joint Committee Staff that Congress intended compound interest to be used throughout, and that clarification will be forthcoming. Rev. Rul. 84-163 seems to support this view, even if not explicitly.]

For term loans, the amount to be reckoned for tax purposes is "the excess of (A) the amount loaned, over (B) the present value of all payments which are required to be made under the terms of the loan." I.R.C. § 7872(b)(1). Using the above example, with a loan due December 31, 1986 (i.e., a one-year term loan), the taxable amount would be:

Amount loaned	$100,000
Present value of $105,000 (6% discount, 2 periods)	93,450
Excess	$ 6,550

Assuming all facts are the same, an acknowledged *term* loan involves a smaller transfer than a *demand* loan (i.e., $810 or 11% less interest in the above example). Since the statute directs (purportedly for simplicity, *see* Conf. Rep. 1020 fn. 11) that all term gift loans be treated as demand loans for income tax timing and computation purposes (but not in the selection of the interest rate or for any gift tax purposes), some will say that gift loans are given harsher treatment than compensation-related or corporation-shareholder loans under the statute.

The interest rate for every term loan is fixed on the date the loan is made and is carried forward at that initial rate. The interest rate on a true demand loan, on the other hand, fluctuates, up or down, at the higher or lower "applicable Federal rate" of interest for each January-June and July-December period. Thus, if income tax considerations are controlling, a gift loan would fare better under the demand loan valuation rules in times of declining interest rates, and worse in times of rising interest rates.

Moreover, a true demand loan gives a donor/lender more control over the use of his available gift tax exclusion(s) if the funds are expected to remain outstanding beyond December 31. For true demand loans, each year is a separate valuation period for gift tax purposes, even with its varying interest rates. For example, if demand loans have an average interest rate of 12%, a combined $20,000 annual exclusion could absorb a $161,800 interest-free demand loan that year, whereas only a $61,875 4-year loan would be within the combined $20,000 annual exclusion this year, even if made at the low 10% transition discount rate: ***again, if gift taxes are the only consideration!***

B. *Income Tax*

1. *The Lender*

Interest income will now be imputed to every lender who lends more than $10,000 to another, if any of his loans are made after June 6, 1984 at a rate below the applicable Federal rate.

In the case of most compensation-related loans, the lender will not be hurt by this treatment because its imputed interest income can be offset by an increase in its deduction for compensation paid, assuming this additional compensation represents reasonable compensation (i.e., is not a dividend) and, if the borrower is an employee, he already earns more than the FICA wage base (increasing to $39,600 in 1985). Of course, if the lender is a personal holding company or S corporation, it may be embarrassed by the receipt of additional interest income.

The lender of a gift loan or a corporation-shareholder loan, however, has no offsetting deduction, since his deemed transfer to the borrower constitutes a non-deductible gift, dividend or return of capital. Accordingly, the income tax impact on gift loans and corporation-shareholder loans will chill such transactions in the future, at least as far as any assignment of income aspects are concerned. [Note: The category of corporation-shareholder loans also covers below-market loans from shareholders to their corporations.]

Compensation-related *term* loans, however, deserve a more extended explanation. Seldom will they now be beneficial to the borrowing employee or service-provider.

New § 7872 adopts what was referred to in the preenactment literature as the "two-transaction approach." The first part of the transaction is a transfer of value from lender to borrower (i.e., employer to employee, corporation to shareholder, donor to donee, etc.), and the second part of the transaction is a retransfer or payment of interest by the borrower back to the lender (or from employee to employer, shareholder to corporation, donee to donor, etc.). In the case of an employer/employee (or other compensation-related loan where the lender can offset the deductible value of his deemed payment against his imputed interest income), a *demand* loan creates a "wash," since both sides reckon their payments on December 31. I.R.C. § 7872(a)(2). In the case of a conventional compensation-related *term* loan, however, there is no "wash" because of the application of the new original issue discount (OID) rules to the interest (or second step) in the transaction.

What this means is that, if an employer on July 1, 1985 lends $100,000 to an employee repayable in two years without interest, and the applicable federal rate is 12% at the time the loan is made, the following will result:

First, the employer will be deemed to have paid additional compensation of $20,791 on the date the loan was made, and have an offsetting compensation deduction (assuming reasonable compensation). The employer's FICA liability will also attach at this time.

Second, the employee will have an additional $20,791 in compensation on the date the loan is made. Somehow he must contribute his portion of the FICA withholding liability if, at the time the loan was made, any part of his compensation for the year was below the social security wage base (initially $39,600 for 1985)—perhaps as an additional interest-free loan (i.e., an advance) when his employer makes its tax deposit.

Third, the employer will realize a varying amount of interest income over the two-year term under the new OID rules; namely, $4,753 in calendar 1985, $10,378 in calendar 1986 and $5,660 in calendar 1987. This will mean that the employer will have a compensation deduction in 1985 (i.e., $20,791) much larger than its interest income that year (i.e., $4,753), and unsheltered interest income in 1986 and 1987.

Fourth, the employee will also get an interest deduction only on the OID methods, meaning that he will have a much smaller deduction (i.e., $4,753) than the additional compensation income he is deemed to receive in the first year $20,791).

