

Fall 1998

Ambushed in a Safe Harbor: Taxation of Intrafamilial Installment Sales Contracts

Stephen J. Wolma

Follow this and additional works at: <https://scholar.valpo.edu/vulr>



Part of the [Law Commons](#)

Recommended Citation

Stephen J. Wolma, *Ambushed in a Safe Harbor: Taxation of Intrafamilial Installment Sales Contracts*, 33 Val. U. L. Rev. 309 (1998).

Available at: <https://scholar.valpo.edu/vulr/vol33/iss1/11>

This Notes is brought to you for free and open access by the Valparaiso University Law School at ValpoScholar. It has been accepted for inclusion in Valparaiso University Law Review by an authorized administrator of ValpoScholar. For more information, please contact a ValpoScholar staff member at scholar@valpo.edu.



Welma: Ambushed in a Safe Harbor: Taxation of Intrafamilial Installment

AMBUSHED IN A SAFE HARBOR: TAXATION OF INTRAFAMILIAL INSTALLMENT SALES CONTRACTS

*Taxes are the price we pay for a civilized society.*¹

I. INTRODUCTION

Ms. Vreet has established her law practice in the small town of Rudyard, Michigan. She earns her living by offering legal services to members of the immediate community. One sunny afternoon in August, Mrs. Barnes and Mr. Sheers visited Ms. Vreet, seeking legal advice on a similar matter.²

Mrs. Barnes is a fifty-six year old widow living near Rudyard. At the time of his death, Mr. Barnes owned seventy-five acres of farmland with his wife. With the help of their son, Mr. Barnes raised crops on the land and sold them. Although Mr. and Mrs. Barnes could always afford to pay for food and shelter, the profits from selling the crops barely covered their necessities. As a result, Mr. and Mrs. Barnes could not save much money for the future. Under the terms of Mr. Barnes' will, Mrs. Barnes became sole owner of the farmland after his death.

¹ As quoted in different materials on taxation, Oliver Wendell Holmes remarked, "Taxes are what we pay for a civilized society." See CHARLES ADAMS, *FOR GOOD AND EVIL* xxi (1993); SIDNEY RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 17 (1967). While Justice Holmes correctly noted that taxes are necessary to support a civilized society, those taxes should remain predictable and fair. Adam Smith, an influential economist who lived during the latter half of the eighteenth century, created the following maxims as a guide for the statesmen who must institute taxes:

- 1) Taxes should be equitable;
- 2) Taxes should be certain;
- 3) Taxes should be conveniently levied;
- 4) Taxes should be economical.

HAROLD M. GROVES, *TAX PHILOSOPHERS: TWO HUNDRED YEARS OF THOUGHT IN GREAT BRITAIN AND THE UNITED STATES* 18 (Donald J. Curran ed., 1974). For more information on these maxims and tax policy, see section V.A. of this Note.

² Ms. Vreet, Mrs. Barnes, Mr. Sheers, and all other characters appearing in this section compose a hypothetical that this Note will use to demonstrate the problems associated with the taxation of intrafamilial installment sales contracts, and also to show the effects of the solution to that problem. The reader should keep in mind that this Note uses this hypothetical merely as a device for providing a clear explanation of the problems and effects associated with the taxation of intrafamilial installment sales contracts. This hypothetical merely presents a representative reaction to the current taxation of intrafamilial installment sales contracts. It is not meant to suggest exactly how every taxpayer would respond when facing the current taxation of intrafamilial installment sales contracts.

At fifty-six, Mrs. Barnes does not want to manage the farm, but she still needs to replace the revenue earned from the growing and selling of the crops. Although she dislikes the idea of parting with the farm, Mrs. Barnes realizes that she must sell the farm to replace the lost revenue. The local appraiser determines that the fair market value for the farm land would be \$150,000.³ Naturally, Mrs. Barnes wants the farmland to stay "in the family," so she asks her son, Horace, if he would be interested in buying the farm for \$150,000. Having little money himself, Mrs. Barnes' son promises to buy the farm so long as he does not have to pay the \$150,000 in a lump sum. Of course, Mrs. Barnes agrees to the scheduled payment arrangement. Sympathetic to her son's financial difficulties, Mrs. Barnes does not want to charge her son more than the fair market value for the farm. Now Mrs. Barnes asks Ms. Vreet to draft a contract under which she would sell the farm to Horace for a series of payments over five years totaling \$150,000.

Unlike Mrs. Barnes, Mr. Sheers is a prosperous resident of Rudyard. He owns the local grocery store and barber shop. Mr. Sheers' daughter is a beautician. She asks her father if she can buy the barber shop and convert it into a beauty salon. Mr. Sheers agrees, estimating that the fair market value of the barber shop and the surrounding property is \$100,000. She cannot pay the \$100,000 immediately, but convinces her father that she will be able to pay the full price in installments. She also offers to pay interest on top of the sale price. Mr. Sheers knows that his daughter can afford to pay the interest. He agrees to establish a loan arrangement consisting of principal and interest payments over the next five years.

Because Mr. Sheers has been involved in many previous business dealings, he commands a more sophisticated knowledge of installment sales contracts than Mrs. Barnes. Whereas Mrs. Barnes does not consider

³ Valuing seventy-five acres of farmland at \$150,000 may seem low. However, this hypothetical does not place Mrs. Barnes on farmland located close to any housing or industrial developments. Rather, Mrs. Barnes lives in a removed, rural area. The farming equipment and the barn are not worth much either. Thus, the \$150,000 appraisal would not be outrageously low. However, for the purposes of this Note, an accurate appraisal is not necessary. This Note only needs to assign some reasonably accurate dollar values to Mrs. Barnes' and Mr. Sheers' property, because this Note will note use the hypothetical dollar values to say anything about the actual worth of the land located in Rudyard, but rather to illustrate the problems associated with the taxation of intrafamilial installment sales contracts. Furthermore, this Note does not address taxpayers' attempts to manipulate appraisal figures in order to gain a tax advantage. Such schemes are always available if a taxpayer is willing to pay enough and run the risk of an audit. See *infra* notes 279-286 and accompanying text.

tax implications, Mr. Sheers anticipates that the installment sales contract with his daughter will carry tax consequences. Mr. Sheers then asks Ms. Vreet to draft an installment sales contract that will result in the least amount of tax liability.⁴ Mr. Sheers makes no secret that he expects to take advantage of any tax loopholes that exist in this area.⁵

After assuring her clients that she can draft their installment sales contracts, Ms. Vreet pages through the Internal Revenue Code (IRC), looking for potential income⁶ and gift⁷ tax consequences. Ms. Vreet

⁴ Mr. Sheers wants Ms. Vreet to draft his installment sales contract to avoid, not evade, taxes. Avoidance is an individual's manipulation of affairs within the law so as to reduce tax liability. SIMON JAMES & CHRISTOPHER NOBLES, *THE ECONOMICS OF TAXATION* 102 (1978). Evasion is an illegal manipulation to avoid tax liability. *Id.* This Note does not address the issue of tax evasion. For a discussion of tax evasion see generally CARL P. SIMON & ANN D. WITTE ET AL., *BEATING THE SYSTEM: THE UNDERGROUND ECONOMY* (1982).

⁵ Although Mr. Sheers' desire to avoid taxes is legal, his attitude toward capitalizing on tax loopholes creates problems with other taxpayers in itself. See RONALD PASQUARIELLO, *TAX JUSTICE: SOCIAL AND MORAL ASPECTS OF AMERICAN TAX POLICY* 53 (1985) (pointing out that a sense that tax loopholes are unfair is one of the primary motivations to cheat on taxes).

⁶ Under 26 U.S.C. § 63 (1994), Congress has the power to tax gross income minus any deductions. This Note assumes Mr. Sheers and Mrs. Barnes cannot make any deductions pertaining to their intrafamilial sales contracts. 26 U.S.C. § 61 (1994) defines gross income as "income from whatever source derived." The question then becomes what is income for the purposes of the IRC. Professor Simons' often repeated definition of income is the "algebraic sum of (1) the market value of rights exercised in consumption, and (2) the change in the value of the store of property rights between the beginning and the end of the period in question." See HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938). However, Professor Simons conceded that this definition of income was too broad to provide a workable tax base. See PAUL R. MCDANIEL ET AL., *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 84 (3d ed. 1994). The United States Supreme Court has stepped in to narrow Simons' definition of income through an evolution of holdings. In *Eisner v. Macomber*, 252 U.S. 189, 207 (1920), the Court defined income as "the gain derived from capital, from labor, or from both combined, provided that it be understood to include profit gained through a sale or conversion of capital assets." Refining the *Eisner v. Macomber* definition, the Court later held that income is "undeniable accessions to wealth, clearly realized, and over which the taxpayer have complete dominion." See *Glenshaw Glass v. Commissioner*, 348 U.S. 426, 431 (1955). Given the above definition of income, it is easy to see that selling property to your children constitutes taxable income under 26 U.S.C. §§ 61, 63. If they sell the property for more than they originally paid for it, Mrs. Barnes and Mr. Sheers would experience an accession to wealth, that was realized through the conversion of the property to cash payments. They would also exercise complete dominion because they could spend the money received for the property however they wanted.

⁷ Under 26 U.S.C. § 2501 (1994), Congress may impose a tax on any property transferred by gift. For the purposes of the IRC, the word gift is not used in its "colloquial sense," and "donative intent"—the conventional common law test of a gift—is not a requisite of a taxable gift. See BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL INCOME TAXATION OF INCOME, ESTATES, AND GIFTS* 121-22 (2d ed. 1984) (citing *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945)). The Tax Court has held that to be a gift, the transfer merely needs to be donative in character. See *Bradford v. Commissioner*, 34 T.C. 1059, 1064 (1960) (acq.). Although Mr.

discovers that the installment sales contracts that Mrs. Barnes and Mr. Sheers wish to enter into may incur both federal income and gift tax liabilities.⁸ Congress has passed statutes that do not allow taxpayers to escape tax liability on installment sales contracts that do not include interest payments.⁹ Under these statutes, the Internal Revenue Service (IRS) may impute interest into a portion of the payments if the terms of the contract do not provide for a minimum level of interest payments.¹⁰ However, Congress also allowed an exception for qualified sales, which occur when an individual sells or exchanges land to a member of that individual's family.¹¹ For a qualified sale, the safe harbor interest rate is six percent.¹² The safe harbor prevents the IRS from imputing more than a six percent interest rate in those qualified sales that do not include the minimum level of interest.¹³

Congress has also addressed installment sales contracts by enacting statutes that allow the IRS to impose gift tax liability on below-market loans.¹⁴ A below-market loan is a loan arrangement that fails to include minimum level interest payments.¹⁵ This minimum level corresponds to the interest rate required in regular installment sales contracts to avoid

Sheers does not reveal any donative intent anyway, Mrs. Barnes may reveal some donative intent, because she does not wish to charge any interest on the sale to her son.

⁸ In addition to taxing the amount of gain Mr. Sheers and Mrs. Barnes would realize from selling the property, the IRS will impute interest into any installment sales contract that does not provide for interest payments in an amount equal to the applicable federal rate. See 26 U.S.C. §§ 483, 1274 (1994). The IRS will also determine that Mr. Sheers and Mrs. Barnes made a taxable gift of the amount of the forgone interest to their children if their installment sales contracts do not provide for interest payments equal to the applicable federal rate. See 26 U.S.C. § 7872 (1994). Under an alternative theory, the IRS could also find that Mr. Sheers and Mrs. Barnes made a taxable gift of the forgone interest, because failing to charge interest on a deferred sale does not constitute full and adequate consideration for the transfer. See 26 U.S.C. § 2512 (1994). The income and gift taxation of these contracts is dealt with later in depth. See *infra* section III.

⁹ See 26 U.S.C. §§ 483, 1274, 2512, 7872 (1994).

¹⁰ See 26 U.S.C. §§ 483, 1274, 2512, 7872 (1994). This means that the IRS will recategorize any payment scheme that does not include enough payments for interest, thereby making the payments for interest greater and the payments for principal less for tax purposes.

¹¹ See 26 U.S.C. § 483(e)(2). For the purposes of section 483(e), the IRC defines a family as brothers, sisters, ancestors, and lineal descendants. See *infra* note 24.

¹² See 26 U.S.C. § 483(e)(1).

¹³ See *Id.*

¹⁴ 26 U.S.C. § 7872 is one provision that handles the treatment of below-market loans for gift tax purposes. 26 U.S.C. § 2512 does not explicitly discuss below-market loans, but it does require full and adequate consideration for a transfer of property to avoid gift tax liability. A below-market loan is a transfer of property for below full and adequate consideration. See *infra* notes 47-53 and accompanying text.

¹⁵ See 26 U.S.C. § 7872(e)(1).

the imputation of income tax.¹⁶ However, the minimum level employed to determine a below-market loan significantly exceeds the safe harbor rate for qualified sales.¹⁷ Here, Ms. Vreet recognizes a discrepancy. A seller involved in a qualified sale could include a six percent interest rate and receive a safe harbor from the imputation of interest for income tax purposes, but not for gift tax purposes.¹⁸ Thus, compliance under one section of the IRC results in liability under another, and the safe harbor becomes a gift tax trap.¹⁹

Unfortunately, the case law interpreting these provisions does not reconcile the conflicting requirements between the gift and income tax provisions of the IRC pertaining to qualified sales. Furthermore, a conflict exists between the Seventh, Eighth, and Tenth Circuits, with regard to the reach of the safe harbor provision. The Seventh Circuit has held that the safe harbor for qualified sales protects taxpayers from undesirable income and gift tax liability.²⁰ The Eighth and Tenth

¹⁶ The minimum level of interest for the income and gift tax provisions pertaining to installment sales contracts is the applicable federal rate as determined under 26 U.S.C. § 1274(d). See 26 U.S.C. § 483(b); 26 U.S.C. § 7872(f)(2). Because the applicable federal rate is gauged to be close to the prevailing market interest rate, the IRS would probably use that rate to determine full and adequate consideration under 26 U.S.C. § 2512.

¹⁷ The imputed interest rate used to be determined with the fixed percentage rate found in 26 U.S.C. § 483. However, Congress concluded that using a fixed test rate resulted in an imputation rate which was frequently less than the prevailing market rates. Burton W. Kanter & Sheldon I. Banoff, *Have Imputed Interest Amendments Backfired?*, 65 J. TAX'N 375 (1986). Congress then enacted 26 U.S.C. § 1274 to attempt to maintain a test rate closer to the prevailing market rate by replacing a fixed test rate with a floating rate equal to the applicable federal rate, compounded semiannually. *Id.* Prevailing market interest rates exceeded six percent in the 1980's because of high inflation, continued deficit spending by the federal government, and an ever increasing national debt. See Frank J. Slagle, *Accounting for Interest: An Analysis of Original Issue Discount in the Sale of Property*, 32 S.D. L. REV. 1(1987).

¹⁸ Consider a person who wishes to sell a hundred acres of land to her daughter. Because her daughter is her lineal descendant, the person could set up an installment sales contract with a six percent interest rate and remain free from imputed interest. See 26 U.S.C. § 483(e); 26 U.S.C. § 1274(c)(3)(F). However, the IRS would still use the applicable federal rate to determine if the person's installment sales contract will incur gift tax liability. See 26 U.S.C. § 7872(f)(2); 26 U.S.C. § 2512. The applicable federal rate is higher than six percent. See *supra* note 17. Therefore, including a six percent interest rate, in lawful compliance with section 483(e), will prevent the IRS from using the applicable federal rate to impute additional interest for income tax purposes, but the IRS will still use the applicable federal rate to impute additional interest for gift tax purposes.

¹⁹ See Jay D. Benjamin, Note, *The Safe-Harbor Interest Rates Under Section 483 of the Internal Revenue Code: A Gift Tax Trap*, 20 IND. L. REV. 679 (1987) (pointing out that use of an inappropriate interest rate in installment sales contracts can create unforeseen gift tax consequences for related parties, because the IRC applies two different rates in these situations: the market rate and the safe harbor rate).

²⁰ See *Ballard v. Commissioner*, 854 F.2d 185, 188 (7th Cir. 1988).

Circuits have disagreed and held that the safe harbor interest rate for the imputation of income tax is irrelevant for the purposes of gift tax valuation.²¹ The Tax Court has held repeatedly that the safe harbor rate does not protect taxpayers from gift tax liability.²²

Ms. Vreet grows perplexed and slumps back into her chair. She cannot adequately advise her clients about the income and gift tax consequences of their desired installment sales contracts.²³ For both Mrs. Barnes and Mr. Sheers, selling the property to their children constitutes a qualified sale.²⁴ Ms. Vreet can include a six percent interest rate and insulate her clients from the imputed income tax liability, but she cannot promise that the safe harbor rate will protect them from potential gift tax liability.²⁵ Ms. Vreet must either draft installment sales contracts that require interest payments up to the minimum level required for gift tax purposes or include the safe harbor rate that may subject her clients to undesirable gift tax liability.²⁶ The best that Ms. Vreet can do is to tell Mrs. Barnes and Mr. Sheers the current legal situation and hope that neither one storms out of her office in disgust.²⁷

²¹ See *Schusterman v. United States*, 63 F.3d 986, 994 (10th Cir. 1995); *Krabbenhoft v. Commissioner*, 939 F.2d 529, 533 (8th Cir. 1991).

²² See *Frazee v. Commissioner*, 98 T.C. 554, 585 (1992); *Krabbenhoft v. Commissioner*, 94 T.C. 887, 890 (1990), *aff'd with the separate concurring opinion of Judge Henley by Krabbenhoft v. Commissioner*, 939 F.2d 529 (1991); *Ballard v. Commissioner*, 53 T.C.M. (CCH) 323, 327 (1987), *rev'd by Ballard v. Commissioner*, 854 F.2d 185 (1988).

²³ The United States Supreme Court never reconciled this conflict in the Circuits. Thus, the holdings of the Seventh, Eighth, or Tenth Circuits do not bind the Sixth Circuit, which is the United States Court of Appeals that has jurisdiction over Michigan, Ms. Vreet's state of practice. See DIANA V. PRATT, *LEGAL WRITING: A SYSTEMATIC APPROACH* 38 (2d ed. 1993) (stating that under the rule of stare decisis, a court is bound by cases that it has already decided previously and by all court decisions of a higher court in its system).

²⁴ 26 U.S.C. § 483(e)(2) states that 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). 26 U.S.C. § 267(c)(4) (1994) limits the family of an individual to brothers, sisters, spouse, ancestors, and lineal descendants. Mrs. Barnes' son and Mr. Sheers' daughter are certainly their lineal descendants and therefore qualify as members of the families of Mr. Sheers and Mrs. Barnes within the meaning of 26 U.S.C. § 267(c)(4).

²⁵ See *supra* notes 18-23 and accompanying text.

²⁶ The conflict in the circuits opens two different approaches for taxpayers who enter into qualified sales involving an installment sales contract. See Courtney N. Stillman, *Choosing Interest Rates for Family Transactions To Avoid a Gift As Well As Imputed Income*, 83 J. TAX'N 155 (1995). A taxpayer can either take an aggressive position and use the safe harbor rate that may result in a confrontation with the IRS, or the taxpayer could take a conservative position and use the slightly higher applicable federal rate that would create no unforeseen tax liability. *Id.*

²⁷ Both the aggressive and conservative positions are unacceptable for Mrs. Barnes because she does not have the resources to litigate the matter with the IRS nor does she have the

The IRC should be clear so that an attorney in Ms. Vreet's position can give tax advice with certainty.²⁸ Furthermore, anyone in Mrs. Barnes' or Mr. Sheers' situation should not have to include interest payments above the safe harbor rate in order to avoid gift tax consequences.²⁹ This Note proposes that once the six percent safe harbor interest rate is written into an intrafamilial installment sales contract, the seller should not only be free from the imputed interest for income tax purposes, but also from gift tax liability for a below-market loan. Congress should amend the IRC to include a section that permits a taxpayer to write the safe harbor rate into an intrafamilial installment sales contract without incurring adverse income or gift taxes.³⁰

Section II of this Note will examine some basic concepts relating to the time value of money implicated by installment sales contracts.³¹ Section III will discuss the legislative attempts to tax installment sales contracts according to their appropriate time value of money.³² Section IV will chronologically recount the cases that have created confusion about the extent to which the safe harbor rate of 26 U.S.C. § 483(e) applies for gift tax valuation.³³ Section V will show that the safe harbor rate of 26 U.S.C. § 483(e) must apply for both income and gift tax purposes in order to remain consistent with good tax policies.³⁴ After emphasizing why the safe harbor needs reform, Section V will also demonstrate how that reform may be implemented.³⁵ Section VI will propose a statutory amendment that will properly reform the IRC so that taxpayers who include the safe harbor in an intrafamilial installment sales contract will insulate themselves from additional income or gift tax liability.³⁶

money to pay the additional gift tax. Although Mr. Sheers could afford to pay the gift tax, he does not want to pay a higher tax if he can avoid it. Also, Mr. Sheers could afford litigation on this issue, but paying this cost would defeat his underlying purpose of saving money. Thus, although the situation is undesirable for both, it is much bleaker for Mrs. Barnes. See *infra* notes 250-253 and accompanying text.

²⁸ See *infra* notes 257-261 and accompanying text.

²⁹ Senators Mechler, Boschwitz, Grassley, and Jespen express some of the policy reasons why someone in Mrs. Barnes and Mr. Sheers should not need to include an interest rate higher than the safe harbor. See *infra* note 120.

³⁰ See *infra* notes 328-338 and accompanying text.

³¹ See *infra* notes 37-77 and accompanying text.

³² See *infra* notes 78-161 and accompanying text.

³³ See *infra* notes 162-236 and accompanying text.

³⁴ See *infra* notes 245-278 and accompanying text.

³⁵ See *infra* notes 302-338 and accompanying text.

³⁶ See *infra* section VI.

II. THE TIME VALUE OF MONEY AND INSTALLMENT SALES CONTRACTS

This section begins by discussing two central concepts of the time value of money. Next follows the effect of the time value of money on installment sales and how taxpayers can manipulate installment sales contracts to gain a tax benefit. This manipulation prompted Congress to realize that it needed to pass statutes that tax the time value of money accurately.

A. Central Concepts of the Time Value of Money

In order to demonstrate how taxpayers can manipulate installment sales contracts, two central concepts of the time value of money require explanation. Those two concepts are lost investment opportunity and present value.

1. Lost Investment Opportunity

Although calculating the time value of money depends on many circumstances,³⁷ the fundamental principle of the time value of money is that an amount of money in the present is worth more than the same amount of money in the future.³⁸ The value of a fixed amount of money decreases over time because of lost investment opportunities.³⁹ In other

³⁷ See DANIEL Q. POSIN, *FEDERAL INCOME TAXATION OF INDIVIDUALS: WITH DIAGRAMS FOR EASY UNDERSTANDING OF THE LEADING CASES AND CONCEPTS 1-33* (3d ed. 1997) for a discussion of these subjects, including the growth of capital, interest, present value analysis, and simple and compound interest. Posin's text also addresses how the time value of money can eliminate taxes, create multimillionaires, allow a corporation to run over a pedestrian for a profit, and affect the calculations of original issue discount. This Note's central thesis concerns the taxation of intrafamilial installment sales contracts, and therefore does not need to address the time value of money beyond its application in the context of intrafamilial installment sales contracts. Of course, the time value of money is a key principle involved in numerous other areas including accounting, finance, and business. For more information about the time value of money outside the scope of this Note see generally Calvin H. Johnson, *Accounting in Favor of Investors*, 19 CARDOZO L. REV. 637, 657-663 (1997); Stephen B. Land, *Contingent Payments and the Time Value of Money*, 40 TAX L. REV. 237 (1987); Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 9 (1986); Theodore S. Sims, *Debt, Accelerated Depreciation, and the Tale of a Teakettle: Tax Shelter Abuse Reconsidered*, 42 UCLA L. REV. 263 (1994).

³⁸ Another way to consider this concept is in terms of future debt or repayment of debt: the present value of a future expense obligation or a future receipt right is worth less than its stated amount. JAMES S. EUSTICE, *THE TAX REFORM ACT OF 1984: A SELECTIVE ANALYSIS 2-2* (1984). Simply stated, a dollar in hand today is worth more than the dollar in hand tomorrow. *Id.*

³⁹ Daniel Posin offers a clear example of an investment opportunity situation. POSIN, *supra* note 37, at 7. He explains that \$100 today is more valuable because the money can earn a six percent interest rate in a savings account and grow to \$106 after a year. POSIN, *supra*

words, if a person is given \$10,000 today, that person can invest that \$10,000 and collect a yield based on a certain percentage of the \$10,000 over the next five years.⁴⁰ A second person who instead receives \$10,000 after five years does not have the opportunity to invest this money and will ultimately have less money than the person who could invest the money immediately.⁴¹ Thus, the time value of money can be defined as the amount of money given at a certain date plus the amount of the investment opportunity.⁴²

2. Present Value

Another key principle involved with the time value of money is present value.⁴³ Because the value of money can grow over time, a future sum of money has a different value than the same present sum of money.⁴⁴ For example, if a person wants to purchase a \$30,000 car in five

note 37, at 7. Although depositing money into a savings account is not the most lucrative investment, the \$6 increase does provide an investment return. Not possessing the money in the present denies any person the opportunity to acquire an investment return. See also MCDANIEL ET AL., *supra* note 6, at 1132 (including a similar discussion about investment opportunities using a dollar and a ten percent interest rate). Inflation also decreases the value of a fixed amount of money over time. See ROBERT S. MORRISON, INFLATION CAN BE STOPPED 3 (1973) (defining inflation more precisely as a general and continuing increase in the price of raw materials, products, services, real estate, intangibles, wages, taxes, and other items for which money is paid). This Note is concerned with the effect of the time value of money on one person, rather than on all the people, within an economic system. Opportunity costs affect a single person within an economic system and merit further discussion in this Note. However, inflation affects the time value of money for all people within an economic system, so this Note does not address it any further. For more discussion on inflation see generally MORRISON, *supra* this footnote.

⁴⁰ The certain percentage of \$10,000 is interest, which the Supreme Court defined as "compensation for the use or forbearance of money." See *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). In other words, interest is the amount that a person has contracted to pay for the use of borrowed money. See *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552, 560 (1931). A person who borrows money must compensate the lender, because borrowing the money denies the lender's investment opportunity. See *supra* notes 38-39 and accompanying text.

⁴¹ Conversely, a person given a lump sum of money not owed until a later date will receive a benefit from being able to invest this money early. See David L. Roberts & William F. Landesa, *Inflation and the Present Value of Future Economic Damages*, 37 U. MIAMI L. REV. 93, 94 (1982).

⁴² See POSIN, *supra* note 37, at 7. The time value of money could also be defined as the amount of money given at a certain date minus the amount of an investment return. See Roberts & Landesa, *supra* note 41.

⁴³ This term appears numerous throughout the I.R.C. See 26 U.S.C. §§ 42, 56, 72, 143, 149, 280G, 401, 404, 411, 412, 414, 416, 417, 420, 457, 467, 483, SOI, 514, 832, 846, 60E, 86OI, 1272, 1274, 1298, 1379E, 4980, 7448, 7872 (1994).

⁴⁴ POSIN, *supra* note 37, at 7. The value of a fixed amount of money can also decrease over time because of inflation. See MORRISON, *supra* note 39, at 3.

years, that person does not need to set aside \$30,000 now. Assume that this person finds an account that bears an eight percent interest rate compounded annually. If that person deposits \$18,905.09 into that account today, she will have \$30,000 after five years.⁴⁵ Present value then is the current worth of a future sum of money.⁴⁶ Having abstractly defined lost investment opportunity and present value, these concepts can be concretely applied to installment sales of real property.

B. Time Value of Money Analysis Applied to Installment Sales Contracts

In the context of an installment sale of real property, the seller does not receive the total payment for the purchased land at the time of the sale.⁴⁷ The seller then experiences a loss of investment opportunity.⁴⁸

⁴⁵ Exactly what sum of money a person needs to set aside now to produce \$30,000 after five years depends on the rate of interest involved and how the interest is compounded. Slagle, *supra* note 17, at 21. Present value can be determined using the following equation:

$$PV = \frac{FV}{(1+I)^N}$$

where "PV" is present value, "I" is the interest rate, "FV" is the future value, and "N," is the number of compounding periods in which the interest will accrue. See MCDANIEL ET AL., *supra* note 6, at 1268. This formula then allows the person who wants to buy a \$30,000 car in five years to calculate how much he will need to invest in an account that bears an eight percent interest rate compounded annually. The desired "FV" is 30,000, the "I" is .08 (8%), and the "N" is 5 (compounding annually means once a year for five years). Replacing these variables yields the following equation:

$$PV = \frac{30,000}{(1+.08)^5}$$

Crunching these numbers through the formula demonstrates that the present value equals 18905.09. This means that the person who wants a \$30,000 car only needs to invest \$18905.09 in the proper account to have the car after five years. For another application of this formula, see MCDANIEL ET AL., *supra* note 6, at 1269.

⁴⁶ Slagle, *supra* note 17, at 21.

⁴⁷ Two of the financing agreements that contracting parties use to govern the installment sales of real property are mortgages and installment land contracts. JOHN E. CRIBBET ET AL., PROPERTY: CASES AND MATERIALS 997 (7th ed. 1996). A mortgage document conveys the land from the buyer to the seller, but the object of the document is not to effect a sale of land, but to provide security for the payment of debt. KRATOVIL, REAL ESTATE LAW (5th ed. 1996), reprinted in JOHN E. CRIBBET ET AL., PROPERTY: CASES AND MATERIALS 1001 (1996). An installment land contract does not give title to the buyer as the mortgage does. OSBORNE, SECURED TRANSACTIONS (1967) reprinted in JOHN E. CRIBBET ET AL., PROPERTY: CASES AND MATERIALS 1007 (1996). However, the buyer under an installment land contract occupies a similar relative position to the buyer under a mortgage, because both take possession of the property under either document. *Id.* Thus the seller turns over real property for possession without receiving full payment for the purchase price of the land.

Because some buyers cannot afford to pay the seller the total purchase price in one lump sum, these buyers must compensate the seller for the loss of investment opportunity.⁴⁹ Otherwise, the seller would hold the land until someone would pay the full purchase price, insuring that the seller suffers no loss.⁵⁰ In this scenario, the buyer will need to pay interest to compensate the seller's lost investment opportunity.⁵¹ The buyer and seller generally determine the amount of interest based on a percentage of the principal.⁵² Then, the buyer and seller construct a contract in order to govern the amount of interest and principal that the buyer must pay at the end of every pay period.⁵³

Normally when two parties enter into a loan arrangement,⁵⁴ each party negotiates the terms of the contract in favor of their own economic interest.⁵⁵ The seller wants to receive full compensation for the

⁴⁸ If the seller had the total purchase price, the seller would be able to invest all of that money. Under a deferred payment plan, the seller only receives a portion of the total purchase price at the time of the sale. See *supra* note 47. Thus, if the buyer paid under a deferred payment plan, the seller can only invest a portion of the total sale price at the time of the sale, whereas if the buyer paid the total purchase price immediately, the seller could invest the total purchase price at the time of the sale. Compare *supra* notes 39-41 and accompanying text.

⁴⁹ Both Mrs. Barnes' son and Mr. Sheers' daughter fall into this situation. See *supra* section I.

⁵⁰ Basic economic theory contends that people will maximize their wealth if given the opportunity to voluntarily contract for an exchange. See ANTHONY T. KRONMAN & RICHARD A. POSNER, *THE ECONOMICS OF CONTRACT LAW* 1-7 (1979).

⁵¹ For a definition of interest see *supra* note 40.

⁵² The principal is the present sale price of the property. The buyer and seller use the principal as a base because the principal represents the value of the land that will decrease overtime and require compensation. See *supra* notes 37-46 and accompanying text.

⁵³ Historically, the courts and the IRS have respected the contracting parties' choice to allocate the payments as to principal and interest. See Daniel S. Goldberg, *Tax Planning or Interest After TRA 1984: Unstated Interest and Original Issue Discount*, 43 INST. OF FED. TAX'N 23-1, 23-41 (1985). See also *Sefton v. Commissioner*, F.2d 399, 401, 402 (9th Cir. 1961); *O'Dell v. Commissioner*, 26 T.C. 592, 597, 600 (1956); *Huntington-Redondo Co. v. Commissioner*, 36 B.T.A. 116, 117 (1937); *EP Greenwood v. Commissioner*, 34 B.T.A. 1209, 1214-1215 (1936); Rev. Rul. 70-647, 2 (1970); Rev. Rul. 63-57, 2 (1963).

⁵⁴ Demand and term loans are two loan arrangements specifically recognized by the IRC. 26 U.S.C. § 7872(f)(5), (6) (1994). The IRC defines a demand loan as any loan that is payable in full at any time at the lender's demand. 26 U.S.C. § 7872(f)(5). The IRC defines a term loan as any loan that is not a demand loan. 26 U.S.C. § 7872(f)(6). A more independent definition of a term loan is any loan that is not a demand loan, where the loan agreement specifies an ascertainable period of time during which the loan must remain outstanding. See Katherine C. Bairey & Thomas D. Terry, *Executive Compensation and the Time Value of Money*, 39 MAJOR TAX PLANNING 13-1, 13-7-8 (1987).

⁵⁵ To determine whether a party protected its economic self-interest, the United States Supreme Court uses an ordinary course of business test. See *Commissioner v. Wernys*, 324 U.S. 303, 306 (1945) (accepting the Treasury Regulations conclusion that no genuine

devaluation of the sale price over time, while the buyer wants to pay no more than is absolutely necessary to compensate the seller.⁵⁶ However, pure economic interests do not always motivate a buyer and seller,⁵⁷ and sometimes they enter into installment sales contracts that do not protect their economic interests.⁵⁸ When people sell property to family members or friends, benevolence often motivates them more than the desire to make a profit.⁵⁹

Sometimes contracting parties draft the terms of their installment sales contracts intentionally to avoid certain tax consequences.⁶⁰ Different deferred payment plans carry different tax consequences.⁶¹ The sale of a piece of property results in income for the seller,⁶² assuming that the property is sold for more than its original cost to the seller.⁶³

business transaction exists when a sale, exchange, or other transfer of property is not made in the ordinary course of business, at arm's length, and free from any donative intent).

⁵⁶ This statement also hinges on the economic theory mentioned *supra* note 50.

⁵⁷ Here the basic economic theory that people act to maximize personal wealth breaks down. In actuality, rational, economic judgment does not always inform a person's decision-making process. See THOMAS HOBBS, LEVIATHAN 70-71 (Everyman's Library ed., J.M. Dent & Sons LTD 1970) (1651) (noting that a human's ambition, avarice, anger, and other passions would make it impossible to maintain a contractual relationship between two human beings without the fear of some coercive power).

⁵⁸ See *Helvering v. Robinette*, 129 F.2d 832 (3d Cir. 1942) (holding that a daughter made a gift to trustees when she irrevocably transferred property to them in exchange for the promise to receive income payments from the property for the rest of her life). People enter into loan arrangements without protecting their economic interest for items other than real property as well. See *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995) (involving a transfer of stock in exchange for promissory notes including the fair market value of the stock and a six percent interest rate).

⁵⁹ See *Fehrs v. U.S.* 620 F.2d 255 (Ct. Cl. 1980) (noting that intrafamilial transfers of land prompt special tax scrutiny because the genuineness of the transactions generally lack circumstantial assurances of business purpose).

⁶⁰ Congress recognized that sometimes taxpayers construct installment contracts vaguely in order to avoid paying ordinary income from the interest received under the deferred payment schedule. H.R. REPORT NO. 88-749 (1964), reprinted in 1964 U.S.C.C.A.N. 1313, 1381.

⁶¹ See Joseph G. Walsh, *Time Value of Money Concepts*, 45 INST. ON FED. TAX'N 33-1, 33-4, 6-7 (1987) (demonstrating how a seller's income could be either \$450 of ordinary income and \$500 of capital gain or \$516 of ordinary income and \$434 of capital gain on the same debt instrument, depending on how and when the instrument accounts for interest payments).

⁶² 26 U.S.C. § 61(a)(3) (1994) (specifically including gains derived from dealings in property in gross income). Because a single sale of property results in a gain that is casual and nonrecurrent, one line of thinking, more prevalent in Great Britain than in the United States, argues that this gain is not income. See RICHARD GOODE, *THE INDIVIDUAL INCOME TAX 187-191* (1964) (discussing the different tax perceptions of capital gains in America and Great Britain).

⁶³ The I.R.C. calls the original cost to the seller basis. 26 U.S.C. § 1001 (1994). However, basis does not equal cost in all circumstances. Basis is an involved concept in taxation and not the subject of this Note. For a more detailed discussion of basis, see generally John J.

Likewise, any amount the seller acquires above the cost of the property will constitute a capital gain.⁶⁴ Any amount the seller receives as interest on the sale price would constitute ordinary income.⁶⁵ Although these capital gains are still a form of income,⁶⁶ Congress has chosen to tax capital gains at a lower rate than ordinary income tax.⁶⁷ In an intrafamilial installment sales contract, the federal government considers interest payments to be ordinary income and principal payments to be capital gains.⁶⁸ This special capital gains treatment prompts taxpayers to manipulate installment sales contracts in order to gain a tax advantage.

C. *Taxpayer Manipulation of Installment Sales Contracts To Gain a Tax Advantage*

Applying the time value of money analysis to Mrs. Barnes' and Mr. Sheers' situations illustrates how taxpayers can manipulate the terms of their installment sales contracts to gain a tax advantage.⁶⁹ Mrs. Barnes

Potts, *Did Your Law Professor Tell You Basis Means Cost? The Recognition Theory of Basis*, 22 VAL. U. L. REV. 233 (1988).

⁶⁴ Income on the buying and selling of property receives capital gains tax treatment if the sold or exchanged property is a capital asset. 26 U.S.C. § 1222 (1994). A capital asset is any property which does not include 1) inventory or stock in trade; 2) depreciable property used in a trade or business; 3) a literary, musical, or artistic composition, a copyright, or similar property held by the taxpayer who performed the efforts to create such property; 4) accounts or notes receivable, 5) certain government publications. 26 U.S.C. § 1221 (1994). It looks like number two of section 1221 disqualifies Mr. Sheers' and Mrs. Barnes' property, because realty or farmlands are depreciable assets used in a trade or business. See 26 U.S.C. § 167(a)(1) (1994). However, the IRC makes an exception for these assets that allows them to still receive capital gains treatment in the case of a gain. 26 U.S.C. § 1231 (1994). Thus, the sale or exchange of Mr. Sheers' or Mrs. Barnes' property would certainly qualify for capital gains treatment under sections 1221 and 1222.

⁶⁵ 26 U.S.C. § 61(a)(4) (specifically including interest payments in gross income).

⁶⁶ See MCDANIEL ET AL., *supra* note 6, at 75, 76 (explaining that capital gains from the sale of property fit the definition of income, because the sale of property can still result in an accession to wealth).

⁶⁷ See 26 U.S.C. § 1(h) (1994). See also MCDANIEL ET AL., *supra* note 6, at 799 (commenting that the twenty-eight percent maximum tax rate for net capital gains prevents a taxpayer from being subjected to tax at a higher marginal rate). For a discussion of the policy reasons for providing special tax treatment on capital gains, see generally David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); Debroah M. Weiss, *Can Capital Tax Policy Be Fair? Stimulating Savings Through Differentiated Tax Rates*, 78 CORNELL L. REV. 206 (1993); George R. Zodrow, *Economic Analyses of Capital Gains Taxation: Realizations, Revenues Efficiency, and Equity*, 48 TAX L. REV. 419 (1993).

⁶⁸ The only difference between an intrafamilial installment sales contract and a regular installment sales contract is that the former effects a qualified sale and the latter does not. See 26 U.S.C. § 483(e).

⁶⁹ The application of the income and capital gains tax principles to Mr. Sheers' and Mrs. Barnes' situations in this paragraph does not account for the imputed interest income taxes and aid tax provisions in an effort to reveal the tax consequences of their desired

needs to receive a fair price for her farm in order to survive; yet she does not want to charge her son any interest on the sale. She could set up an installment sales contract that would include only principal payments. Without receiving interest, Mrs. Barnes would not be earning any ordinary income.⁷⁰ Motivated by benevolence for her son, she would only pay the cheaper capital gains tax on the principal payments. Thus, a non-tax avoidance motive would allow Mrs. Barnes to receive the special capital gains treatment.

On the other hand, Mr. Sheers is admittedly trying to avoid taxes.⁷¹ He could sell his barber shop at a price high enough to account for his lost investment opportunity if he were to set up an installment sales contract composed of inflated principal payments. In essence, Mr. Sheers would receive both interest and principal payments, but the terms of the contract would characterize the interest as part of the principal and allow Mr. Sheers to avoid paying the higher ordinary income tax. Ultimately, Mr. Sheers can manipulate the terms of his installment sales contract so that he can receive a form of ordinary income, interest, and pay the cheaper capital gains tax on it. The manipulation of installment sales contracts to avoid paying ordinary income tax on interest payments spurred a congressional reaction.

D. Congressional Reaction to the Manipulation of Installment Sales Contracts

Regardless of whether the desire to avoid tax liability motivates a seller, Congress recognized that the manipulation of the principal and interest payments in installment sales contracts results in unacceptable tax breaks.⁷² Congress refused to allow a tax break for those who did not explicitly allocate a portion of their installment payments as interest.⁷³ Any installment sales contract containing terms that did not

installment sales contracts without these special provision. This Note discusses Mr. Sheers' and Mrs. Barnes' installment sales contracts among the imputed interest rules and below-market loan provisions in detail later. See *infra* notes 92-95, 98-100, 144-148 and accompanying text.

⁷⁰ The reader may have noticed that lowering the payments to below the annual exclusion would not seem to result in gift tax. Although this sounds logical, the annual exclusion does not prevent gift tax on installment sales contracts this easily. See *infra* notes 132, 148 and accompanying text.

⁷¹ Mr. Sheers' tax avoidance mentality has created substantial problems for the IRS. See Theodore C. Falk, *Tax Ethics, Legal Ethics, and Real Ethics: A Critique of ABA Formal Opinion 85-352*, 39 TAX LAW. 643, 661(1986) (stating that nonpayment of taxes through homemade loopholes and unreported income is a colossal social problem); Marjorie E. Kornhauser, *The Rise of Rhetoric in Tax Reform Debate: An Example*, TUL. L. REV. 2345, 2359 (1996) (noting that our current tax system is unfair, often levying different burdens on people with the same income).

explicitly account for the time value of money became suspect.⁷⁴ Congress believed that taxpayers should not rearrange the terms of their installment sales contracts simply to avoid certain tax liabilities.⁷⁵ To preserve the integrity of its system of taxation,⁷⁶ Congress recognized the need to pass statutes that taxed installment sales contracts based on the time value of money.⁷⁷ The next section describes Congress' efforts to impose both income and gift taxes on the appropriate time value of the seller's money under the terms of an economically unhampered installment sales contract.