Thus, there is no "wash" as between the first and second steps of the transaction. Indeed, the employer can accelerate a deduction (not offset by an equivalent amount of interest income) if the employee can stand accelerated income in the first year. Ingenious practitioners can also be expected to search for loopholes in the cancellation of indebtedness and prepayment rules, at least as long as Congress continues to deny more sweeping reallocation of income and deduction powers to the tax collector under § 482.

There is one statutory exception in the employer-employee term loan area. A term loan made after June 6, 1984 that is not transferable and "the benefits of the interest arrangements of which is [sic] conditioned on the future performance of substantial services by an individual" will be treated as a demand loan for all timing purposes of new § 7872 (but not for computing the interest rate, where "the applicable Federal rate" for the stated term will still apply). I.R.C. § 7872(f)(5). As a demand loan, the parties' compensation income/deduction and interest income/deduction will accrue ratably throughout the year at the applicable Federal rate, compounded semiannually, and be transferred on the last day of the calendar year (except as may otherwise be specified by the regulations that are supposed to neutralize any tax advantages that may accrue to a fiscal year taxpayer).

The same opportunity does not exist for corporation-shareholder term loans because the corporation gets no deduction for its deemed transfer (i.e., dividend or return of capital). A term loan from the family corporation would be enticing only in those rare instances when a shareholder wanted to accelerate income into his first year—perhaps to absorb an expiring carryover deduction or deal with an alternative minimum tax problem.

2. *The Borrower*

On the borrower's side, he is deemed to have received an equivalent payment of additional compensation or dividends (or return of capital), or a tax-free gift depending on the loan's context. As additional compensation, there can be more employee FICA taxes to pay. With his imputed income from the first step transaction and presumably additional income from his investment of the loan proceeds, the borrower will have a higher threshold for his medical and casualty loss deductions, or an expanded base for deducting contributions to charity.

Since the demand loan borrower who itemizes will normally have an offsetting deduction (or, in the case of a gift, a new deduction), the new income tax rules would appear to weigh more heavily on the lender in the corporation-shareholder and gift loan cases. The special damage possible to the employee or shareholder borrower under a term loan has already been noted. In every case, the borrower will be embarrassed if his imputed interest payment back to the lender is disqualified as a tax deduction because of his holdings of tax-exempt securities or violation of the excess investment interest rules.

3. *Exemptions*

Congress has delegated broad authority to the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section," and even to adopt "regulations exempting from the application of this section any class of transactions the interest arrangements of which have no significant effect on any Federal tax liability of the lender or the borrower." I.R.C. § 7872(g)(1). The area of interest-free loans between estates, trusts and their beneficiaries is not mentioned in the statute or committee reports. Obviously, much valuable information on the scope and effect of the new rules must be imparted by the Regulations, whenever published.

The congressional conferees seemed to be particularly concerned about existing loans made to a continuing care facility by its residents, and felt it necessary to include a specific exception for any transaction of this type entered into before June 6, 1984. TRA § 172(c)(3). The Regulations will obviously deal with such transactions hereafter. On the other hand, the House Report anticipates that the Regulations will exempt low-interest student loans, insurance policy loans, regular savings accounts at financial institutions, and similar "occasional transactions . . . not designed to shift income." H.Rep. 98-432, 98th Cong., 2d Sess. 1378 (Mar. 5, 1984).

For compensation-related loans, the Regulations may exempt employee-relocation loans under the "no significant effect" rubric (*see* Conf. Rep. 1023), but there is only one stated *de minimis* exception; namely, aggregate loans of $10,000 or less to the borrower. Presumably, this will cover most small advances for travel expenses or other day-to-day routing allowances for someone who has not otherwise borrowed any money from the company (regardless of the interest rate). The statute withdraws even this small exception for both compensation-related and corporation-shareholder loans as to "any loan the interest arrangements of which have as 1 of their principal purposes the avoidance of any Federal tax" (e.g., FICA taxes). I.R.C. § 7872(c)(3)(B).

As to gift loans "directly between individuals" (i.e., trusts and family corporations are not included), a separate $10,000 *de minimis* exception also applies if, after aggregated husband and wife as one lender (and again, regardless of the interest rates charged), the loan proceeds are not found "directly attributable to the purchase or carrying of income-producing assets"—

conclusively presumed to be the only type of tax avoidance individuals are interested in. *Compare* I.R.C. § 7872(c)(3)(B) *with* I.R.C. § 7872(c)(2)(B). Acknowledging (but rejecting) the vigorous pre-enactment opposition to any test that requires the donor to invade the privacy of the donee's income tax return, "the conferees wish to emphasize that this is an anti-abuse provision, and should be interpreted in light of its purpose of preventing the avoidance of the assignment of income rules and the grantor trust rules." Conf. Rep. 1021.