III. TAXATION OF THE TIME VALUE OF INSTALLMENT SALES CONTRACTS

Installment sales contracts of real property may constitute both a source of income to and a gift from the seller.⁷⁸ The seller of real property through an installment sales contract can receive principal payments that produce a capital gain⁷⁹ and interest payments that

⁷² See H.R. REPORT NO. 88-749 (1964), reprinted in 1964 U.S.C.A.N. 1313, 1381 (stating that manipulation of the tax law in this manner is undesirable).

⁷³ It appears that Congress assumes taxpayers always receive interest payments in an installment sales contract. Note the following language: "Your committee sees no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments." If taxpayers who allocate a portion of the payment for interest are treated differently from those who do not provide for interest payments, then both must receive interest payments. However, this is not always true. Mrs. Barnes would not include any allocation for interest payments in her installment sales contract because she would not actually be receiving any interest. This raises issues of equity discussed *infra* at notes 245-256 and accompanying text.

⁷⁴ H.R. REPORT NO. 88-749 (1964), reprinted in 1964 U.S.C.A.N. 1313, 1381 (noting that the committee's bill poses a solution to the problem created when the terms of an installment loan do not include a high enough interest rate).

⁷⁵ *Id.* (asserting that a buyer and seller distort the treatment of payments in an installment sales contract depending on the tax advantages).

⁷⁶ If taxpayers could simply label their transactions using a nomenclature that the IRC does not identify, taxpayers could avoid paying taxes altogether. Even though the IRC and the taxpayer would mean the same thing, a jurisprudence that relied on form over substance would not allow tax liability to attach when the language of the IRC did not match the language used by the taxpayer. For this reason, the United States Supreme Court has repeatedly held that substance must govern over form in tax matters. See *Diedrich v. Commissioner*, 457 U.S. 191, 195 (1982); *Commissioner v. Hansen*, 360 U.S. 446, 461 (1959); *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929).

⁷⁷ See *Slagle*, *supra* note 17, at 5 (pointing out that Congress has attempted to prevent taxpayers from converting ordinary interest income into capital gains income in installment transactions since 1964). See also notes 72-75 and accompanying text.

⁷⁸ See *supra* note 8.

⁷⁹ See *supra* note 64 and accompanying text.

constitute ordinary income.⁸⁰ In addition, if the seller allows the buyer to purchase the property below its market value, the seller may also make a partial gift of the property to the buyer.⁸¹ As a result, Congress eventually attached both income and gift tax liability to certain forms of installment sales contracts.⁸² This section first discusses the enactment of section 483 and section 1274, both of which handle the income taxation of installment sales contracts. Next this section scrutinizes the long-standing valuation standard of section 2512 and the enactment of section 7872, both of which govern the gift taxation of installment sales contracts.

A. Income Taxation of Installment Sales Contracts

The current imputed interest rules have changed a great deal since their inception. Those rules began in the original enactment of section 483. However, this version caused problems that prompted Congress to amend section 483 to include the safe harbor rate. The original version of section 483 also created other problems that eventually warranted the enactment of a new section containing updated imputed interest rules, namely section 1274. The following paragraphs analyze the original version of section 483 and its changes through the years.

1. The Original Enactment of Section 483

In 1964, Congress reacted to the manipulation of an installment sales contract's terms to seemingly remove any interest payments.⁸³ It amended the IRC to include section 483,⁸⁴ which was designed to impute interest payments in an installment contract no matter how the

⁸⁰ See *supra* note 65 and accompanying text.

⁸¹ See *supra* notes 14-17 and accompanying text.

⁸² Congress created a tax liability for imputed interest on installment sales contracts in the income tax sphere much earlier than it did in the gift tax sphere. H.R. REPORT NO. 88-749 (1964), *reprinted in* 1964 U.S.C.C.A.N. 1313, 1381-82 (in which Congress formulates the imputed interest taxation rules); H.R. REPORT No. 98-432 (1984), *reprinted in* 1984 U.S.C.C.A. N. 1017 (when twenty years after the formation of the original imputed interest rules, Congress architects the below-market loan rules applying gift tax to certain installment sales). However, gift tax liability through the valuation of an installment sales contract could be attached much earlier than the enactment of the imputed interest provisions in either income or gift taxation, section 2512 has been part of the I.R.C. since 1954. See Internal Revenue Act of 1954, 68A Stat. 406 (1954).

⁸³ See *supra* notes 72-75 and accompanying text.

⁸⁴ For the text of 26 U.S.C. § 483 as it appeared in 1964 see Internal Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 77 (1964).

contractual terms characterized the payments.⁸⁵ This meant that if a seller inflated the principal payments to include an unstated interest, section 483 allowed the IRS to ignore the contractual terms and name a certain portion of the payments as interest.⁸⁶ In its original version, section 483 required an installment sales contract to include a minimal test rate for interest payments.⁸⁷ If the loan arrangement required interest payments in an amount equal to or above the test rate, the seller could avoid imputed interest under the loan arrangement.⁸⁸ Thus, section 483 allowed the IRS to manufacture fictitious interest payments if the taxpayers did not include the test rate in their installment sales contracts.

a) Legal Fiction Under Section 483

Rather than achieving Congress' stated purpose for enacting section 483,⁸⁹ the imputation of interest under section 483 created a legal fiction.⁹⁰ Under section 483, the IRS viewed every installment sales contract as providing for interest payments, no matter whether the parties negotiated for an interest payment. Even if a seller genuinely did not include or receive any interest payments under the installment sales contract, the IRS could assess an ordinary income tax on interest that does not exist.⁹¹ This legal fiction introduced a problem. It imposed

⁸⁵ See Philip E. Harris, *Imputed Interest on Installment Sales After the 1984 Tax Reform Act As Amended*, 56 U. COLO. L. REV. 227 (1985) (commenting that section 483 was supposed to plug the loophole created when taxpayers camouflage interest as a higher purchase price in an installment sale). See also *supra* notes 9-12 and accompanying text.

⁸⁶ See Benjamin, *supra* note 19, at 680-683 (explaining that section 483 recharacterizes the installment sales contract to include a portion of the amount of interest that should have been, but was not, stated in the contract).

⁸⁷ The original version of section 483 gave the Secretary of the Treasury the power to determine the test rate and discount or revalue the installment sales contract based on that rate. See section (b) of the 1964 version of section 483, *supra* note 84.

⁸⁸ See Benjamin, *supra* note 19, at 682-683 (providing three examples in which the imputed interest income is computed for installment sales contracts that do not include an interest rate as high as the test rate of section 483).

⁸⁹ See section (a) of the 1964 version of section 483, *supra* note 84.

⁹⁰ A legal fiction is pragmatically defined as a falsehood that is deemed true for limited purposes. John A. Miller, *Liars Should Have Good Memories: Legal Fictions and the Tax Code*, 64 U. COLO. L. REV. 1, 3 (1993). It is not surprising that a legal fiction exists in the taxation of installment sales contracts, because the formalistic and inflexible nature of tax law provides a fertile area for legal fictions to flourish. *Id.* at 3.

⁹¹ Here lies the falsehood that creates the fiction: an installment sales contract that does not include any interest payments in reality is deemed to include interest payments for tax purposes. To describe this another way, section 483 allows the IRS to completely rewrite a taxpayer's installment sales contract in order to determine tax liability. If the minimum test rate is ten percent and a taxpayer only names principal payments of \$5,000, the IRS will recharacterize these payments so that \$500 of the payment is for interest. Even though the

interest as an indestructible entity on any deferred payment schedule regardless of what the parties intended or actually received.⁹²

Mr. Sheers' and Mrs. Barnes' situations both illustrate the problem and effect caused by the legal fiction of indestructible interest. Mr. Sheers plans to compensate himself for the investment loss he would receive on a deferred payment plan. He calculates how much interest he needs as compensation and then simply tacks that amount onto the sale price. Thus, his installment sales contract explicitly requires only principal payments while it implicitly includes both interest and principal payments.⁹³ Section 483 flushes out the interest payments that Mr. Sheers intended to receive from the beginning and taxes them accordingly.⁹⁴

However, Mrs. Barnes wants Ms. Vreet to draft the terms of her installment sales contract so that they do not include interest payments. Mrs. Barnes neither intends to receive interest payments, nor will she actually receive them under the terms of the installment sales contract that she desires. However, the IRS could rely on section 483's legal fiction to manufacture interest where Mrs. Barnes had excluded interest. With the indestructible interest created under section 483, the IRS could draft interest payments into the terms of Mrs. Barnes' installment sales contract, forcing Mrs. Barnes to pay ordinary income tax on interest that she never receives. In order to avoid section 483 tax liability on income that Mrs. Barnes does not receive, Mrs. Barnes would need to include the test rate level of interest. To secure the test rate, Mrs. Barnes must negotiate the terms of her installment sales contract with her son as if he were an adversarial party in the ordinary course of business.⁹⁵ However, Congress did attempt to remedy this situation.

seller does not receive the \$500 in interest, the IRS taxes the seller as if she did receive \$500 in interest.

⁹² The indestructibility of interest is not the only problem the enactment of section 483 caused. See *infra* notes 101-106 and accompanying text.

⁹³ Mr. Sheers' manipulation of the allocation of interest as part of the principal payment is exactly what prompted Congress to implement section 483. See H.R. REP. NO. 88-749 (1964), reprinted in 1964 U.S.C.C.A.N. 1381.

⁹⁴ Even though it did allow other loopholes that Mr. Sheers could have capitalized on in its original statutory form. See *infra* notes 101-106 and accompanying text.

⁹⁵ While the fiscal object of taxation should be to collect revenue, the government must realize that it cannot derive this kind of revenue without inevitably affecting social relations. EDWIN R. A. SELIGMAN, *ESSAYS IN TAXATION* 316 (1921). Forcing family members to treat each other in this cold, business-like fashion does not seem to promote good public policy. See *Johnson v. United States*, 254 F. Supp. 73, 77 (N.D. Tex. 1966) (refusing to force parents to deal with their children at arm's length with regard to loan

b) Safe Harbor Provision Enacted as Attempted Remedy

Congress eventually provided an exception to the imputed interest rules in the case of intrafamilial installment sales contracts.⁹⁶ The exception provided for a safe harbor interest rate that could shelter the taxpayer from liability for a portion of the interest otherwise imputed under the general rate.⁹⁷ A family member selling to another family member could then avoid imputed interest by including the safe harbor interest rate as one of the terms of the installment sales contract. In the case of Mrs. Barnes and Mr. Sheers, this safe harbor would actually protect the wrong person. Mr. Sheers, whose primary concern is to avoid paying taxes, will reap a substantial benefit by including the safe harbor interest rate in the installment sales contract with his daughter.⁹⁸

In contrast, Mrs. Barnes, who does not want to charge her son interest on top of the fair market value, will not receive any benefit from the safe harbor interest rate.⁹⁹ In order to protect Mrs. Barnes from incurring imputed income tax, Ms. Vreet begrudgingly advises Mrs. Barnes that the installment sales contract should include interest payments at the safe harbor rate of section 483. At this point, Ms. Vreet could have reassured Mrs. Barnes that her son would not need to pay excessive market interest rates.¹⁰⁰ Not only did the safe harbor provision

arrangements because a substantial amount of people may believe that a better source still exists for raising taxes).

⁹⁶ See the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981), amending the Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 77 to include an exception for qualified sales.

⁹⁷ Under the Economic Recovery Tax Act, the safe harbor was seven percent. *Id.* At this time the Secretary raised the test rate to ten percent. *Id.* Thus a taxpayer involved in a qualified sale could include a seven percent interest rate and still avoid the extra three percent of imputed interest under the general test rate.

⁹⁸ Mr. Sheers will be able to receive interest payments up to the market rate and only be taxed on those interest payments up to the safe harbor. The remaining portion of the payment would constitute principal and allow Mr. Sheers to receive the favorable capital gains tax. See *supra* text accompanying note 71.

⁹⁹ Remember that Mrs. Barnes does not want her installment sales contract to include any interest payments. Capping the test rate for imputed interest will still result in ordinary income tax up to the safe harbor in an installment sales contract that does not include any interest payments. Therefore, even the section 483 safe harbor rate would force Mrs. Barnes to pay income tax on income she did not receive. See *supra* text accompanying notes 94-95.

¹⁰⁰ At times the prevailing market interest rate is almost twice the safe harbor rate. See *Krabbenhoft v. Commissioner*, 939 F.2d 529 (8th Cir. 1991) (in which the IRS used an eleven percent interest rate to value the taxpayers intrafamilial sales contract); *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995) (in which the prevailing market interest rate was eleven and one half percent).

fail to remedy the legal fiction situation, the safe harbor also failed to address the other problems that the original enactment of section 483 created.

c) Additional Problems Under Section 483

The legal fiction was only one of the problems that surfaced under the original provisions of section 483. This section did not accurately account for the appropriate time value of money in installment sales situations.¹⁰¹ This discrepancy resulted from the use of an inflexible, flat rate to determine the amount that the seller should have allocated to interest payments.¹⁰² With dramatic market fluctuations in real estate in the late 1970's and early 1980's,¹⁰³ the fixed test rate did not accurately reflect the prevailing market interest rate needed to prevent an investment loss.¹⁰⁴ In addition, section 483 only imputed interest onto installment sales, but not onto any other type of deferred payment plans.¹⁰⁵ Finally, section 483 created loopholes for the sophisticated taxpayer by failing to require the same accounting method to be used when figuring the tax on an installment sales contract.¹⁰⁶ These problems warranted a remedy more drastic than a simple amendment to section 483.

¹⁰¹ Walsh, *supra* note 61, at 33-3 (commenting that the use of a simple rate of interest as the test rate ignored the economic reality of interest compounding on unpaid interest, a fundamental time value concept).

¹⁰² *Id.* See also Slagle, *supra* note 17, at 35 (noting that if the IRC is to reflect the economic realities of the marketplace, without distortion resulting from the artificial rates and computations, the reporting and interest requirements should resemble interest rates in the financial market place).

¹⁰³ Judge Henley commented about this fluctuation in his concurring opinion in *Krabbenhof*, 939 F.2d at 534.

¹⁰⁴ Congress reveals an intent to keep the regular test rate in step with the prevailing market rates by expressing a belief that the Secretary of the Treasury would establish a test rate which reflected the market rates. HOUSE REPORT NO. 88-749, reprinted in 1964 U.S.C.C.A.N. 1313, 1381. During periods of high fluctuation, a fixed rate on a debt instrument is impractical because it will not reflect the accurate time value of money. Thus the rate must be allowed to change regularly to meet the rapid change in the marketplace. See *infra* notes 109-112 for congressional attempts to reevaluate the test rate frequently enough to reflect market rates.

¹⁰⁵ See Goldberg, *supra* note 53, at 23-1, 23-3 (1985). This caused a problem because deferred payment for services, the use of property, or other non-sale situations still remained immune to imputed interest payments. *Id.* See also Bairey & Terry, *supra* note 54, at 13-1, 13-2, 13-3 (1987) (outlining the different situations in which an employer compensates an employee through deferred payments that result in certain tax advantages).

¹⁰⁶ Walsh, *supra* note 61, at 33-3 (recognizing that the gaps in the original section 483 resulted in a loophole in which an accrual method buyer and a cash method seller could structure a transaction so that the buyer could claim a current interest deduction, but the seller was not required to report interest income currently).

2. Section 1274: The New Imputed Interest Rules

Attempting to remedy the problems created under the original enactment of section 483, Congress amended the imputation of interest in seller-financed debt instruments by instituting section 1274.¹⁰⁷ Under section 1274,¹⁰⁸ the IRS could still impute interest if the deferred payment plan included an unstated amount of interest.¹⁰⁹ However, section 1274 liberated the test rate from its formerly static position.¹¹⁰ Section 1274 defined the test rate as the applicable federal rate, which required a new calculation every month.¹¹¹ The applicable federal rate under section 1274 stays much closer to the actual market rate than the original test rate under section 483 did.¹¹² At the same time, Congress amended the test rate under section 483 to be the same as the applicable federal rate found under section 1274.¹¹³ Thus, section 483 became more sensitive to the market time value of money as a result of the 1984 amendments.

The enactment of section 1274 substantially reduced the applicability of section 483.¹¹⁴ Section 483 only applied to those installment sales contracts that did not fit under section 1274.¹¹⁵ One of the key exceptions under section 1274 lies in the area of qualified sales.¹¹⁶ In other words, qualified sales are not subject to the requirements imposed on other installment sales contracts.¹¹⁷

¹⁰⁷ See H.R. REP. NO. 98-432 (1984), reprinted in 1984 U.S.C.C.A.N. 905-07 (discussing the problems with the imputed interest rules under section 483, and how the new provision will remedy those problems).

¹⁰⁸ For the original text of 26 U.S.C. § 1274 (1994) see The Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 538.

¹⁰⁹ 26 U.S.C. § 1274(a)(1994).

¹¹⁰ 26 U.S.C. § 1274(d)(1994).

¹¹¹ 26 U.S.C. § 1274(d)(1)(B)(1994).

¹¹² See Walsh, *supra* note 61, at 33-5 (commenting that Congress enacted 1274 to conform the tax consequences of seller-financed sales of property more clearly to economic reality).

¹¹³ See EUSTICE, *supra* note 38, at 2-20. See The Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 553 for the original amendment.

¹¹⁴ See Harris, *supra* note 85, at 228 (noting that section 1274 has largely replaced section 483 as the source of imputed interest rule for installment contracts, because after the 1984 amendments, section 483 only applies to those installment sales contracts falling within one of the exceptions to section 1274).

¹¹⁵ See Walsh, *supra* note 61, at 33-12 (stating that section 483 will apply to most situations in which section 1274 will not apply).

¹¹⁶ 26 U.S.C. § 1274(c)(3)(F) (1994). For other exceptions see generally 26 U.S.C. § 1274(c)(3).

¹¹⁷ 26 U.S.C. § 483(e) defines a qualified sale. See *supra* note 24.

Among these sweeping changes to the imputed interest rules, Congress did not alter the safe harbor rate itself.¹¹⁸ By leaving the qualified sale exception and the safe harbor rate undisturbed, Congress unequivocally manifests an intent to grant favorable tax treatment to intrafamilial installment sales in the context of imputed interest.¹¹⁹ At times, members of Congress have zealously expressed sentiments of preserving this safe harbor rate for family sales.¹²⁰ In the gift taxation arena this intent is not as clear.

¹¹⁸ See Benjamin, *supra* note 19, at 703 (pointing out that Congress in fact retained the lower safe harbor rate for intrafamilial installment sales contracts even when the Secretary of the Treasury raised the test rate for regular installment sales contracts).

¹¹⁹ All three circuits agree that the safe harbor provisions reflect this policy. See Ballard v. Commissioner, 854 F.2d 185, 187 (7th Cir. 1988); Krabbenhoft v. Commissioner, 939 F.2d 529, 532-33 (8th Cir. 1991); Schusterman v. United States, 63 F.3d 986, 990 (10th Cir. 1995).

¹²⁰ In 1981, the IRS wanted to increase the test rate to ten percent under section 483. However, Senators Melcher, Boschwitz, Grassley, and Jespen worked out a compromise so that the test rate would not govern intrafamilial installment sales contracts. See 127 CONG. REC. S17, 806 (daily ed. July 28, 1981) (statements of Sen. Mechler, Boschwitz, Grassley, Jespen). The following quotes reveal that these Senators demanded a separate rate for intrafamilial installment sales contracts, because they believed that the IRS should not interfere with the affairs of those who are trying to pass on a business or farm from one generation to the next: "Personally, I believe that the Internal Revenue Service gets into too much of the ordinary daily lives of people....[I]t is vitally important that we hold these [imputed interest] rates down, particularly in the sale of family farms, and small businesses." *Id.* at S17,805 (statement of Sen. Mechler) (brackets added); "This amendment [inclusion of a safe harbor] is a reasonable compromise to relieve the burdens the regulations impose on family farms and small businesses....[T]he small businessman will be able to sell the stock of his company, and the farmer will be able to sell his land, without undue meddling by the IRS." *Id.* at S17, 806 (statement of Sen. Boschwitz) (brackets added);

One of the tools for accessibility of younger generations to continue the family farming operation has been the lower rate of interest that mothers and fathers have been willing to give to their sons and daughters in helping to start this family farm operation or small business. This intergenerational loan or gift is not ever in the vein of trying to avoid taxes or 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 another. This [the safe harbor rate] will eliminate one impediment to this transfer of property from one generation to the other.

Id. (statement of Sen. Grassley) (brackets added);

The most important reasons against raising the imputed interest rates are not the law or statistics but people . . . I am talking about men and women with calloused hands and sore backs – the individuals who produce our food and the entrepreneurs who take a dream and through years of hard work turn that dream into a business . . . Why do these men and women . . . labor so hard? . . . They do so in order to give their offspring a better life than they had and to leave them

B. Gift Taxation of Installment Sales Contracts

The gift taxation of installment sales contracts has developed without the drastic upheaval that occurred in the area of income taxation. Under the 1976 amendments to the gift tax, section 2512 originally valued installment sales contracts for gift tax purposes. However, a string of cases refused to allow gift taxation to attach to any interest-free loan arrangement, including interest-free loans between family members. After the United States Supreme Court ended this trend, Congress enacted section 7872 to handle the taxation of installment sales contracts that include below-market interest rates. This section discusses the gift taxation of intrafamilial installment sales contracts from section 2512 to section 7872.

1. Background Information on Gift Taxation

Unlike income tax,¹²¹ gift tax raises revenue from gratuitous transfers of wealth.¹²² Congress designed the original gift tax to achieve a two-fold purpose.¹²³ First, the gift tax safeguarded the evasion of estate taxes,¹²⁴ because it prevented taxpayers from making *inter vivos* transfers

something which they in turn will pass on to their children. The new regulations [increasing the test rate] issued by the Treasury strike at the very heart of this venerable tradition . . . The IRS is venturing where they have absolutely no business to be. This is Government at its worst. While this amendment [the safe harbor rate] does not solve all the problems of retaining family farms and family business, it is a major step in the right direction.

Id. (statement of Sen. Jepsen) (brackets added). For further comment on these Senators' statements, see also Benjamin, *supra* note 19, at 699, 700.

¹²¹ Income tax raises revenue from the increase in net worth, which is not a transfer of but an accession to wealth. See MCDANIEL ET AL., *supra* note 6, at 69 (providing the theoretical and ubiquitous Schanz-Haig-Simons definition of income). See also 26 U.S.C. § 61, 63 (1994) (which does not provide a definition of income, but does impose a tax on sources that increase an individual's net worth).

¹²² 26 U.S.C. § 2501(a)(1) (1994) provides that "A tax . . . is hereby imposed for each calendar year on the *transfer* of property by gift during such calendar year by any individual resident or nonresident" (italics added). Although section 2501(a)(1) uses the word "property," commentators historically consider the gift tax a transfer of wealth. See BITTKER & LOKKEN, *supra* note 7, at 120-1-3 (2d ed. 1993) (lumping gift taxes into the historical discussion of federal taxes on transfers of wealth).

¹²³ Congress first enacted a gift tax in 1924, which was repealed the following year. See BITTKER & LOKKEN, *supra* note 7, at 120-2. In 1932, Congress reimposed the gift tax and, with amendments, the gift tax has remained in force to this day. *Id.* The two-fold purpose of the gift tax is noted at FREDERICK J. GERHART, *THE GIFT TAX* 2 (1980).

¹²⁴ 26 U.S.C. § 2001(a) (1994) imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

of their entire estates before their deaths.¹²⁵ The gift tax did not actually facilitate this purpose effectively until its amendment in 1976.¹²⁶ Second, the gift tax supplemented the income tax system by subjecting property transferred to others to an excise tax,¹²⁷ allowing the IRS to recover the donor's loss of income on the transfer.¹²⁸

For the purpose of assessing a tax the IRC defines a gift broadly. It imposes a tax on the "transfer of property,"¹²⁹ not on the presence of the strict common law elements of an *inter vivos* gift.¹³⁰ Because the IRC incorporates this broad definition of "gift," the gift tax reaches into a

¹²⁵ See GERHART, *supra* note 123, at 2, citing *Sanford Estate's v. Commissioner*, 308 U.S. 39, 44 (1939). Essentially, the federal government did not want to allow people to simply give away all of their possessions in an effort to deplete their estate and thereby avoid estate taxation.

¹²⁶ The 1932 enactment taxed gifts on a cumulative basis over the course of a person's entire life. See BARRY M. NUDELMAN & MAX E. BLUMENTHAL, *FEDERAL TAXATION OF ESTATES, GIFTS, AND TRUSTS* 423 (5th ed. 1995). In addition, the 1932 gift tax was separate from the estate tax, imposing each gift tax under a different rate system. BITTKER & LOKKEN, *supra* note 7, at 120-2. The 1976 amendment "unified" the gift and estate tax systems. BITTKER & LOKKEN, *supra* note 7, at 120-2. This accomplished three things: (1) the application of the same rates to both taxes; (2) the aggregation of gifts with the taxable estate for the purpose of computing estate taxes; and (3) the unified credit applied to both gift and estate taxes. See NUDELMAN & BLUMENTHAL, *supra* this footnote, at 423. For the text of the amendments that unified the rates used for estate and gift taxes see Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1805; Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1849.

¹²⁷ An excise tax is defined as "a tax on the manufacture, sale, or use of goods or on the carrying on of an occupation or activity, or a tax on the transfer of property . . . the term has been extended to include various license fees and practically every internal revenue tax except the income tax." JOSEPH R. NOLAN ET AL., *BLACK'S LAW DICTIONARY* 363 (6th ed. 1990).

¹²⁸ See GERHART, *supra* note 123, at 2. Generally a taxpayer gives gifts to someone who is in a lower tax bracket. If the gift is property that generates income for its owner, such as an apartment complex, that income will be taxed at the lower rate of the donee rather than the higher rate of the donor. This results in a loss of revenue for the federal government. The gift tax helps to compensate this loss of revenue.

¹²⁹ Note that the actual language of 26 U.S.C. § 2501(a)(1)(1994) reads "a tax . . . is hereby imposed for each calendar year on the *transfer of property by gift* during such calendar year" (Italics added).

¹³⁰ The common law elements of a gift are donative intent, delivery, and acceptance. See *Pierce v. Rummell*, 535 So.2d 594, 598 (Ala. 1988); *Gussin v. Gussin*, 836 P.2d 484, 494 (Haw. 1992); *Bradford v. Dumond*, 675 A.2d 957, 962 (Me. 1996); *Schuldies v. Millar*, 555 N.W.2d 90, 97 (S.D. 1996); *Lewis v. Poduska*, 481 N.W.2d 898, 899 (Neb. 1992). See also JOHN E. CRIBBET & CORWIN W. JOHNSON, *PRINCIPLES OF THE LAW OF PROPERTY* 153 (3d ed. 1989). Because the IRC does not define "gift" as strictly as the common law, the determination of whether the donor made a gift turns more on the transfer of the property without adequate and full compensation, rather than the intent of the transferor. NUDELMAN & BLUMENTHAL, *supra* note 126, at 427.

considerable number of transactions,¹³¹ provided that these transactions exceed the annual exclusion¹³² and the unified credit.¹³³

¹³¹ This language includes an overwhelming bulk of gifts, some of which involve straight forward transactions, such as delivery of deed, the creation of trust, and the physical transfer of tangible assets, and other more subtle transfers which include canceling a debt, deliberately allowing the statutes of limitations to run on enforcement of a debt, and permitting a valuable right to lapse. See BITTKER & LOKKEN, *supra* note 7, at 121-9.

¹³² Taxpayers are allowed to "give" up to \$10,000 per year to any person without incurring gift tax liability. See 26 U.S.C. § 2503(b) (1994). Because the annual exclusion does not carryback or carryover beyond the calendar year in which the taxpayer made the gift, taxpayers have incentive to transfer gifts through installments rather than one lump sum. See BITTKER & LOKKEN, *supra* note 7, at 124-2. Some authority has allowed the annual exclusion to apply to each annually forgiven payment under an installment sales contract. See *Estate of Kelley v. Commissioner*, 63 T.C. 321, 325 (1974) (holding that forgiving annual payments under an enforceable installment sales contract qualified for the annual exclusion, even though the forgiveness of each payment constituted only partial forgiveness of the entire debt); *Haygood v. Commissioner*, 42 T.C. 936, 943 (1964) (holding that forgiving separately enforceable notes on the same debt constituted separate gifts that could qualify for the annual exclusion). In *Kelley and Haygood*, the Tax Court held that two family members had created a bona fide sale of property, even though the facts of each case strongly suggested that the seller intended to forgive the buyer's payments. *Id.* These decisions have been criticized by other courts that have held that an installment sales contract between family members does not effect a bona fide sale when an intent to forgive the payments exists. See *Estate of Maxwell v. Commissioner*, 3 F.3d 591, 596-97 (2d Cir. 1993) (holding that an installment sales contract between family members in which the seller prearranged to forgive the buyer's payments constituted a gift, rather than a bona fide sale, of property); *Estate of Musgrove v. United States*, 33 Fed. Cl. 657, 664 (1995) (holding that a son and father did not enter into a bona fide sale when a son's unsecured demand note would be forgiven upon the father's death, because this arrangement manifested an intent to forgive the payments). Furthermore, the IRS explicitly rejected the holdings of *Kelley and Haygood*. See Rev. Rul. 77-299 (1977) (in which the IRS stated that even though the notes may have been legally enforceable, the intent to forgive the payments revealed that the transaction was in substance a disguised gift, rather than bona fide sale). Because of the IRS's position after *Kelley and Haygood*, taxpayers who forgive a family member's payments on an installment sales contract and claim the annual exclusion should plan on a legal battle with the IRS. For discussion of this point as it relates to the taxation of intrafamilial installment sales contracts, see *infra* note 148 and accompanying text.

¹³³ In addition to the annual exclusion, taxpayers also receive a unified credit against gift tax. See 26 U.S.C. § 2505(a) (1994). Currently, the unified credit is \$192,800. See 26 U.S.C. § 2505(a)(1) (1994). Under the "unified" transfer tax system of 1976, gifts amounting to roughly \$600,000 incur gift tax liability of \$192,800. See 26 U.S.C. § 2001 (c)(1) (1994). Thus, taxpayers can give up to \$600,000, and the unified credit will protect them from gift tax. However, using the unified credit for inter vivos transfers creates potentially undesirable estate tax consequences. See DOUGLAS A. KAHN ET AL., *FEDERAL TAXATION OF GIFTS, TRUSTS, AND ESTATES* 562-65 (1997). Taxpayers receive a unified credit against estate tax equal to the amount they receive for gift tax. See 26 U.S.C. §§ 2010, 2505 (1994). Estate tax is reduced by "the aggregate amount of tax which would have been payable . . . with respect to gifts made by the decedent." See 26 U.S.C. §2001(b)(2) (1994). The word "payable" is significant. KAHN ET AL., *supra* this footnote, at 565. When taxpayers make

2. Valuation Standard for Transactions Subject to Gift Tax

Section 2512 handles the valuation of transactions subject to gift tax. The following portion addresses how section 2512 values transactions pertaining to the disposition of real property. Next comes the valuation of installment sales contracts under section 2512.

a) Gift Tax Valuation of Dispositions with Real Property

One of the transactions subject to gift tax pertains to the disposition of real property.¹³⁴ When a mother gives forty acres of land to her daughter, the transfer of the forty acres constitutes a taxable gift.¹³⁵ The question then becomes how much gift tax the mother needs to pay. If she gives the property away and receives nothing in return, she will be liable for a gift tax on the fair market value of the property.¹³⁶ If the mother exchanges her forty acres for her daughter's twenty acres, then the determination of gift tax liability becomes more complicated. Still the mother receives less than she surrendered in the exchange.¹³⁷ Under the statutory language, the mother does not receive "adequate and full consideration in money or money's worth" for the forty acres she gives to her daughter.¹³⁸ The amount of the mother's gift tax then becomes the difference between the property value she surrendered and the property value she received.¹³⁹ This somewhat straight-forward valuation

gifts for less than \$600,000, the gift tax incurred on those gifts would not be payable and therefore is included in estate tax. *Id.* The amount of gift tax liability that taxpayers do not need to pay during their lifetimes must be paid by their estate at death. *Id.* Essentially, when taxpayers make gifts above the annual exclusion, they exhaust the amount of the unified credit that their estates could use against gift taxes, whether or not taxpayers actually claim the unified credit against gift taxes. *Id.* Thus, inter vivos transfers above the annual exclusion create a "use it or lose it" situation that ultimately depletes the testamentary unified credit. *Id.* This "use it or lose it" situation would deter wealthy taxpayers involved in intrafamilial installment sales contracts from using their unified credit against any gift tax incurred on an installment sales contract that includes only the safe harbor interest rate. See *infra* note 148 and accompanying text.

¹³⁴ This is not surprising since 26 U.S.C. § 2501(a)(1) (1994) specifically imposes a tax on a transfer of "property."

¹³⁵ To determine gift tax liability, the IRS applies the appropriate tax rate against the value of the taxpayer's gift. See 26 U.S.C. §§ 2501, 2502. When a taxpayer gives away property, the IRS must determine the value of the property before they can properly assess gift tax liability. Section 2512 handles the valuation of property for gift tax purposes. See 26 U.S.C. § 2512 (1994).

¹³⁶ 26 U.S.C. § 2512(a) (1994).

¹³⁷ This hypothetical assumes that one acre of the mother's property has the same value as one acre of her daughter's property.

¹³⁸ The fair market value is the equivalent of full and adequate compensation under 26 U.S.C. § 2512(b) (1994).

standard can become more involved when it is applied to installment sales contracts.

b) Gift Tax Valuation of Installment Sales Contracts

Adding another layer of complexity, gift tax liability may also exist in the context of an installment sale of real property.¹⁴⁰ If a person transfers property in exchange for a loan arrangement consisting of a series of payments, the transferor will suffer gift tax liability if the loan payments amount to less than the property value.¹⁴¹ The determination of the value of the loan payments implicates the time value of money.¹⁴² More specifically, the value of the installment sales contract depends on the terms that require interest and allocate a certain portion of each payment as this interest.¹⁴³

To illustrate the valuation of an installment sales contract, recall Mrs. Barnes and Mr. Sheers. If Mrs. Barnes sells her farm for \$150,000 to her son in exchange for a series of payments totaling \$150,000,¹⁴⁴ and if the installment contract does not include any interest payments, Mrs. Barnes will give the farm to her son for less than its fair market value.¹⁴⁵ This sale subjects Mrs. Barnes to gift tax liability in an amount equal to the difference between \$150,000 and the present value of an interest-free loan arrangement having a face value of \$150,000.¹⁴⁶ Mr. Sheers, who intends to surreptitiously include the prevailing market interest rate in his installment sales contract, would not incur gift tax liability. His disguised inclusion of the prevailing market rate would make the

¹³⁹ *Id.* The exchange does not need to be for similar property to incur gift tax liability. The statutory language that states "where property is transferred for less than an adequate and full consideration in money or money's worth," indicates that the daughter does not need to exchange similar property than her mother to incur gift tax liability. *Id.* The daughter could pay cash, bonds, newspaper, or chickens for the forty acres, and so long as whatever the daughter paid was worth less than the forty acres, her mother would incur gift tax liability to the extent of the difference in value between what the daughter paid and what the mother gave away.

¹⁴⁰ See *supra* notes 14-19 and accompanying text.

¹⁴¹ See GERHART, *supra* note 123, at 89.

¹⁴² See *supra* note 139 and accompanying text.

¹⁴³ See GERHART, *supra* note 123, at 90.

¹⁴⁴ \$150,000 is the undisputed fair market value of the farmland. See *supra* section I.

¹⁴⁵ Payments over time are inevitably less than full payment in the future. This means that an arrangement to pay \$150,000 over time is not worth the immediate payment of \$150,000 unless the deferred payment arrangement compensates the investment loss with interest. See *supra* notes 37-53 and accompanying text.

¹⁴⁶ Exactly what the present value of an interest-free loan arrangement totaling \$150,000 on its face is can be determined using a mathematical formula. See *supra* note 45.

present value of the installment sales contract equal to \$100,000.¹⁴⁷ Mrs. Barnes cannot catch a break.¹⁴⁸ However, the courts did at one time carve a temporary exception to the gift tax valuation of interest-free loans that would have benefited Mrs. Barnes.

3. Prudential Exception for Interest-Free Loans

For a number of years, the United States Court of Appeals and the Tax Court refused to impose gift tax liability on a party to an interest-free loan arrangement.¹⁴⁹ In particular, these courts refused to find gift tax

¹⁴⁷ Remember that Mr. Sheers does not want to lose any money when selling the barber shop to his daughter. See *supra* section I. Therefore, Mr. Sheers would make sure that however the terms of the installment sales contract with his daughter characterized principal or interest payments, he would still receive the proper time value of \$100,000. Whether Mr. Sheers' installment sales contract states it or not, it will still include interest payments, whereas Mrs. Barnes would neither state nor include interest payments in her installment sales contract with her son. But see *infra* note 274.

¹⁴⁸ Mrs. Barnes could try to avoid gift tax by structuring the installment sales contract so that the annual interest payments are less than the annual exclusion. She could then forgive her son's interest payments each time they came due. However, the IRS frowns upon this tactic, considering this kind of arrangement between family members to be a gift rather than a bona fide sale. See *supra* note 132. Thus, the IRS would send Mrs. Barnes a deficiency notice for gift tax on the forgiven interest payments, and because Mrs. Barnes could not afford to prove to a court that her installment sales contract with her son effected a bona fide sale, Mrs. Barnes would end up being subject to gift tax liability anyway. The unified credit would actually allow Mrs. Barnes to avoid paying the gift tax. 26 U.S.C. § 2505. However, Mrs. Barnes would deplete her testamentary unified credit. See *supra*, note 133. Thus, the unpaid gift tax liability that Mrs. Barnes incurred on her installment sales contract with her son would reduce the amount of unified credit available to her estate to apply against her estate taxes. Because Mrs. Barnes will probably pass away without an estate large enough to need the full unified credit, spending some of her unified credit during her lifetime would probably not cause a serious problem. However, if Mrs. Barnes were wealthy, spending this unified credit before death would limit the protection she could provide for her estate. In other words, wealthy taxpayers would pay the gift tax through their estate, rather than the year after making the gift. Thus, the unified credit may allow Mrs. Barnes to escape paying gift tax on her installment sales contract with her son. However, if Mr. Sheers, whose estate will be able to use the entire unified credit, includes only the safe harbor interest rate in his installment sales contract with his daughter, his estate will end up paying the gift tax liability he would incur. Therefore, the unified credit does not protect all parties who include only the safe harbor interest rate in their intrafamilial installment sales contracts. As a result, the gift tax trap can only receive its remedy through the alteration of the provisions that create this trap, namely sections 483, 1274, 2512, 7872.

¹⁴⁹ See *Hardee v. United States*, 708 F.2d 661, 667 (Fed. Cir. 1983) (holding once again that interest-free loans do not result in tax consequences); *Commissioner v. Greenspun*, 670 F.2d 123, 125 (9th Cir. 1982) (deferring to the holding in *Dean*); *Dean v. Commissioner*, 35 T.C. 1083 (1961) (although this holding was primarily concerned with the potential income tax implications of an interest-free loan, the court still concluded that the taxpayers had realized no tax consequences attributable to the free use of borrowed money).

liability on a party to an interest-free intrafamilial installment sales contract.¹⁵⁰ However, the United States Supreme Court held that the interest-free loan of funds constituted a taxable gift under the IRC.¹⁵¹ This decision supplanted more than two decades of case law¹⁵² and stirred up a great deal of criticism.¹⁵³ Congress reacted to this decision by adding section 7872 to the IRC.¹⁵⁴

4. Section 7872: Another Gift Tax Valuation Standard for Installment Sales Contracts

In addition to the valuation standard in section 2512, section 7872 also prescribes gift tax treatment for loans with below-market interest rates.¹⁵⁵ Under this section, any loan that does not include interest payments equivalent to the applicable federal rate is deemed to make a taxable gift.¹⁵⁶ The amount of the taxable gift equals either the forgone interest or the amount loaned over the sum of the present value of all payments that the terms of the loan require.¹⁵⁷ However, section 7872 retains an exception for contracts to which the safe harbor provision

¹⁵⁰ See *Johnson v. United States*, 254 F. Supp. 73, 77 (N.D. Tex. 1966) (holding that taxpayers did not make a taxable gift to their children for allowing their children to repay loaned money without any interest); *Crown v. Commissioner*, 67 T.C. 1060, 1064 (1977) (holding that an interest-free loan between family members bears neither income nor gift tax consequences).

¹⁵¹ *Dickman v. Commissioner*, 465 U.S. 330, 338 (1983).

¹⁵² The first of these cases, *Dean v. Commissioner*, *supra* note 149, was decided in 1961. The last of these cases, *Hardee v. United States*, *supra* note 149, was decided in 1983.

¹⁵³ See generally Beverly McDonel, *Dickman and Code Section 7872: The Death Knell to Interest-free and Below-Interest Loans*, 19 AKRON L. REV. 703 (1986); Barry R. Senterfitt, *Below-market Intrafamily Loans – The Recognition of Unrealized Earnings and Accumulations of Wealth: I.R.C. Section 7872 and Dickman v. Commissioner*, 104 S.Ct. 1086 (1984), 16 TEX. TECH. L. REV. 599 (1985); William T. Sharpe, *Interest-free Demand Loans Now Subject to Gift Tax: Dickman v. Commissioner*, ___ U.S. ___, 104 S. Ct. 1086 (1984), 7 CAMPBELL L. REV. 217 (1984); David Vetter, *Case Comment, Gift Taxation: Interest-free Demand Loans – Gift or Equivalent Exchange?*, 35 U. FLA. L. REV. 549 (1983).

¹⁵⁴ For the original text see Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 699.

¹⁵⁵ 26 U.S.C. § 7872 (1994). It should be noted that some cases have used section 2512 to handle loan arrangements that use below-market rates. See *Krabbenhoft v. Commissioner*, 939 F.2d 529, 532 (8th Cir. 1991); *Schusterman v. United States*, 63 F.3d 986, 991 (10th Cir. 1995).