4. *Gift Loans for Consumption*

Gift loans used by a borrower for his consumption needs (e.g., education, medical costs, housing or the like), as contrasted to reinvestment for interest or dividend income, are given more liberal treatment. If the borrower's net investment income for the year does not exceed $1,000 (determined under § 163(d)(3) and including a ratable portion of any deferred payment obligations held—even a U.S. savings bond), then the new income tax rules do not apply at all to loans "directly between individuals" of up to $100,000 from each lender (husband and wife being treated as one). I.R.C. § 7872(d)(1). Nevertheless, if one of the loans' "principal purposes [is] the avoidance of any Federal tax," the Regulations may disqualify the use of low-interest loans: perhaps if used to establish a venture that throws off business rather than investment income. An indigent may still be able to buy a Rolls Royce, unless the tax collector decrees that any loan to someone who has no income is a sham *per se* and not worthy of the still essential debtor/creditor classification.

Even if the borrower has net investment income of more than $1,000 during the year, aggregate non-tax avoidance gift loans of $100,000 or less will subject the lender to tax only on the amount of the borrower's net investment income for the year. I.R.C. § 7872(d)(1)(A). Accordingly, if the borrower (and his spouse, if any) nets only 6% on the gift loan and his other resources during the year, the lender's imputed interest income and the borrower's imputed interest deduction is limited to the 6% earned (*cf.*, the grantor trust rules).

If the borrower has gift loans from different lenders (e.g., his parents and grandparents), then his net investment income will be allocated proportionately between the loans on the basis of what would have been their imputed interest shares. I.R.C §7872(d)(1)(C). There does not appear to be any requirement that the borrower's net investment income be apportioned only to the period the loan was outstanding during the year, so that presumably a gift loan made or paid off in October, for example, must deal with the borrower's net investment income for the entire year.

B. *Gift Tax*

Since the Act inserts the new interest-free and below-market interest loan rules into the Code as § 7872 (i.e., under Chapter 80 prescribing general rules for provisions affecting more than one subtitle of the Code), the new valuation rules, as well as the $10,000 *de minimis* aggregate loan exception, now also apply for gift tax purposes. The $100,000/net investment income exception, however, is applicable only "[f]or purposes of Subtitle A" (i.e., income taxes) and, therefore, does not carry over to the gift tax area. *See* I.R.C. § 7872(d)(1)(A).

The statute also makes clear that, in the initial transfer step, the value of a term gift loan cannot be reported as a ratable gift each year on December 31, as its conversion to demand loan status for income tax purposes would appear to require. I.R.C. § 7872(d)(2). The form of a term loan between family members is, therefore, fully recognized in its gift tax context, even though for income tax timing purposes it is disregarded and treated in substance as a demand loan for reporting simplicity (and possibly increased revenue since the usually higher Federal rate applicable to the initial stated term still applies when valuing the retransfer of interest for income tax purposes in each subsequent year). *See* Conf. Rep. 1020 at fn. 11.

C. *Estate Tax*

The statute directs the Secretary to prescribe regulations requiring a below-market term loan to be valued in the estate of the lender in a manner consistent with the gift tax treatment of that loan. I.R.C. § 7872(g)(2). The same uniform valuation rules will now be applied for estate tax purposes as to any term loans made, renegotiated, extended or revised after June 6, 1984. *See* TRA § 172(c)(5).

Conclusion

There is nothing simple about the new interest-free and below-market interest rules. No party to a term loan, for example, can compute his tax liability without present value tables or a calculator.

Absent an extraordinary degree of tolerance in the Regulations, only the $10,000 *de minimis* exception is available to cover the multitude of routine transactions that may now be classified as below-market loans. Nor are there any convenient safe harbors, like the old 6% or 9% minimum interest rates under § 483.

In employer-employee situations, the FICA tax implications can be serious. Although Chapter 24 income tax withholding is not required, Chapter 21 FICA tax payments are. *See* Conf. Rep. 1019.

The use of term loans in a nongift context (remember: term gift loans are treated as demand loans for timing the income tax results) is not going to be tax neutral hereafter. Paradoxically, new § 7872's attempt to sweep tax avoidance loans into its ambit appears to be thwarted by its own provisions, since the only time a term loan arrangement will now be used is to lock in a low term rate (like the 10% transitional rate in place through December 31, 1984) in the special employer-employee loan category (i.e., nontransferable and conditioned on future services) or to shift the tax impact on one, or perhaps both, of the parties to the transaction due to the failure of the original issue discount rules to match the interest income/deduction element to the compensation paid/received side of the transaction.

Interest-free loans to help a child finance his higher education or a parent enjoy a more secure retirement are still practical, but not as pure income-shifting devices as in the past. Clifford trusts are available for that (and the gift tax cost—under the new actuarial tables at 10% interest compounded annually, could be a small bargain, depending on the term required).

New questions are raised if the family member prepays his note before its scheduled maturity (no gift tax recovery and, since deemed a demand loan for income tax timing purposes, presumably no cancellation of indebtedness income to the father), or the lender extends the loan's maturity at some point along the way (pretty clearly a new gift), or the loan is modified to begin charging some interest (recomputations needed all around, assuming the lender does not follow a regular pattern of giving the family member the interest payments, *see* Conf. Rep. 1021).

Few will be faulted if they cannot fathom the new rules. Even more may choose to disregard them. The tax system will be the losers, if they do.