¹⁵⁶ 26 U.S.C. § 7872(a), (b), (e).

¹⁵⁷ 26 U.S.C. § 7872(a) (treatment of gift loans and demand loans). 26 U.S.C. § 7872(e)(2)(A) and (B) define forgone interest as the amount of interest that would have been payable on the loan for the period if interest accrued on the loan at the applicable federal rate and were payable annually over any interest payable on the loan properly allocable to such period. 26 U.S.C. § 7872(b) (treatment of other below-market loans). In the case of any below-market loan that is not a gift or demand loan, the lender gives away the amount loaned over the present value of all payments that are required to be made under the terms of the loan.

applies.¹⁵⁸ Despite the explicit language of section 7872, the courts have not applied the gift tax provisions against the safe harbor rate uniformly.¹⁵⁹ In addition, sometimes courts will avoid the application of section 7872 completely and rely solely on section 2512 to attach gift tax to an intrafamilial installment sales contract.¹⁶⁰ These different applications of the gift tax to intrafamilial installment sales contracts result from the lack of exclusory language in the text of section 483 itself.¹⁶¹ The next section demonstrates how the Seventh, Eighth, and Tenth Circuits and the Tax Court have applied the gift tax statutes to the safe harbor provision differently.

IV. TREATMENT OF INTRAFAMILIAL INSTALLMENT SALES BY COURTS

Although Congress intended to remedy the loopholes created by the inaccurate time value taxation of installment sales contracts,¹⁶² the application of sections 483, 1274, 2512, and 7872 actually created havoc in the taxation of qualified sales.¹⁶³ Federal courts have not ruled consistently regarding the reach of the safe harbor rate.¹⁶⁴ The Seventh Circuit has allowed the safe harbor rate to cap the amount of interest the IRS may use to compute gift tax liability on an intrafamilial installment sales contract.¹⁶⁵ Alternatively, the Eighth and Tenth Circuits and the Tax Court have limited the safe harbor rate to the computation of imputed interest income only.¹⁶⁶ These different applications have

¹⁵⁸ 26 U.S.C. § 7872(f)(8).

¹⁵⁹ In *Ballard v. Commissioner* and *Krabbenhoft v. Commissioner*, the Seventh and Eighth Circuits did not discuss section 7872 at all. The Tax Court and the Tenth Circuit applied section 7872 against the safe harbor provisions differently in *Frazee v. Commissioner* and *Schusterman v. United States*. See *infra* section IV.

¹⁶⁰ See *infra* notes 191, 229 and accompanying text.

¹⁶¹ The best remedy for the conflict surrounding the current taxation of intrafamilial installment sales contracts would be exclusory language found in section 483 itself. For further discussion see *infra* notes 181-182, 221, 229 and accompanying text.

¹⁶² See *supra* notes 72-77 and accompanying text.

¹⁶³ The inconsistent application of the safe harbor as protection from income and gift tax disrupts the continuity of law, an essential attribute of a legal system. GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 3 (1982).

¹⁶⁴ However, a trend limiting the safe harbor provisions under section 483(e) has certainly developed in the latter cases which address this issue. See *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995); *Krabbenhoft v. Commissioner*, 939 F.2d 529 (8th Cir. 1991); *Frazee v. Commissioner*, 98 T.C. 554 (1992). See *infra* text accompanying notes 234-35.

¹⁶⁵ *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988).

¹⁶⁶ *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995); *Krabbenhoft v. Commissioner*, 939 F.2d 529 (8th Cir. 1991); *Frazee v. Commissioner*, 98 T.C. 554 (1992); *Ballard v. Commissioner*, 53 T.C.M. (CCH) 323 (1987) *rev'd* by *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988).

caused significant problems in this area of taxation.¹⁶⁷ This section analyzes the cases that have created this conflict, assessing the strengths and weaknesses of their holdings.

A. *Ballard v. Commissioner*¹⁶⁸

After the United States Supreme Court held that an interest-free loan resulted in gift tax liability,¹⁶⁹ federal courts needed to determine if a taxpayer could rely on the section 483 safe harbor rate for the purposes of gift valuation under sections 2512 or 7872 as well as the imputation of interest under section 1274.¹⁷⁰ *Ballard v. Commissioner*¹⁷¹ was the first case to address this issue. The taxpayer, Eleanor M. Ballard, entered into an installment sales contract with her three children.¹⁷² She sold her children 286 acres of land for a series of annual payments that included a principal of \$386,000 plus interest at a six percent rate.¹⁷³ The fair market value of the property was \$572,000.¹⁷⁴ The taxpayer reported a taxable gift of \$186,000, determined by subtracting the contract price of the property (\$386,000) from its fair market value (\$572,000).¹⁷⁵ However,

¹⁶⁷ See *infra* section V.A.

¹⁶⁸ 53 T.C.M. (CCH) 323 (1987), *rev'd* by *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988).

¹⁶⁹ *Dickman v. Commissioner* 465 U.S. 330 (1983).

¹⁷⁰ See *Dickman v. Commissioner*, 465 U.S. at 338. Although this Note limits its discussion to the effect of *Dickman* and the subsequent enactment of section 7872 on intrafamilial sales contracts, *Dickman* actually fomented many other issues for tax planners to cope with. See McDonel, *supra* note 153, at 713 (recognizing that because gift loans had been used as a tax planning device ever since Congress passed the revenue acts, tax planners needed to use different methods of shifting their client's income); Senterfitt, *supra* note 153, at 616 (now that intrafamily loans are no longer [after *Dickman*] valid tax avoidance devices, intrafamily lenders must face several decisions regarding their past and future arrangements).

¹⁷¹ 53 T.C.M. (CCH) 323 (1987), *rev'd* by *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988).

¹⁷² *Id.*

¹⁷³ Although the figures stated above are complete enough to understand the holding, the terms of the Ballard's contract actually employed a more elaborate repayment schedule. First the children needed to pay \$1,000 at the execution of the contract. *Id.* at 324. During the first five years of the contract, the children were to pay interest only, with each payment due on the date one year after the date of the contract's execution. *Id.* After this period, the children needed to pay a sum of principal and interest until they paid off the remainder of the purchase price plus interest. *Id.* According to these terms, the children would not pay the full purchase price until the year 2026. *Id.*

¹⁷⁴ The taxpayers original tax form listed the price of the property as \$570,000. *Id.* at 323. However, both the IRS and the taxpayer stipulated that the actual price for the property was \$572,000. *Id.* at 324.

¹⁷⁵ *Id.*

the IRS discounted¹⁷⁶ the contract price using an 18 percent interest rate that reduced the total purchase price to \$134,298.26.¹⁷⁷ The amount of the gift subject to taxation then became \$437,701.74, a full \$253,701.74 more than the taxpayer had figured.¹⁷⁸ The taxpayer contested the IRS's discount on the grounds that her compliance with the section 483 six percent safe harbor rate did not subject her to gift tax consequences.¹⁷⁹

The Tax Court held that the taxpayer could not rely on the section 483 six percent interest rate to value the sale price of the property.¹⁸⁰ The Tax Court reasoned that when a party does not sell property for the value at which it would change hands between a willing buyer and a willing seller, that party has made a taxable gift.¹⁸¹ Because a willing buyer and seller would not have exchanged the property under the terms of the installment sales contract, the taxpayer made a gift to her children.¹⁸² The Tax Court pointed out that *Blackburn v. Commissioner*¹⁸³ had already established the willing buyer and seller standard for gift tax valuation.¹⁸⁴ Although the taxpayer argued that *Blackburn* was decided before the enactment of section 483, the Tax Court reasoned that nothing in the legislative history of section 483 demonstrated a congressional intent to change the standard of gift tax valuation instituted in *Blackburn*.¹⁸⁵

¹⁷⁶ The IRS discounts a loan arrangement by finding the difference between the stated redemption price of the obligation at maturity and the price for which it was initially issued. Rick J. Taylor & William A. Raabe, *Original Issue Discount After the Tax Reform Act of 1984*, 63 TAXES: THE TAX MAGAZINE 587, 588 (1985). That difference represents additional interest that the obligator should have been required to pay for the use of the borrowed funds. *Id.*

¹⁷⁷ *Ballard v. Commissioner*, 53 T.C.M. (CCH) at 324.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.* at 325.

¹⁸⁰ *Id.* at 327.

¹⁸¹ *Id.* at 326. The Tax court relied on section 2512, stating that the contract was made before section 7872 existed. *Id.* at 327. The Tax Court's language reflected a reliance on the ordinary business test. See *Commissioner v. Wemyss*, 324 U.S. at 303, 306 (1994).

¹⁸² Another way to state the problem would be to say that the taxpayer did not receive "adequate and full" compensation for her property as section 2512 requires. *Ballard v. Commissioner*, 53 T.M.C. (CCH) 323 (1987).

¹⁸³ 20 T.C. 204 (1953).

¹⁸⁴ *Ballard v. Commissioner*, 53 T.C.M. (CCH) at 326.

¹⁸⁵ This argument is specious. Actually, the legislative history suggests neither an intent to alter nor to maintain the gift tax valuation standards with the enactment of the safe harbor interest rate of section 483. The Seventh Circuit noted this legislative silence and arrived at an opposite holding. See *infra* note 190 and accompanying text. Furthermore, the Tax Court hinted that section 7872 would have controlled in this case had the taxpayer entered the installment sales contract later. *Ballard v. Commissioner*, 53 T.C.M. (CCH) at 324. In that scenario, Congress would show an intent to extend the safe harbor into the gift tax

On appeal, the Seventh Circuit overruled the Tax Court, finding that the taxpayer's compliance with the section 483 safe harbor interest rate protected her from gift tax consequences.¹⁸⁶ The Seventh Circuit arrived at this finding by employing plain meaning statutory interpretation.¹⁸⁷ Because section 483 began with the words, "For the purposes of this title,"¹⁸⁸ the court reasoned that this language meant exactly what it said; that the taxpayer's compliance with the safe harbor insulated her from all adverse tax consequences under Title 26.¹⁸⁹ In addition, the Court realized that although the legislative history of section 483 did not manifest an intent to change the gift tax valuation standards, the legislative history did not indicate any intent to prevent section 483 from reaching into the gift tax arena.¹⁹⁰ The Seventh Circuit dismissed the valuation standard used in *Blackburn*, because that case was decided before the constraints of section 483 existed.¹⁹¹ The next case to address this issue was *Krabbenhoft v. Commissioner*.¹⁹²

B. Krabbenhoft v. Commissioner¹⁹³

Three years later in *Krabbenhoft v. Commissioner*,¹⁹⁴ the Eighth Circuit refused to follow the Seventh Circuit's interpretation of section 483.¹⁹⁵ The taxpayers, the Krabbenhoffs, transferred land to their sons through a

arena, because section 7872 specifically excepts those installment contracts governed by the safe harbor provision. See *supra* note 158 and accompanying text.

¹⁸⁶ *Ballard v. Commissioner*, 854 F.2d 185, 189 (7th Cir. 1988).

¹⁸⁷ *Id.* For discussion of the plain meaning doctrine of statutory interpretation, see *infra* notes 324-26 and accompanying text.

¹⁸⁸ This language still appears at the beginning of section 483. See 26 U.S.C. § 483(a) (1994).

¹⁸⁹ *Ballard v. Commissioner*, 854 F.2d at 189. Title 26 is the I.R.C.

¹⁹⁰ *Id.* at 188. The Seventh Circuit may properly conclude that the legislative silence does not limit the application of section 483 to the imputation of interest, because when the legislature has remained silent on an issue, the judiciary may slip into a the role of policymaker. See *Gregory v. Ashcroft*, 501 U.S. 452, 466-67 (1991) (noting that although judges might not be considered policymakers in the same sense as the executive or legislature, when no statute provides a definitive text, judges must derive their opinions from the interstices of prior opinions and a well considered judgment of what is best for the community). Extending the safe harbor into the gift tax arena is the appropriate policy. See *infra* section V.A.

¹⁹¹ *Ballard v. Commissioner*, 854 F.2d at 189. Also note that the Seventh Circuit makes no mention of section 7872 at all, implying that the courts will continue to rely on section 2512 for the taxation of intrafamilial sales contracts.

¹⁹² 939 F.2d 529 (8th Cir. 1991).

¹⁹³ *Id.*

¹⁹⁴ *Id.* This Note omits the Tax Court opinion of this case, because it mirrors most of the arguments it raised in *Ballard v. Commissioner*, 53 T.C.M. (CCH) 323 (1987). See *Krabbenhoft v. Commissioner*, 94 T.C. 887 (1990).

¹⁹⁵ *Krabbenhoft v. Commissioner*, 939 F.2d at 533.

contract for deed.¹⁹⁶ The contract provided for a purchase price of \$400,000, an interest rate of six percent, and annual payments of \$29,060 for thirty years.¹⁹⁷ Discounting the contract at the applicable federal rate,¹⁹⁸ the IRS determined that the contract for deed had a present value of \$252,642.¹⁹⁹ With \$443,400 as the fair market value of the property, the IRS determined that the taxpayers gave their sons \$190,758 as a taxable gift.²⁰⁰ Like Mrs. Ballard, the Krabbenhofs argued that their compliance with the six percent interest rate under section 483 bound the IRS to using the safe harbor as the maximum rate for gift tax valuation purposes.²⁰¹ However, the Krabbenhofs did not fare as well as Mrs. Ballard.

The Eighth Circuit refused to allow compliance with section 483(e)²⁰² to cap the interest rate that the IRS may use for gift tax valuation purposes.²⁰³ The court considered section 483 irrelevant to the valuation of gifts.²⁰⁴ The court held that Congress designed section 483 to prevent taxpayers from manipulating principal and interest payments to avoid ordinary income taxes.²⁰⁵ The court reasoned that because no statutory language or legislative history grants the safe harbor any power outside

¹⁹⁶ *Id.* at 530.

¹⁹⁷ *Id.*

¹⁹⁸ The process of discounting is described *supra* note 176 and accompanying text.

¹⁹⁹ *Krabbenhof v. Commissioner*, 939 F.2d at 530.

²⁰⁰ The IRS arrived at the amount of \$190,758 by subtracting the recalibrated present value (\$252,642) from the fair market value (\$443,400). *Id.*

²⁰¹ *Id.*

²⁰² The IRS arrived at the amount of \$190,758 by subtracting the recalibrated present value (\$252,642) from the fair market value (\$443,400). *Id.*

²⁰³ *Krabbenhof v. Commissioner*, 939 F.2d at 533.

²⁰⁴ *Id.* While agreeing with the Seventh Circuit that the words "for the purposes of this title" indicate that section 483 applies to the entire IRC, the Eighth Circuit refused to see how the imputed interest rules had anything to do with gift tax valuation. *Id.* at 523-33. This reasoning reflects the entrenched principle that the estate and gift tax systems should be construed *in pari materia*, meaning in conjunction with each other, whereas the gift and income tax systems should not be construed *in pari materia*. See *Cummings v. Commissioner*, 506 F.2d, 454 (2d Cir. 1974); *Early v. Commissioner*, 44 F.2d 812, 814-15 (2d Cir. 1947); *McGinnis v. Commissioner*, 65 T.C.M. (CCH) 1870, 1873 (1993); *Towe v. Commissioner*, 64 T.C.M. (CCH) 1424, 1426 (1992). This *in pari materia* principle has been criticized. See Mark J. Wolff, *Dickman Confined: The Taxation of Gratuitous Transfers of Use*, 21 STETSON L. REV. 509, 512 (1992) (stating that the gift tax functions as a back stop to protect the income tax system, and they should be read *in pari materia*); Erwin N. Griswold, *A Plan for the Coordination of Income, Estate, and Gift Tax Provision with Respect To Trusts and Other Transfers*, 56 HARV. L. REV. 337 (1942) (pointing out that the income and gift tax provisions should be coordinated with each other to prevent the amendment of the income and gift tax statutes pertaining to trusts, because these amendments create unnecessary litigation to determine their scope).

²⁰⁵ *Krabbenhof v. Commissioner*, 939 F.2d at 531.

of the imputed interest rules, the safe harbor bears no influence on the valuation of gifts in installment sales contracts.²⁰⁶ The court had previously used the section 483 safe harbor rate to limit tax liability under a different section of the IRC.²⁰⁷ However, the court stated that both of these sections pertained to the income taxation of installment sales contracts, rendering the safe harbor rate relevant only for the determination of the income tax.²⁰⁸

In a separate concurring opinion, Senior Circuit Judge Henley expressed some reservations about the majority's holding in *Krabbenhoft*.²⁰⁹ He did not believe that Congress wanted or anticipated the application of a gift tax to a family transaction like the one that the *Krabbenhofts* constructed.²¹⁰ Judge Henley argued that the court's technical holding implied that Congress either intended, or simply failed to consider, the "gift tax traps" created when market rates rose above six percent.²¹¹ Judge Henley stated that a "gift tax trap" occurred, because compliance with the safe harbor provision protected the taxpayer from imputed interest income tax, but opened the taxpayer up to additional gift tax liability.²¹² Judge Henley attempted to console the taxpayers by

²⁰⁶ *Id.* at 531, 532. This court repeats the weak argument on legislative intent begun in *Ballard v. Commissioner*, *supra* note 185 and accompanying text, and corrected in *Ballard v. Commissioner*, *supra* note 190 and accompanying text.

²⁰⁷ *Krabbenhoft v. Commissioner*, 939 F.2d at 532. See *Robinson v. Commissioner*, 439 F.2d 767 (8th Cir. 1971) (holding that application of the section 483 safe harbor rate to section 453, which addresses the installment basis of reporting, was proper).

²⁰⁸ *Krabbenhoft v. Commissioner*, 939 F.2d at 532-33.

²⁰⁹ *Id.* at 534.

²¹⁰ *Id.* This hesitance concerning government involvement in intrafamily affairs is reminiscent of *Johnson v. United States* and *Crown v. Commissioner*. See *supra* note 150.

²¹¹ No matter whether Congress anticipated the gift tax liability or not, the gift tax should not be imposed under Judge Henley's reasoning. Either Congress intended to create this gift tax trap or Congress inadvertently failed to anticipate it. Either way, imposition of the tax could promote hostility among taxpayers. If Congress did plan to create a gift tax trap, taxpayers may begin to consider the government malicious and oppressive. *ADAMS*, *supra* note 1, at xvii (noting that taxpayers instinctively rebel when the government levies oppressive taxes and that these taxpayers can pose a lethal threat). However, if Congress absent-mindedly created the gift tax trap, then taxpayers may still consider the tax too burdensome and lose respect for the system of taxation. See *LILLIAN DORIS, THE AMERICAN WAY IN TAXATION: INTERNAL REVENUE, 1862-1963* 1, 2 (1994) (noting that self-assessment and voluntary compliance, which are the heart and strength of any tax system, become threatened when the public loses confidence that the tax laws are operating fairly and impartially). See also *infra* notes 279-298 and accompanying text.

²¹² *Krabbenhoft v. Commissioner*, 939 F.2d at 534. Judge Henley also saw another gift tax trap relating to the timing of the valuation. *Id.* If an installment sales contract undergoes valuation during a period of high interest rates, that installment sales contract must forever carry a substantial discount, even if the market interest rates dip later. *Id.* This raises a potential equal protection problem outside the scope of this Note. For a discussion of the

stating that the majority's holding would only affect a small percentage of transactions occurring in the early eighties.²¹³ The next case to visit this issue proved Judge Henley's consolation to be ephemeral.

C. *Fraze v. Commissioner*²¹⁴

After *Krabbenhoft*, the Tax Court followed the Eighth Circuit and held that the safe harbor interest rate under section 483 does not apply for the purposes of gift tax valuation.²¹⁵ The taxpayers, Edwin and Mabel Frazee, transferred 12.2 acres of property to their four children in exchange for a promissory note that contained a principal sum of \$380,000 and an interest rate of seven percent.²¹⁶ The note provided for a 20-year graduated repayment schedule.²¹⁷ The IRS determined that this promissory note constituted a below-market loan under section 7872 and discounted this note so that the present value equaled only \$260,000.²¹⁸ The taxpayers argued that their compliance with the safe harbor provisions of section 483 insulated them from any adverse tax consequences.²¹⁹

Admitting that section 7872 does not cover the loans to which section 483 applies, the Tax Court still refused to conclude that compliance with the safe harbor rate precluded the application of gift tax liability under section 7872.²²⁰ The Tax Court reasoned that section 483

equal protection problems that can result from property valuation for tax purposes, see generally *Nordlinger v. Hahn*, 505 U.S. 1 (1992); *Allegheny Pittsburgh Coal Co. v. County Comm'n of Webster County*, 488 U.S. 336 (1989); *Charleston Fed. Sav. Loan Ass'n v. Alderson*, 324 U.S. 182 (1945).

²¹³ *Id.* at 535. This kind of language suggests that Judge Henley wants to distance his personal opinion from the majority's opinion, as if he desired to disassociate himself from the majority's ruling in this case.

²¹⁴ 98 T.C. 554 (1992).

²¹⁵ *Id.* at 585.

²¹⁶ *Id.* at 555.

²¹⁷ *Id.* at 554. The court also addressed an issue concerning the valuation of the property itself at the time of the sale. *Id.* at 561.

²¹⁸ *Id.* at 580.

²¹⁹ *Id.*

²²⁰ *Fraze v. Commissioner*, 98 T.C. at 554, 581 (1992). Although the Tax Court noted the language in section 7872 that excepted those installment sales contracts to which section 483(e) applies, the Tax Court somehow concluded that section 483 does not apply in this case and therefore the IRS was not precluded from valuing the installment sales contract with the applicable federal rate for gift tax purposes. *Id.* at 581, 582. This does not make sense. The exception in section 7872 does not require that section 483(e) apply for gift tax purposes, only that section 483 apply in some undefined capacity. 26 U.S.C. § 7872(f)(8). Thus, because section 483 applies for income tax purposes, it does apply in some capacity and should therefore fall into the exception found in section 7872.

did not apply, because Congress only intended to enact a safe harbor for income tax purposes, not for gift tax purposes.²²¹ On this point, the Tax Court found it significant that no mention of gift taxes appeared in section 483's legislative history.²²² Although the Tax Court considered potential problems with the Seventh Circuit's holding in *Ballard*,²²³ the Tax Court supported its holding only with this tenuous legislative history argument.²²⁴ As Judge Henley may have feared, the Eighth Circuit's holding in *Krabbenhof* has begun to look like the start of a trend toward denying taxpayers the protection of the safe harbor rate for gift tax valuation purposes.

²²¹ *Frazer v. Commissioner* 98 T.C. at 585. Frankly, the Tax Court simply misapplied section 7872. Congress provided an exception to the taxation imposed under section 7872 for those installment sales contracts to which section 483(e) applies. 26 U.S.C. § 7872(f)(8). Once section 483 applies to an installment sales contract, it applies for purposes of the entire IRC. *Ballard v. Commissioner*, 854 F.2d at 185, 189 (7th Cir. 1988). The Eighth Circuit, which did not directly address section 7872 in *Krabbenhof*, and the Tax Court agree that section 483 applies to the entire IRC, but only to the extent that section 483 is relevant. *Krabbenhof v. Commissioner*, 939 F.2d 529, 532 (5th Cir. 1991); *Frazer*, 98 T.C. at 584. Section 483 is in fact relevant to the application of section 7872, because if section 483 applies to an installment sales contract, the clear statutory language excludes that installment sales contract from tax consequences under section 7872. See Stillman, *supra* note 26, at 155, 158 (pointing out that statutory and regulatory language has been ignored as taxpayers who used the income tax safe harbor rates have been hit with gift tax consequences). To avoid this problem, Congress should include an exception within section 483 itself. See *infra* note 229 and accompanying text.

²²² This argument has been tried before, and it is as weak here as it was on earlier occasions. See *supra* notes 185, 190, 206 and accompanying text.

²²³ The Tax Court believed that following *Ballard* would lead to anomalous results. *Frazer v. Commissioner*, 98 T.C. 554, 584 (1992). According to the Tax Court, the Seventh Circuit's reasoning would mean that a person could die in possession of an installment sales contract, and the decedent's estate would need to pay an estate tax on the remaining unpaid portion of the installment sales contract. *Id.* Essentially, the Tax Court is worried that allowing section 483 to fix the face value of the installment sales contract would force the decedent's estate to pay tax on the entire face value of the installment sales contract, whether that face value had been fully paid or not, rather than imposing a tax on the discounted present value of the installment sales contract at the time of death. *Id.* at 583. This fear is unfounded. A skillful drafter could write in a default provision in the installment sales contract that states that in the event of the buyer's death, if the contract has not been paid in full, the buyer forfeits the property to the seller. Then the land will not remain in the estate at the time of the buyer's death, which is the time that the probate court or executor of the will must use to determine what is part of the estate. See 26 U.S.C. § 2001 (1994).

²²⁴ *Frazer v. Commissioner*, 98 T.C. 554, 585 (1992).

D. Schusterman v. United States²²⁵

In *Schusterman v. United States*,²²⁶ the Tenth Circuit continued the trend toward limiting the range of the safe harbor protection that started in the Eighth Circuit. The taxpayers, Charles and Lynn Schusterman, transferred 420 shares of stock to five irrevocable trusts.²²⁷ In exchange for the stock, the trustee issued promissory notes payable to the taxpayers for \$7,954,046.60 in addition to a six percent interest rate.²²⁸ Because the promissory notes required an interest rate lower than the prevailing market interest rate at the time these notes were issued, the IRS claimed that the taxpayers were liable for gift tax under section 2512.²²⁹ The taxpayers contended that compliance with the six percent safe harbor formed a ceiling on the rate that the IRS could use to value their installment sales contracts.²³⁰

The Tenth Circuit held that the IRS was entitled to use the prevailing market interest rate in the gift tax valuation of promissory notes that only included the safe harbor interest rate.²³¹ After outlining the debate begun in the Seventh Circuit, the Tenth Circuit aligned its opinion with the reasoning of the Eighth Circuit and Tax Court.²³² After curiously concluding that section 483 did not apply to the installment sales contract at issue,²³³ the Tenth Circuit rejected the contention that

²²⁵ 63 F.3d 986 (10th Cir. 1995).

²²⁶ *Id.*

²²⁷ *Id.* at 988. Although it does not concern intrafamilial installment sales of real property, this case is significant because it reveals a trend away from special treatment for intrafamilial installment transfers of property in general. See *infra* text accompanying notes 234-35.

²²⁸ *Schusterman v. United States*, 63 F.3d at 988.

²²⁹ *Id.* at 989. Notice that the Tenth Circuit relies on section 2512 rather than section 7872 to attach gift tax liability on this below-market loan. This raises the issue beyond a simple misapplication of the exception in section 7872. Ultimately the circuits could use section 2512 to avoid the section 7872 exception entirely. For this reason, section 483 should include its own exception to gift tax liability that will apply to sections 2512 and 7872 and any other gift tax provision. See *supra* notes 181, 182, 191, 221, 229 and accompanying text.

²³⁰ *Schusterman v. United States*, 63 F.3d at 989.

²³¹ *Id.* at 993.

²³² *Id.*

²³³ *Id.* at 990. The Tenth Circuit engaged in a technical reading of the safe harbor provision. *Id.* The Tenth Circuit claimed to glean a congressional intent to limit section 483 to the income tax arena after an examination of how sections a), b), and c) work together. *Id.* While it is true that the remedy for the IRS under section a) only refers to income tax liability, this does not mean that Congress intended to maroon section 483 in the income tax system. Because no other court has generated reasoning similar to the Tenth Circuit's in this matter, this opinion really proves that the safe harbor provisions are ambiguous at best. An ambiguous statute that provides no legislative history pertaining to the safe

section 483's prefatory language precluded the IRS from valuing an intrafamilial installment sales contract using the prevailing market rate.²³⁴ Therefore, while this case did not contribute much insightful discourse pertaining to the gift tax valuation of intrafamilial installment sales contracts, the Tenth Circuit did further a possible trend toward limiting the scope of the safe harbor to the income tax arena.

While these latter cases may suggest a trend toward limiting the safe harbor provision to the income tax arena, other jurisdictions that have not ruled on the section 483 safe harbor issue could follow any of these three circuits.²³⁵ Inconsistency and uncertainty are repugnant to an effective taxation system.²³⁶ Thus, this conflict between the circuits needs reconciliation. Next this note considers the social tax policy involved in order to determine whether the Seventh Circuit or the Eighth and Tenth Circuits decided the reach of the section 483 safe harbor provision correctly.

V. NECESSITY OF REFORM AND MEANS TO ACCOMPLISH IT

The federal government must collect taxes to maintain an ordered society.²³⁷ Because living in an ordered society benefits all citizens, paying taxes should benefit the individual citizen who must pay them.²³⁸

harbor provisions certainly does not indicate a clear congressional intent to restrict the safe harbor.

²³⁴ *Id.* at 993, 994.

²³⁵ Because the Supreme Court has not ruled on this issue, any circuit outside of the Seventh, Eighth, and Tenth Circuits is not bound to decide this issue either way. See PRATT, *supra* note 23. In fact, one of the primary reasons the Supreme Court grants certiorari is to resolve conflicts in the circuits. See *Stone v. INS*, 514 U.S. 386, 389 (1995); *Edwards v. Home Medical Group For Women*, 215 U.S. 1303, 1303 (1994) (stating that the Supreme Court will probably not grant certiorari until a conflict in the Circuits exists on the issue); *Howlett v. Birkdale Shipping Co.*, 512 U.S. 92, 95 (1994).

²³⁶ See GROVES, *supra* note 1, at 18. Notice that two of the Smith Canons require that taxes be certain and equitable. *Id.* The conflict in the circuits violates both of these because it generates uncertainty and unequal treatment of taxpayers in similarly situated positions. See *infra* section V.A. See also THOMAS J. REESE, *THE POLITICS OF TAXATION* xii (1980) (stating that a key principle that guides tax policymakers when they try to facilitate a tax reform is fairness, similar tax treatment for taxpayers with similar incomes and assets, which is the opposite of the situation currently existing in the tax law concerning the section 483 safe harbor interest rate).

²³⁷ For Oliver Wendell Holmes' famous statement, see *supra* note 1. A "revenue imperative" motivates the federal tax policymakers first and foremost, because they must plan for contingencies, primarily war, that create a colossal fiscal need for the government. See SHELDON D. POLLACK, *THE FAILURE OF U. S. TAX POLICY* 2 (1996).

²³⁸ See PASQUARIELLO, *supra* note 5, at 15, 16 (arguing that taxation can be good because it supports the government that maintains the cooperative association between individuals necessary for human survival). Not everyone agrees that the government collects taxes for

However, the government's system of taxation must remain properly organized and administered. Otherwise, tax-paying citizens will lose faith that the government collects taxes to effectuate any social benefit.²³⁹ A properly organized system of taxation requires both equity and predictability.²⁴⁰ Because the taxation of intrafamilial installment sales contracts lacks these two essential elements of a properly organized and administered tax system,²⁴¹ the taxation of intrafamilial installment sales contracts needs reform. This section examines both the necessity and methods of reform for the taxation of intrafamilial installment sales contracts.

A. *The Need to Reform the Taxation of Intrafamilial Installment Sales Contracts*

A system of taxation that benefits its citizens exhibits at least two main attributes.²⁴² First, the imposition of taxes should remain equitable or fair among all citizens.²⁴³ Second, the imposition of taxes must be predictable or consistent.²⁴⁴ When a system of taxation does not effect equity or predictability, the government and its citizens risk facing

the good of society. See ADAMS, *supra* note 1, at 1-3 (analogizing the tax collector to a robber, because both take money and property, by force if necessary, without paying for it).

²³⁹ DORIS, *supra* note 211, at 2.

²⁴⁰ See *infra* section V.A.

²⁴¹ See *infra* notes 253-56, 263-78 and accompanying text.

²⁴² Actually, a properly organized system of taxation exhibits more than fairness and predictability. See GROVES, *supra* note 1, at 18 (where the reproduced Smith Canons require a tax system to be equitable, certain, convenient, and economic); REESE, *supra* note 236, at xii (including fairness, simplicity, efficiency, and burden shifting in the system of taxation among the policies reformers hope to promote). This Note only focuses on fairness and predictability, because the taxation of intrafamilial installment sales contracts is for the most part a substantive tax law issue. Fairness and predictability are the policies that should drive the substantive tax law. Simplicity, efficiency, convenience, and economy are policies that should drive the procedural tax law, and thus are not as important to this Note. For a discussion of these procedural aspects of social policy relating to taxation and their differences from the substantive issues, see generally POLLACK, *supra* note 237.

²⁴³ The word "fairness" will be used synonymously with the word "equity" in this Note, because these two terms possess similar meanings in the scholarly discourse on tax policy. See JAMES & NOBLES, *supra* note 4, at 83; REESE, *supra* note 236, at xii. Both of these authors discuss the same concept of taxpayers sharing the societal burden equally, but while James and Nobles call this concept tax equity, Reese calls it fairness.

²⁴⁴ The word "predictability" will be used synonymously with the word "consistency" in this Note, because these two concepts are used interchangeably in the scholarly discourse on tax policy. See GROVES, *supra* note 1, at 18-9 (discussing the emphasis Adam Smith placed on the certainty of taxes, meaning that taxes are both predictable and consistent so that they remain clear and plain to the taxpayer). Furthermore, predictability and consistency are naturally related concepts, because a tax is not predictable if the federal courts do not apply the tax consistently. See *infra* notes 263-78 and accompanying text.

adverse social and economic consequences. The current conflict between the circuits of the United States Court of Appeals creates inequity and unpredictability in the taxation of intrafamilial installment sales contracts. This section begins by demonstrating how the current taxation of intrafamilial installment sales contracts does not conform to important social policy. This section also discusses the consequences that follow when a system of taxation does not properly conform to social policy.

1. Failure to Conform with Social Policy

This section demonstrates how the current taxation of intrafamilial sales contracts fails to exhibit the policies of equity and predictability. The analysis of these policies and the safe harbor provision reveals that the taxation of intrafamilial installment sales contracts can only promote both equity and predictability if the safe harbor provision protects taxpayers from additional income and gift tax consequences.

a) Unfairness of the Safe Harbor Imputed Interest Rules

Fairness is a fundamental policy consideration in taxation.²⁴⁵ For a tax system to be fair, people with similar income and assets should pay the same amount of taxes.²⁴⁶ In other words, all members of society must equally share the monetary burden required to preserve their society.²⁴⁷ If taxpayers believe that the federal government does not impose taxes fairly, they will lose respect for the system of taxation.²⁴⁸ If the federal government persists in levying unfair taxes, the taxpayers will ultimately develop hostility toward the federal government.²⁴⁹ Because the safe

²⁴⁵ See PASQUARIELLO, *supra* note 5, at 6-9 (pointing out that a just system of taxation requires that a society equitably share the burdens and benefits of social collaboration).

²⁴⁶ Two forms of equity exist in tax policy: horizontal and vertical. Horizontal equity requires similarly situated taxpayers to pay the same amount in taxes. See JAMES & NOBLES, *supra* note 4, at 75. Vertical equity requires differently situated taxpayers to pay a different amount in taxes. *Id.* Horizontal equity is at issue in this Note. See *infra* note 253 and accompanying text.

²⁴⁷ STEPHEN G. UTZ, *TAX POLICY: AN INTRODUCTION AND SURVEY OF THE PRINCIPAL DEBATES* 41, 42 (1993) (noting the agreement between scholars that each taxpayer should equally share the sacrifice created by the necessary tax burden).

²⁴⁸ A general sense that a system of taxation is unfair motivates citizens to cheat on their taxes, evidencing a lack of respect for the tax system. See PASQUARIELLO, *supra* note 5, at 53 (stating that the CPA institute, after a two year study, concluded that people evade paying taxes for three basic reasons: (1) a sense that one's tax burden has risen above its fair share; (2) erosion of public confidence that the tax law is treating everyone fairly, because the tax regulations have become increasingly complex, and (3) a sense that tax loopholes are unfair).

²⁴⁹ History demonstrates that when taxpayers lose respect for a system of taxation, they grow angry and rebel against the government imposing oppressive taxation. ADAMS, *supra*

harbor rules are not applied equitably, the taxation of intrafamilial installment sales contracts may be one more step toward the taxpayers losing faith in the federal government's current system of taxation.

Mrs. Barnes' and Mr. Sheers' situations demonstrate the lack of fairness created by the safe harbor rules. Mr. Sheers wants to include the prevailing market interest rate in his installment sales contract with his daughter, but he does not want to pay ordinary income tax on this interest. Mr. Sheers can afford to gamble that he will win any litigation the IRS may bring against him.²⁵⁰ As a result, Mr. Sheers decides that his installment sales contract with his daughter will include only a six percent interest rate on its face. At the same time, Mr. Sheers inflates the sale price of the barber shop so that the principal payments will also include the difference between six percent and the prevailing market interest rate. This difference will then receive the special capital gains tax treatment, while protecting Mr. Sheers from any additional gift tax.²⁵¹

Mrs. Barnes neither wants to charge her son the prevailing market interest rate nor can she afford a court battle with the IRS. To be safe from litigation, Mrs. Barnes must charge the prevailing market interest rate in her installment sales contract with her son.²⁵² Thus, Mrs. Barnes will need to pay ordinary income tax on the difference between the safe harbor rate and the prevailing market rate, whereas Mr. Sheers only needs to pay the cheaper capital gains tax on this difference. This

note 1, at xviii (where the author introduces the following as the thesis for his approximately 500 page book: taxes played an important part in stirring insurrection in every society from ancient Greece, Rome, and Israel to the modern world). Such hostility is already evident in militia groups. See *infra* notes 289, 291 and accompanying text.

²⁵⁰ Of course, Mr. Sheers would like to avoid the cost of litigation as well. Granted, taking calculated risks is part of being a good business person. Even so, the current trend of holdings in this area suggest that Mr. Sheers should not count on this litigation as a gamble which will pay off. See *supra* text accompanying notes 234-35.

²⁵¹ Mr. Sheers would not incur additional gift tax under section 2512 or section 7872 because the terms of the contract provide full and adequate compensation. The sum of the present value of all the payments under the installment sales contract would equal the sum of the payments which incorporate the prevailing market rate. In essence, Mr. Sheers incorporates the prevailing market interest rate without stating the total prevailing market interest rate on the face of the installment sales contract. Mr. Sheers then fools the gift tax which does not pay attention to allocation of payments between interest and principal, but to the total value given by the donor. However, the IRS may decide Mr. Sheers' maneuvering smacks of tax evasion and choose to litigate the issue. See *United States v. Midland-Ross Corp.*, 381 U.S. at 57 (stating that the court will look to substance and not form when determining interest rates).

²⁵² Including the prevailing market interest rate in an intrafamilial installment sales contract is the most conservative position a taxpayer can take to avoid litigation by the IRS. See Stillman, *supra* note 26, at 155.

situation departs from equitable taxation. Both Mr. Sheers and Mrs. Barnes are engaging in a similar installment sale, and the federal government is not taxing them the same.²⁵³

Mr. Sheers' and Mrs. Barnes' situations also demonstrate how a taxpayer can grow to resent a government that supports an inequitable tax system. Mrs. Barnes could become upset with the federal tax system for two reasons. First, Mrs. Barnes will not appreciate the federal taxation of intrafamilial installment sales contracts, because it does not allow her to ease her son's financial burden in the sale of the farmland.²⁵⁴ Second, and more critically, the knowledge that Mr. Sheers enjoys a tax benefit on the same sort of installment sales contract will infuriate Mrs. Barnes.²⁵⁵ Mrs. Barnes' anger at the federal government's taxation of intrafamilial installment sales contracts could push her closer to resenting the federal government's system of taxation as a whole, and possibly even the federal government itself.²⁵⁶

b) Unpredictability of the Safe Harbor Imputed Interest Rules

As if this lack of equity were not bad enough, the conflict between the Seventh Circuit and the Eighth and Tenth Circuits creates unpredictability in the current system of taxation. This conflict regarding the application of the safe harbor provision will also cause

²⁵³ See *supra* note 246.

²⁵⁴ Remember that Mrs. Barnes' son agreed to buy the farm from his mother at this time because he realized that his mother cannot afford to keep the land herself. Mrs. Barnes perceived her son's gesture to buy the farm as a favor to her, and the safe harbor rules do not allow her to return this favor. Although this "tugs on" the heart strings, this sentiment in itself does not render the safe harbor rules unfair. The government must impose certain unlikeable restrictions on individuals in order to maintain the consistency of the case law system. See *Reiter v. Dyken*, 290 N.W.2d 510 (Wis. 1980) (holding that the court could not change its precedent on the interpretation of the comparative fault statute, even though that precedent denied the plaintiffs the compensation they deserved for personal injuries). Even so, explaining this to Mrs. Barnes will not make her feel any warmer toward the federal government.

²⁵⁵ Here the classic violation of equity in the system of taxation exists: the federal government is not ensuring that taxpayers in the same or similar circumstances pay the same or similar taxes. See *JAMES & NOBLES*, *supra* note 4; *REESE*, *supra* note 236. Mrs. Barnes will be forced to pay ordinary income tax on the total prevailing market interest rate, whereas Mr. Sheers only needs to pay ordinary interest up to the safe harbor rate. Mrs. Barnes will realize that only reason Mr. Sheers can take advantage of this loophole instead of her is because she cannot afford to litigate this matter while Mrs. Sheers can. Mrs. Barnes will quickly conclude that the loophole is unfair because it favors the rich over the poor. See *PASQUARIELLO*, *supra* note 5, at 53 (noting that one of the major problems with the American tax system is that tax breaks such as these cause a lack of progressivity, which is the common tool for taxing according to the ability to pay).

²⁵⁶ See *infra* notes 290-301 and accompanying text.

taxpayers to grumble, because the conflict introduces unpredictability into the taxation of intrafamilial installment sales contracts.²⁵⁷ Just as the government must create a tax system that is equitable,²⁵⁸ the government must also administer that tax system with predictability.²⁵⁹ Taxpayers, both corporate and individual entities, inevitably structure their budgets to account for the cost of tax.²⁶⁰ In order for taxpayers to structure a meaningful budget, they must be reasonably certain as to the amount they must allot to pay taxes. For taxpayers to know how much taxes will cost them, they must be able to predict the tax consequences that will attach to their economic behavior.²⁶¹

For example, a corporation assembles bearings from different components purchased from other manufacturers. The corporation decides to expand its business. It wants to manufacture the components of the bearings and eliminate the need to purchase them from outside manufacturers. To support the expansion, the corporation will need to build new plants, hire employees with different skills, and purchase additional raw materials. All of these transactions will have tax consequences.²⁶² When the corporation finally needs to decide the economic feasibility of its proposed expansion, it must know the total cost of the expansion. This total cost includes tax liability. Therefore, the corporation must know its exact amount of tax liability in order to confidently determine the feasibility of the expansion. Only a

²⁵⁷ For those under the jurisdiction of the Seventh, Tenth, and Eighth Circuits, the safe harbor provisions application against potential gift tax would be predictable. These courts have already ruled on this issue and are bound by that decision. See PRATT, *supra* note 23. However, in the remaining eight circuits, it is not clear whether the Seventh Circuit or the Eighth and Tenth circuit's opinions will be followed.

²⁵⁸ See *supra* section V.A.1.a.

²⁵⁹ See *Ivan Allen Co. v. United States*, 422 U.S. 617, 641 (1975) (the dissenting opinion indicates that predictable and regular administration of federal taxation are considerable virtues); *Dotson v. United States*, 87 F.3d 682-87 (5th Cir. 1996) (noting the taxpayer interest in the predictability of taxation). See also John Wei-Ching Kuo, *Sales/Use Taxation of Software: An Issue of Tangibility*, 2 HIGH TECH. L. J. 125, 140 (1987) (stating predictability and certainty are fundamental principles of an ideal tax structure).

²⁶⁰ See SELIGMAN, *supra* note 95.

²⁶¹ See Kuo, *supra* note 259, at 140 (pointing out that when a tax law is imprecise and uncertain in its application, courts and taxing entities may inconsistently interpret the tax law such that taxpayers will not know the tax consequences of an activity in advance or that the tax consequence will differ dramatically from one area to another, which describes the current taxation of intrafamilial installment sales contracts perfectly).

²⁶² 26 U.S.C. §§ 301-385 handles the taxation of corporations. For discussion on the taxation of corporations and partnerships, see generally DOUGLAS A. KAHN, *BASIC CORPORATE TAXATION* (3d ed. 1981); DOUGLAS A. KAHN & JEFFERY S. LEHMAN, *CORPORATE INCOME TAXATION* (4th ed. 1994); BERNARD WORLFMAN, *FEDERAL INCOME TAXATION* (3d ed. 1990).

predictable tax system can help this corporation determine the feasibility of its endeavor.

The conflict in the circuits regarding the reach of the section 483 safe harbor leaves the taxation of intrafamilial installment sales contracts in a state of unpredictability.²⁶³ This unpredictability will irritate both the attorneys who must advise taxpayers and the taxpayers themselves. Ms. Vreet practices in the Sixth Circuit.²⁶⁴ While the Seventh, Eighth, and Tenth Circuits have ruled on the reach of the safe harbor provision, the Sixth Circuit has not determined this issue.²⁶⁵ Because a conflict remains between the circuits, Ms. Vreet will not be able to accurately predict whether the Sixth Circuit will follow the Seventh Circuit or the Eighth and Tenth Circuits and the Tax Court.²⁶⁶ Ms. Vreet can only be certain that including the safe harbor rate in an installment sales contract will secure Mr. Sheers and Mrs. Barnes from the income taxes resulting from the imputed interest provisions.²⁶⁷

²⁶³ See *supra* section V.A.1.b.

²⁶⁴ See *supra* note 23 and accompanying text.

²⁶⁵ An attorney must be able to make reasonable predictions rather than outright guesses with regard to tax matters because of the effect that taxes have on the whole economy. See JAMES & NOBLES, *supra* note 4, at 18-43 (noting that unpredictable taxation has the following negative effects on the economy: excess burden and increased compliance and administration costs). Before an attorney can offer a reasonable prediction and not a guess, the courts must interpret the same section of the IRC the same way among similar facts. See CALABRESI, *supra* note 163, at 165 (commenting that courts which provide continuity and change in American law must treat like cases alike). If the Seventh, the Eighth, and the Tenth Circuits had handed down consistent rulings on the reach of the safe harbor provision, Ms. Vreet could use the principle that the courts will treat like cases similarly to predict that the Sixth Circuit will follow the unbinding decisions of the Seventh, Eighth, and Tenth Circuits. However, the Seventh, Eighth, and Tenth Circuits have not treated like cases similar with regard to the reach of the safe harbor provision. Thus, Ms. Vreet, and anyone practicing outside the Seventh, Eighth, or Tenth Circuits, must guess rather than predict how the Sixth Circuit would rule on the safe harbor provision. While attorneys must deal with ambiguities in the law all the time, the economic consequences of taxation dictate that an attorney should be able to give taxpayers more than a guess when they ask for advice on tax matters.

²⁶⁶ The recent decisions on this issue seem to form a trend toward limiting the safe harbor to income taxation alone. See *supra* text accompanying notes 234, 235. However, the fact that two jurisdictions interpret the safe harbor provision the same way does not constitute an entrenched trend. The Seventh Circuit's reasoning, although assaulted by the Eighth Circuit, still remains sound enough to support a holding which would allow section 483(e) to protect intrafamilial installment sales contracts from adverse income and gift tax liability. See *supra* notes 186-191 and accompanying text.

²⁶⁷ The Seventh, Eighth and Tenth Circuit all agree that the safe harbor will protect a taxpayer from additional income tax consequences. See *Schusterman v. United States*, 63 F.3d 986, 993 (10th Cir. 1995); *Krabbenhoft v. Commissioner*, 939 F.2d 529 (8th Cir. 1991); *Ballard v. Commissioner*, 854 F.2d 185, 189 (7th Cir. 1988).

However, if Ms. Vreet only includes the safe harbor interest rate in her clients' installment sales contracts, Mrs. Barnes may or may not suffer gift tax liability.²⁶⁸ If the IRS chose to litigate regarding the installment sales contract, the Sixth Circuit could follow either the Seventh Circuit or Eighth and Tenth Circuits. If the Sixth Circuit were to follow the Seventh Circuit, then Mrs. Barnes would not incur additional gift tax liability.²⁶⁹ If the Sixth Circuit were to follow the Eighth and Tenth Circuits, Mrs. Barnes would suffer additional gift tax liability.²⁷⁰

Thus, Ms. Vreet has two options. On one hand, Ms. Vreet can advise her clients to include the prevailing market interest rate.²⁷¹ This advice will please neither Mr. Sheers nor Mrs. Barnes.²⁷² Otherwise, Ms. Vreet can advise her clients to include the safe harbor rate and brace for potential litigation.²⁷³ In either situation, the conflict in the circuits does not allow Ms. Vreet to accurately predict how the federal government will tax Mrs. Barnes' and Mr. Sheers' installment sales contracts.²⁷⁴ In

²⁶⁸ Remember that the nature of Mr. Sheers' installment sales contract will most likely protect him from gift tax liability, because he would not be making a taxable gift at all. See *supra* note 147 and accompanying text.

²⁶⁹ The Seventh Circuit held that the safe harbor provision protects a taxpayer from additional gift tax liability. See *supra* notes 186-191 and accompanying text.

²⁷⁰ The Eighth and Tenth Circuits held that the safe harbor provision does not protect a taxpayer from additional gift tax liability. See *supra* notes 203-08, 231-34 and accompanying text.

²⁷¹ Including the prevailing market rate is the most conservative, non-litigation breeding position a taxpayer can take on the taxation of intrafamilial installment sales contracts. See Stillman, *supra* note 26, at 153. Ms. Vreet would certainly advise Mrs. Barnes to include the prevailing market interest rate in her installment sales contract, because Mrs. Barnes cannot afford the cost of any potential litigation. See *supra* note 255 and accompanying text. Even though Mr. Sheers does not really need to worry about a gift tax, whether the IRS chooses to litigate the matter or not, Ms. Vreet should still probably advise Mr. Sheers to include the prevailing market rate. If Mr. Sheers only states the safe harbor rate in his installment sales contract, the IRS may notice that Mr. Sheers has not included the prevailing market rate, sense a potential effort to evade taxes, and choose to litigate the matter anyway. Paying the additional ordinary income on the fully stated amount of interest could easily cost less than the court battle Mr. Sheers may need to wage against the IRS.

²⁷² Mr. Sheers will be angry because he will have to pay an ordinary income-tax on the higher prevailing market rate, and Mrs. Barnes will be upset because she must charge her son a sizable interest rate which he will barely be able to afford, possibly subjecting the property to a tax lien.

²⁷³ Including the safe harbor rate alone is the most aggressive, legally defensible position a taxpayer can take on the taxation of intrafamilial installment sales contracts. See Stillman, *supra* note 26, at 157. This option is really not available for Mrs. Barnes, because she does not have the money to pay for litigation against the IRS. See *supra* section I.

²⁷⁴ Ms. Vreet may actually be able to reasonably predict the amount of taxes that the federal government will levy against his installment sales contract. See *supra* note 147 and accompanying text. However, because Mr. Sheers is obviously trying to camouflage interest payments as principal in an effort to avoid paying ordinary income tax on that

turn, neither Mrs. Barnes nor Mr. Sheers could budget for the cost of the tax on their installment sales contracts with any degree of certainty.²⁷⁵ While this lack of predictability will augment Mrs. Barnes' ill-feelings,²⁷⁶ Mr. Sheers may also grow disgusted with the federal system of taxation,²⁷⁷ because even his lawyer cannot give him a straight answer as to how much taxes will cost him.²⁷⁸

Therefore, the current taxation of intrafamilial installment sales contracts does not conform to the basic tax policies of equity and predictability. Taxes that do not conform to these tax policies carry adverse consequences that warrant a reform of the section 483 safe harbor provision. The next section considers these consequences in greater detail.

2. Consequences of the Failure To Conform with Basic Tax Policy

The conflict in the circuits does not allow the current taxation of intrafamilial installment sales contracts to remain equitable or predictable.²⁷⁹ Taxes that do not exhibit equity and predictability cause taxpayers to develop ill-will toward the government.²⁸⁰ When taxes do not display the basic policies of equity and predictability, the government and its citizens encounter adverse economic and social consequences.²⁸¹

interest, the IRS may be able to convince the court that Mr. Sheers' maneuvering violates Congress' original purpose for enacting the imputed interest rules. See *supra* notes 72-77 and accompanying text. Thus, the court may find that Mr. Sheers is liable for ordinary income tax up to the prevailing market interest rate. However, this outcome is so unlikely that Mr. Sheers really would not need to worry about it too much.

²⁷⁵ See *supra* notes 263-70, 274 and accompanying text.

²⁷⁶ Remember that Mrs. Barnes is already angry about the unfairness that is present in the current taxation of intrafamilial installment sales contracts. See *supra* text accompanying notes 254-55.

²⁷⁷ Mr. Sheers, and Mrs. Barnes for that matter, may already have a distaste for the tax system. See REESE, *supra* note 236, at xii (proposing that many taxpayers perceive the federal system of taxation as the government taking sway their hard-earned money).

²⁷⁸ Being a businessman, Mr. Sheers will be acutely aware of the importance of his budget. Not knowing the exact cost of tax in this situation would undermine his attempts to construct an accurate budget. See *supra* notes 261-62 and accompanying text.

²⁷⁹ See *supra* section V.A.1.a.,b.

²⁸⁰ See *supra* notes 254-55, 276-78 and accompanying text.

²⁸¹ See *infra* section V.A.2.a.,b.

a) Economic Consequences of Inequitable and Unpredictable Taxation

Every taxpayer would not react to the taxation of intrafamilial installment sales contracts with Mr. Sheers' and Mrs. Barnes' frustration.²⁸² Rather, some citizens will simply refuse to pay the taxes that they perceive to be inequitable or unpredictable.²⁸³ These taxpayer's refusal originates with their sense of justice.²⁸⁴ When taxpayers discover unfair or unpredictable taxation, they conclude that the tax system as a whole is unjust.²⁸⁵ This sense of injustice causes taxpayers to avoid or to evade paying taxes.²⁸⁶

Tax avoidance and evasion impact the American economy adversely. Those who refuse to pay the inequitable and unpredictable taxes spend an increased amount of time and money trying to avoid and to evade taxes.²⁸⁷ Paying for the costs associated with tax avoidance and evasion reduces the taxpayer's economic welfare.²⁸⁸ Even those who do not try to avoid or to evade taxes suffer adverse economic consequences, because they end up paying the taxes that others have avoided.²⁸⁹ Although the adverse economic impact of inequitable and unpredictable

²⁸² For Mrs. Barnes' and Mr. Sheers' reactions, see *supra* notes 254-55, 276-78 and accompanying text.

²⁸³ This section points out that inequitable and unpredictable taxation drives taxpayers to avoid and to evade taxes. Thus, these taxpayers do not grow mad, as Mr. Sheers and Mrs. Barnes. Rather, they "get even" with the government that tries to impose these kinds of taxes on them. See *supra* notes 280-82 and *infra* notes 284-86 and accompanying text.

²⁸⁴ See JAMES & NOBLES, *supra* note 4, at 74 (describing how the fairness and predictability of taxes are connected to a taxpayer's sense of justice).

²⁸⁵ See JAMES & NOBLES, *supra* note 4, at 74 (noting that a society must face certain practical problems when taxpayers begin to perceive that a system of taxation is unjust).

²⁸⁶ See JAMES & NOBLES, *supra* note 4, at 104 (naming inequity and imprecise laws as two of the causes of tax avoidance and evasion). See also PASQUARIELLO, *supra* note 5, at 53.

²⁸⁷ To avoid and to evade taxes, taxpayers must pay the excessive fees of expert advisers, and in addition, taxpayers must also rearrange their affairs according to that advice. See JAMES & NOBLES, *supra* note 4, at 105.

²⁸⁸ The efforts and resources needed to receive an expert's advice and to effect the necessary rearrangement imposes considerable costs upon the taxpayer. See JAMES & NOBLES, *supra* note 4, at 105. Paying these costs reduces the taxpayer's ability to pay for anything else.

²⁸⁹ The federal government needs to raise a fixed amount of revenue through taxes. JAMES & NOBLES, *supra* note 4, at 106. That amount does not change no matter how many citizens pay taxes. Thus, the failure of one citizen to pay taxes increases the amount that the rest of the citizens must pay. In a sense, taxpayers who continue to pay inequitable and unpredictable taxes pay their own taxes plus the taxes of those who avoid or evade paying them. JAMES & NOBLES, *supra* note 4, at 105. Paying more than a fair share of taxes obviously reduces the wealth of the taxpayer who does not avoid or evade tax liability. These taxpayers may share Mrs. Barnes' anger toward the federal government. See *supra* text accompanying notes 254-55.

taxation causes enough trouble, a system of taxation that lacks these policies creates negative social consequences as well.

b) Social Consequences of Inequitable and Unpredictable Taxation

Inequitable and unpredictable taxes, such as those governing the taxation of intrafamilial installment sales contracts, carry adverse social consequences also. Inequitable and unpredictable taxes bring taxpayers into conflict with the government.²⁹⁰ A certain degree of tension always exists between taxpayers and the government tax official.²⁹¹ However, the current taxation of intrafamilial installment sales contracts unnecessarily exacerbates tensions between the government and its taxpayers.²⁹² If this kind of taxation continues, taxpayers may doubt that the government collects taxes for any good reason.²⁹³ Eventually, taxpayers may begin to lose respect for the government that imposes these taxes.²⁹⁴ The United States of America was born out of a

²⁹⁰ See PASQUARIELLO, *supra* note 5, at 51-3 (stating that American taxpayers are angry with the American tax system, and that most of that anger seems to come from the perceived unfairness of taxes).

²⁹¹ See ADAMS, *supra* note 1, at xvii (pointing out that human rights can suffer under certain systems of taxation because the tax man takes whatever the tax man wants, including a taxpayer's liberty, should the tax man so desire). See also Don L. Boroghs et al., *A Messy Business: Can the IRS Clean Up Its Act and Pacify the Nation's Angry Taxpayers?*, U.S. NEWS & WORLD REPORT, April 8, 1996, at 38 (noting that "tax collectors have been dodging stones ever since biblical times").

²⁹² The present is not the best time to exacerbate tension between the taxpayers and federal government. Boroghs et al., *supra* note 291, at 38 (noting that the chorus of voices challenging the IRS today [1996] has risen to a pitch not heard in decades). In fact, a poll by the Tarrance Group for the U.S. News revealed that fewer than a quarter of registered voters said that the country would be worse off if the IRS were abolished and more than a third thought that the abolishment of the IRS would be an improvement. *Id.*

²⁹³ When the government does not collect taxes in a fair and equitable manner, taxpayers will no longer believe that taxes possess their essential quality, which is the enhancement of strength and prosperity of a people. See ADAMS, *supra* note 1, at xviii. Taxpayers will then consider the tax "dumb" and naturally rebel against paying it. *Id.*

²⁹⁴ That can lead to an insurrection mentality in extreme cases. See ADAMS, *supra* note 1, at xvii, xviii (taxpayers may even become angry at the government tax collector under inequitable and unpredictable circumstances, posing a potential threat of rebellion against the government). See also Christopher John Farley, *The West Is Wild Again*, TIME, March 20, 1995, at 46 (noting that a growing number of citizens are rejecting the federal authority to tax or control property in general); Ralph R. Reiland, *New American Revolutionaries March to a very Different Beat*, INSIGHT MAGAZINE, August 19, 1996, at 31 (recounting an interview with Don Smith, the elected chaplain of the Citizens Militia of Greene County, in which Don Smith indicated that a second Revolutionary War was not such a bizarre idea, because King George's tax on five percent of the average income helped to prompt the first Revolutionary War, and now the federal government takes about forty-five percent). See also NEIL A. HAMILTON, *MILITIA IN AMERICA: A REFERENCE HANDBOOK* 41-42 (1996)

Revolutionary War declared, at least in part, on the colonists' perception that the Royal Crown of England imposed unfair taxes on them.²⁹⁵ Given these historical roots, Americans are particularly distrustful of the federal government's reasons for levying taxes that contravene good social policy.²⁹⁶ That distrust threatens the federal government's ability to collect the tax revenue it needs to function.²⁹⁷

The federal government should strive to keep the IRC free from any tax provisions that may cause taxpayers to question the government's motives.²⁹⁸ The current taxation of intrafamilial installment sales contracts is the kind of tax that would cause taxpayers to lose respect for the federal government.²⁹⁹ Although one inequitable and unpredictable tax will not drive American taxpayers to revolt, the inequitable and unpredictable taxation of intrafamilial installment sales contracts may further foment conflict already existing between taxpayers and the federal government.³⁰⁰ Similarly, the inequitable and unpredictable taxation of intrafamilial installment sales contracts gives taxpayers one more reason to avoid or to evade taxes, causing undesirable economic consequences.³⁰¹

Therefore, the taxation of intrafamilial installment sales contracts should be reformed to be both equitable and predictable. In order to

(determining that one of the main platforms of anti-federal militias is the intrusion of the federal government upon a person's liberty by imposing excessive taxes and other transgressions).

²⁹⁵ Numerous sources of tax scholarship remain cognizant of this fact. See ADAMS, *supra* note 1, at 293-306; JAMES & NOBLES, *supra* note 4, at 1, 74-75; GROVES, *supra* note 1, at 5; PASQUARIELLO, *supra* note 5, at 51.

²⁹⁶ See PASQUARIELLO, *supra* note 5, at 51 (stating that the birth of America out of a tax revolt resulted in an historical trauma, making it a part of an American's culture and tradition to dislike taxes).

²⁹⁷ The federal income tax system is collected through taxpayer self-assessment. See DORIS, *supra* note 211, at 7. If the taxpayers no longer trust the federal government, they may no longer freely assess their own taxes. This would create an administrative burden that the federal government would be hard pressed to bear.

²⁹⁸ See DORIS, *supra* note 211, at 14 (noting that the goal of a tax re-examination conducted by Congress is to strengthen the tax system, to correct inequities, and to obtain a revenue system that is fair, equitable, neutral in impact between similar dollars of income). Some of the major themes in the minds of tax-makers is to avoid confrontations with the public over taxes, because the tax-makers must deal with a public that does not like to be taxed. See REESE, *supra* note 236, at xii.

²⁹⁹ The current taxation of intrafamilial installment sales contracts is a tax that may cause taxpayers to lose faith with the federal tax system, because it lacks equity and predictability. See *supra* section V.A.1.a.,b.

³⁰⁰ See Boroghs et al., *supra* note 291.

³⁰¹ See *supra* notes 282-89 and accompanying text.

comport with these policies, the safe harbor provision needs revision. More specifically, the taxation of intrafamilial installment sales contracts can be both fair and equitable only if the conflict between the Seventh Circuit and the Eighth and Tenth Circuits is resolved so that the safe harbor protects taxpayers from additional gift and income tax liability. The next section analyzes the methods that the federal government could use to reform the taxation of intrafamilial installment sales contracts.

B. Means of Reform for the Taxation of Intrafamilial Sales Contracts

To prevent adverse economic and social consequences, the taxation of intrafamilial installment sales contracts needs reform.³⁰² For the taxation of intrafamilial installment sales contracts to be equitable, the safe harbor provision of section 483(e) must insulate parties to a qualified sale from both imputed interest income tax and below-market loan gift tax.³⁰³ For the taxation of intrafamilial installment sales contracts to be predictable, the conflict in the circuits must be resolved.³⁰⁴ Both the federal courts and Congress possess the power to reform the safe harbor provision.³⁰⁵ However, the federal courts and Congress do not share the same power to reform the taxation of intrafamilial installment sales contracts.³⁰⁶ An examination of the different powers of the federal courts and Congress demonstrates that Congress is the more appropriate forum to effectuate the necessary reformation to the section 483(e) safe harbor provision.

1. Courts and Statutory Interpretation

The federal courts are responsible for interpreting the United States Constitution.³⁰⁷ The federal courts have jurisdiction over any congressional statutes and state statutes that implicate the United States Constitution.³⁰⁸ The IRC is a group of statutes that Congress enacted under the United States Constitution.³⁰⁹ Thus, the federal courts have the power to interpret the IRC, including those provisions related to intrafamilial installment sales contracts.

³⁰² See *supra* section V.A.2.a,b.

³⁰³ See *supra* section V.A.1.a.

³⁰⁴ See *supra* section V.A.1.b.

³⁰⁵ See *infra* notes 304-06, 330-31 and accompanying text.

³⁰⁶ See *infra* notes 330-34 and accompanying text.

³⁰⁷ U.S. CONST. art. III, § 2, cl. 1.

³⁰⁸ *Id.* See also 28 U.S.C. § 1331 (1994).

³⁰⁹ See U.S. CONST. art. I, § 8; U.S. CONST. art. I, § 3, amended by U.S. CONST. amend. XVI.

When a federal statute is at issue, a federal court can either strike the entire statute as violative of the United States Constitution,³¹⁰ or it can interpret the statute to give meaning to ambiguous language.³¹¹ The issue of whether the safe harbor provision extends into both income and gift taxation presents the federal courts with an ambiguous language problem.³¹² The ambiguous language in issue reads as follows: "for purposes of this title, in the case of any payment -- under any contract for the sale or exchange of any property, and to which this section applies...."³¹³ This language is ambiguous, because it elicits two conflicting meanings.³¹⁴ It could mean that when section 483 applies, including the safe harbor provision in an installment sales contract insulates the taxpayer from all income and gift tax consequences not described in section 483.³¹⁵ However, the above language could also mean that section 483 serves to protect the taxpayer from income taxation only.³¹⁶ Thus, a federal court that must rule on the reach of the

³¹⁰ See *Illinois v. Krull*, 480 U.S. 340, 352 (1987) (noting that the biggest deterrent for the legislature is that statutes may be invalidated for lack of constitutionality).

³¹¹ Ambiguity can be defined as doubleness of meaning. See NOLAN ET AL., *supra* note 127, at 79. The following provides an even clearer description of ambiguity:

Ambiguity exists if reasonable persons can find different meanings in a statute, document, etc., when good arguments can be made for either of two contrary positions as to a meaning of a term in a document . . . when application of pertinent rules of interpretation to an instrument as a whole fails to make certain which one of two or more meanings is conveyed by the words....

Id. at 79, 80. The Supreme Court has recognized the power of the federal courts to interpret an ambiguous federal statute on several different occasions. See *Morse v. Republican Party of Virginia*, 116 S. Ct. 1186, 1218 (1996) (pointing out a doctrine that allows the Court to interpret ambiguous statutes to have a meaning that will avoid substantial constitutional questions); *Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California*, 508 U.S. 602, 628-29 (1993) (commenting that in the case of statutory ambiguity the Court should use a method of statutory construction that will construe the statute to have a meaning which does not raise serious constitutional problems); *Steward Org., Inc. v. Ricoh Corp.*, 487 U.S. 22, 38 (1988) (in which Justice Scalia concludes that the majority should have construed the ambiguous statute to have a meaning that would prevent forum shopping).

³¹² The constitutionality of the provisions of the IRC pertaining to the taxation of intrafamilial installment sales contracts is not in dispute in any of the relevant cases. See *supra* section IV.

³¹³ 26 U.S.C. § 483(a) (1994).

³¹⁴ See *supra* note 311.

³¹⁵ This is meaning the Seventh Circuit found in section 483. See *supra* notes 186-90 and accompanying text.

³¹⁶ This is the meaning the Eighth and Tenth Circuits and the Tax Court found in section 483. See *supra* notes 203-05, 221-21, 232-34 and accompanying text.

safe harbor provision must resolve this ambiguity by assigning section 483 a single meaning.³¹⁷

Some of the methods the federal courts used to resolve ambiguous statutory language are the principles of statutory interpretation.³¹⁸ Many different principles of statutory interpretation exist,³¹⁹ and the courts do not treat any one of these principles as definitive.³²⁰ One theory of statutory interpretation, namely originalism, attempts to determine the legislative intent behind the language of the statute.³²¹ Under the originalist approach, a federal court may consult sources of legislative history even when the language of the statute is apparently clear.³²² However, neither the statutory language nor the legislative history provide any insight into Congress' intent regarding the reach of the safe

³¹⁷ The Court can find for one party only if it assigns a single meaning to the statute at issue.

³¹⁸ "Statutory construction" and "statutory interpretation" indicate different systems which the courts employ to resolve ambiguous statutory language. See Adrienne L. Mickells, *The Uniform Statute and Rule Construction Act: Help, Hindrance, or Irrelevancy?*, 44 U. KAN. L. REV. 423, 424 (1996) (noting that the terms "statutory construction" and "statutory interpretation" possess their own separate, technical meaning). Neither statutory construction, which uses canons, nor statutory interpretation, which uses theory, is superior. See Jonathan R. Macey & Geoffrey P. Miller, *The Canons of Statutory Construction and Judicial Preferences*, 45 VAND. L. REV. 647, 648 (1992) (noting that judges may choose to ignore the principles of statutory construction and rely on other sources of authority for resolving ambiguity, such as precedent, legislative history, efficiency, or "fairness"). This Note will only refer to modes of statutory interpretation, because the Seventh, Eighth, and Tenth Circuits chose to evaluate section 483 using the theories of statutory interpretation. See *Schusterman v. United States*, 63 F.3d 986, 989 (10th Cir. 1995); *Krabbenhof v. Commissioner*, 939 F.2d 529, 531 (8th Cir. 1991); *Ballard v. Commissioner*, 854 F.2d 185, 188 (7th Cir. 1988). For further discussion of the canons of statutory construction, see NORMAN J. SINGER, *SUTHERLAND STATUORY CONSTRUCTION* (5th ed. 1992).

³¹⁹ The differing modes of statutory interpretation which have evolved over time demonstrate the lack of conclusivity of any one mode of statutory interpretation. See Mickells, *supra* note 318, at 425-31 (1996) (providing a brief overview of the theories of statutory interpretation from historical to current principles).

³²⁰ However, the Supreme Court does predominantly use the strict statutory construction method of interpretation, which employs the plain meaning rule (resolving conflict pertaining to the interpretation of a statute by looking to the text of the statute governing the conflict). Carlos J. Cuevas, *The Rehnquist Court, Strict Statutory Construction and the Bankruptcy Code*, 42 CLEV. ST. L. REV. 435, 438 (1994).

³²¹ The primary mode of interpretation for federal statutes is originalism, which seeks to discover and apply the intent of the enacting legislature. Mickells, *supra* note 318, at 427. Note that all the cases discussing the reach of the safe harbor provisions attempt to look to the legislative history. See *supra* notes 186-90, 203-05, 221-22, 232-34 and accompanying text.

³²² See Mickells, *supra* note 318, at 427, 428.

harbor provision.³²³ Thus, using the theory of originalism will not help a federal court determine a single meaning for section 483's ambiguous language.

Another popular theory of interpretation is the plain meaning rule.³²⁴ Here a court examines the plain text of the statute to determine its "apparent" or "plain" meaning.³²⁵ The plain meaning rule has already failed to help the United States Court of Appeals resolve the ambiguous language in section 483.³²⁶ Furthermore, any theory of statutory interpretation that tries to resolve the ambiguity of the language in section 483 based on legislative intent or the text of the statute itself will not provide guidance on how far the safe harbor provision should reach.³²⁷

Only methods of statutory interpretation which allow a court to consider "fairness" or public policy will help a federal court resolve the ambiguous language of section 483.³²⁸ However, past and current

³²³ The reason for this is that the text of section 483 is ambiguous and the legislative history does not indicate how far the safe harbor should reach. See *supra* notes 181-82, 221, 229 and accompanying text.

³²⁴ The United States Supreme Court has employed plain meaning statutory interpretation on several occasions. See *Patterson v Shumate*, 504 U.S. 753, 757-58 (1992); *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992); *Union Bank v. Wolas*, 502 U.S. 151, 156-57 (1991); *Toibb v. Radloff*, 501 U.S. 157, 160-61 (1991); *Ron Pair Enter., Inc. v. Barber* 489 U.S. 235, 240-45 (1989).

³²⁵ See *supra* note 324.

³²⁶ The current conflict in the Circuits is a result of the use of the plain meaning rule to interpret the opening language of section 483. See *supra* notes 186-90, 203-06, 232-34 and accompanying text.

³²⁷ No legislative history exists on the reach of section 483 for the purposes of gift taxation, leaving nothing for the court to rely on to determine Congressional intent, and the differing Circuit opinions have demonstrated that the text of section 483 can be read to have two "apparent" meanings.

³²⁸ Some of these public policy based methods of statutory interpretation are as follows:

1) "Mischief or purpose" rule -- the construer of the statute identifies the deficiency in the common law which the statute was meant to remedy, and then continues that remedy;

2) "Equity of statute" rule -- the judge is allowed to resort to enlarge or restrict the text of the statute, to the point of nonliteral construction, based on a sense of equity and purpose;

3) "Public values theory" -- judges may participate in the dynamic process of forming statutes, interpreting them based on current ideas of public policy.

Mickells, *supra* note 318, at 425, 426, 430. Whereas solid textual arguments do not exist on this issue, good public policy arguments do exist for extending the safe harbor beyond income taxation into aid taxation. See *supra* section V.A.2.a.,b. Therefore, these equity and policy-based theories of statutory construction, unlike the textual and legislative intent theories, would actually allow the courts to support a reformation of the taxation of intrafamilial installment sales contracts.

judicial opinion considers these policy-based forms of statutory interpretation a usurpation of congressional power.³²⁹ Congress, not the federal courts, are charged with the duty of implementing social policy through federal statutes,³³⁰ including the IRC.³³¹ Because the federal courts shy away from interpreting congressional statutes to implement judicial, rather than legislative, policy,³³² and the federal courts need to use a policy-based mode of statutory interpretation to reform the taxation of intrafamilial installment sales contracts,³³³ it seems that Congress is better suited to resolve the ambiguity of section 483.³³⁴ The next subsection discusses some other reasons why Congress should remedy the safe harbor provision instead of the courts.

³²⁹ See *Bradley v. Sch. Bd. of the City of Richmond*, 416 U.S. 696, 709 (1974) (in which the majority stated that in a statutory scheme designed to further a public purpose, it may be fairly accepted that it did so purposefully, and that if further awards are to be made to promote the public policy expressed in the legislative action, they should be authorized by Congress and not the courts); *Ins. Group Comm. v. Denver & Rio Grande W. R.R. Co.*, 329 U.S. 607, 626 (1947) (in a dissenting opinion Justice Frankfurter recognized that the Court should carry out the congressionally mandated policy when it must rule on a statute, because litigation in which statutes are at issue does not allow the Court to exercise conventional judicial authority). See also Cass R. Sustein, *Justice Scalia's Democratic Formalism*, 107 YALE L.J. 529, 530 (1997) (reviewing ANTONIN SCALIA, *A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW* (1997)) (noting that Justice Scalia advocates a species of democratic formalism and seeks to develop rules of interpretation that will limit the policy-making authority and decisional discretion of the judiciary).

³³⁰ U.S. CONST. art. 1, § 1. Thus, the Supreme Court would probably defer to congressional policy-making objectives and ignore forms of statutory construction which would implement any policy which the court manufactured by itself. See Cuevas, *supra* note 320, at 439, 440 (noting the hesitancy of the Rehnquist Court to interpret sections of the United States Code based on equity or other methods that do not rely on the express language of the IRC).

³³¹ U.S. CONST. art. I, § 8; U.S. CONST. art. I, § 3, cl. 1, *as amended by* U.S. CONST. amend. XVI.

³³² See *supra* note 329 and accompanying text.

³³³ See *supra* note 326-28 and accompanying text.

³³⁴ This Note does not argue that Congress alone has the power to reform the taxation of the safe harbor provisions. Compelling policy reasons exist for allowing the safe harbor provision to protect taxpayers from income and gift tax consequences. See *supra* Part V.A.1.a.,b. See also *supra* note 120. While the courts must respect legislative supremacy, they must also keep the law functional, whether the law is statutory or common. See CALABRESI, *supra* note 163, at 6. Tax law is supposed to function with predictability and equity. See *supra* notes 237-241 and accompanying text. To keep the laws pertaining to the taxation of intrafamilial installment sales contracts functional, the courts could rightfully rely on policy-based principles of statutory construction to make the safe harbor provisions both equitable and predictable.

2. Congressional Action Regarding the Reform of Section 483

In addition to the argument discussed above,³³⁵ Congress should act to reform the taxation of intrafamilial installment sales contracts for other reasons. First, Congress, as the primary legislative power of the federal government, has plenary power to create and amend its statutes, including the IRC.³³⁶ Second, as the members of Congress are elected officials, they enjoy a closer connection to taxpayer input on matters of taxation than the appointed federal court judges and justices.³³⁷ Finally, taxpayers will probably blame Congress for implementing bad tax law before they will blame the federal courts.³³⁸

VI. PROPOSED AMENDMENT TO THE SAFE HARBOR PROVISION

Congress should amend the language of section 483 to resolve its current ambiguity and conflict.³³⁹ The amended language should unequivocally state that taxpayers will receive protection from both imputed interest income taxation and below-market loan gift taxation when they include the safe harbor rate in their intrafamilial installment sales contracts. The amendment proposed below would affect the policies of equity and predictability that are currently lacking in the taxation of intrafamilial installment sales contracts.³⁴⁰

A. Proposed Amendment and Official Comment

Rather than disturb the opening language of section 483, Congress should alter the language of section 483(e) to accomplish the necessary reform.³⁴¹ Congress should add a fifth subsection under section 483(e),

³³⁵ See *supra* notes 328-31 and accompanying text.

³³⁶ See JAMES WILLARD HURST, *DEALING WITH STATUTES* 3 (1982) (noting that although the court may later strike a statute as invalid on constitutional grounds, no legal barrier prevents the legislature from amending the common law or statutory law).

³³⁷ See CALABRESI, *supra* note 163, at 4 (pointing out that a judge's relationship to the electorate is at best problematic).

³³⁸ See D. Bruce La Pierre, *Political Accountability in the National Political Process—the Alternative to Judicial Review of Federalism Issues*, 80 NW. U.L. REV. 577, 646 (1985) (noting that the first political check is the application of the regulation to private activity, because those who are directly affected [the taxpayers in this case] will assign the blame to Congress).

³³⁹ See *supra* notes 328-38 and accompanying text.

³⁴⁰ See section VI.A.2, B.

³⁴¹ The opening language of section 483 is part of the general rule dealing with imputed interest income taxation on those installment sales contracts which do not fall under section 1274. The specific provision relating to the application of the safe harbor provision against other provisions of the IRC is really at issue here, not the general rule contained under the

similar to the one drafted below. Congress should also include an official comment that explains the reasons for and effects of the amendment to section 483(e).

1. Proposed Amendment

(5) Application of the Safe Harbor to Other Sections Under this Title. No additional gift, estate or income tax shall be recognized under any other section of this title on installment sales contracts that conform to the requirements of Paragraph (1).³⁴²

2. Official Comment on the Proposed Amendment

Official Comment to Section 483(e)(5).--This new section resolves the ambiguity surrounding the safe harbor provision of 26 U.S.C. § 483(e). The ambiguity centered around whether the safe harbor provision would protect taxpayers from additional gift tax as well as imputed income tax. The United States Court of Appeals generated conflicting holdings on this issue. In *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988), the Seventh Circuit held that the section 483(e) safe harbor rate insulated a taxpayer from gift taxes as well as income taxes. However, in *Krabbenhoft v. Commissioner*, 939 F.2d 529 (8th Cir. 1991) and *Schusterman v. United States*, 939 F.3d 986 (10th Cir. 1995), the Eighth and Tenth Circuits held that the section 483(e) safe harbor rate protected the taxpayer from additional income tax liability only. This conflict ushered

opening language. Therefore, it seems easier to correct the ambiguous language at the safe harbor provision of section 483 rather than at its general rule.

³⁴² The amended text of section 483 (e) would read as follows:

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

(1) In general.--In the case of any qualified sale, the discount rate used in determining the total unstated interest rate under subsection (b) shall not exceed 6 percent, compounded semiannually.

(2) Qualified Sale.--For the 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 such 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.

(4) Nonresident alien individuals.--Paragraph (1) shall not apply to any sale or exchange if any party to such sale or exchange is a nonresident alien individual.

(5) *Application of the safe harbor to other sections under this title.*--No additional gift or income tax shall be recognized under any other section of this title on installment sales contracts which conform to the requirements of paragraph (1).

(italics is only used to indicate the text that would be included after the amendment).

the undesirable elements of inequity and unpredictability into the taxation of intrafamilial installment sales contracts. The safe harbor provision needed this amendment to resolve this conflict so that the taxation of intrafamilial installment sales contracts could become equitable and predictable.

The amendment includes broad language that will protect taxpayers from any additional income or gift tax consequences. Thus, taxpayers, regardless of financial circumstances, can now use the safe harbor provision and be certain that the only tax they will pay is on the interest rate under the safe harbor. This amendment plugs the loopholes that were available to certain taxpayers under the ambiguous safe harbor provision. Furthermore, this amendment will allow tax planners and attorneys to offer their clients concrete advice about how the federal government will tax an intrafamilial installment sales contract. In summary, this amendment both resolves the ambiguity surrounding the former safe harbor provision and brings equity and predictability into the taxation of intrafamilial installment sales contracts.

B. Effect of the Proposed Amendment on Mrs. Barnes, Mr. Sheers, and Ms. Vreet

Having discussed the proposed amendment to the safe harbor provision in an official comment, this note turns to analyze the effects of the proposed amendment on Mrs. Barnes', Mr. Sheers', and Ms. Vreet's situations. Under the proposed amendment, Mrs. Barnes does not need to include the fair market interest rate in her installment sales contract with her son in order to protect herself from additional gift taxes.³⁴³ She can simply charge her son a minimal six percent interest rate and remain free of any tax consequences outside of the regular income taxation of principal and interest.

The proposed amendment would also prevent Mr. Sheers from enjoying a tax break that would not be available to Mrs. Barnes.³⁴⁴ The proposed amendment would prevent the imposition of gift tax on either

³⁴³ Remember Mrs. Barnes does not want to force her son to pay any interest other than the amount which is absolutely necessary to protect her from taxation that she cannot afford. See *supra* section I.

³⁴⁴ The proposed amendment to section 483 would probably not affect Mr. Sheers personal tax situation much. He plans to include the fair market interest rate in his installment sales contract with his daughter anyway. However, he would disguise any interest payment above the safe harbor as a principal payment to save him from paying ordinary income tax on all the interest. Thus, Mr. Sheers would most likely not be subject to gift tax consequences anyway. *But see supra* note 274.

Mrs. Barnes' or Mr. Sheers' installment sales contracts, regardless of how they manipulate interest and principal payments. Under the proposed amendment, the IRS could not assess a gift tax on Mrs. Barnes' installment sales contract with her son and at the same time fail to assess a gift tax on Mr. Sheers.³⁴⁵ Therefore, Mrs. Barnes would not perceive the unfairness that currently plagues the taxation of intrafamilial installment sales contracts.³⁴⁶

The proposed amendment would also allow Ms. Vreet to accurately advise Mrs. Barnes and Mr. Sheers about the tax liability that will attach to their installment sales contracts.³⁴⁷ Ms. Vreet would be certain that including the safe harbor interest rate in her clients' installment sales contracts would not elicit undesirable gift tax consequences. The proposed amendment would reconcile the conflict in the circuits by clearly defining the reach of the safe harbor once and for all. Mrs. Barnes and Mr. Sheers could then determine the exact amount they must budget for paying the taxes on their installment sales contracts. They cannot create such an accurate budget under the current taxation of intrafamilial installment sales contracts.³⁴⁸ Therefore, the proposed amendment would make the taxation of intrafamilial installment sales contracts both equitable and predictable, taking away the legitimate complaints that taxpayers can make right now.³⁴⁹

³⁴⁵ See *supra* notes 250-53 and accompanying text.

³⁴⁶ See *supra* section V.A.1.a.

³⁴⁷ See *supra* notes 263-74 and accompanying text for Ms. Vreet's dilemma.

³⁴⁸ See *supra* section V.A.1.b.

³⁴⁹ See *supra* section V.A.

VII. CONCLUSION

The current taxation of intrafamilial installment sales contracts creates a tax trap. Section 483 promises taxpayers that they will be protected from excess taxation if they include a safe harbor interest rate in qualified installment sales. However, this protection proves to be ethereal, because taxpayers that follow the safe harbor provision find themselves subject to gift tax liabilities. Congress should amend section 483 to include language that allows the safe harbor to protect taxpayers from additional gift or income tax liability. Including this language would promote the important social goals of equity and predictability in the taxation of intrafamilial installment sales contracts. Finally, Congress should enact the proposed amendment, because reform is necessary, and Congress is best suited to remedy this problem.

-Stephen J. Wolma