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Does Brummeria Sweep Clean? A U.S. Tax-Law Perspective

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DOES BRUMMERIA SWEEP CLEAN?
A US TAX-LAW PERSPECTIVE

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The title of this article draws on the sixteenth-century Irish proverb, 'a new broom sweeps clean'. It asks whether the recent judgment in Commissioner for the South African Revenue Service v Brummeria Renaissance Ltd sweeps clean in the sense of improving the income tax.

The taxpayer, Brummeria Renaissance Ltd, operated a retirement village. A resident of the village would provide a loan to the company interest-free, that is, with zero stated interest. In return, the company would provide the resident with the right to occupy housing in the retirement village. When the resident vacated the housing, the company was obligated to repay the loan, but without interest.

The issue is whether the company must report as taxable income the economic benefit of the interest-free loan. The Supreme Court of Appeal holds that the foregone interest, the amount of interest that the company would have had to pay at market rates, constitutes taxable income. The decision is controversial. An editorial in The Taxpayer criticized the Brummeria judgment as an 'economic disaster' imposing 'double taxation'.

This article describes the US income-tax treatment of loans like those in Brummeria, generally referred to as loans with a below-market rate of interest, or below-market interest loans for short. The comparison of the Brummeria judgment with US income-tax law leads to two observations.

The first observation is that, as a matter of tax policy, the result in Brummeria is essential to the income tax. As a practical matter, income is calculated primarily with reference to cash transactions, that is, the actual receipt of cash or the accrual of the right to receive cash. Nevertheless, taxable income cannot be restricted to cash and must count significant non-cash economic benefits, including the value of below-market interest loans. To ignore non-cash income is to undermine the fundamental object of

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1 The earliest known reference to the proverb is Heywood Dialogue of Proverbs ii. i. F3 (1546).


the income tax, which is not simply to raise revenues, but to apportion the tax burden according to overall economic capacity as measured by income so that those with larger incomes pay more tax.

Another example of significant non-cash benefits that should be counted in order to apportion the income tax fairly is the in-kind compensation provided to employees in lieu of cash salary, such as housing, cars, vacation trips, and the like. If such non-cash benefits are not included in income, the tax is not fairly apportioned according to economic well-being. No difference in principle exists between these familiar non-cash benefits and below-market interest loans. The economic benefit of such loans must also be considered as income so that the tax is apportioned fairly.

The second observation is that the analysis in the Brummeria judgment is incomplete. The court correctly states that a below-market interest loan produces an economic benefit for the borrower but neither fully, nor properly characterizes the economic effects of the loan. The court fails to disaggregate the loan transaction into its constituent parts, and without such disaggregation it is impossible to determine the appropriate income-tax treatment of the loan.

A below-market interest loan is economically equivalent to a loan bearing interest at the market rate coupled with a non-loan payment of cash from the lender to the borrower that funds the borrower's payment of market-rate interest on the loan. In accordance with this equivalence, US tax law recharacterizes a below-market interest loan as implicitly involving two separate payments between lender and borrower. There is an implicit non-loan payment from the lender to the borrower of an amount equal to the foregone interest, defined as the excess of market-rate interest over the interest nominally charged. This payment is the economic benefit to the borrower correctly identified by the Brummeria judgment. There is also a reciprocal implicit payment of interest at the market rate by the borrower to the lender. It is this additional payment that the Brummeria judgment did not consider.

As explained below, the timing of these two implicit payments depends on whether the loan is a demand loan, repayable at the lender's demand, or a term loan, repayable only after a specified term. In order to prevent tax avoidance, the combined effect of both implicit payments on the lender and the borrower must be analysed. The examples that follow first assume that US law determines the tax treatment of the payments. The results are then revised as needed to reflect instances in which the South African income-tax law differs.

Part I of this article analyses below-market interest loans from an employer to an employee that are repayable on demand. Part II considers the special case of employer-employee loans that are repayable after a specified term. Part III extends the analysis to loans from a corporation to its shareholders and Part IV, to gift loans, for example, from parent to child. Part V applies the analysis to the loans in Brummeria. Part VI considers the special exemption under US law for continuing care facilities for the elderly. Part VII reviews
more general exemptions under US law that attempt to balance preventing tax avoidance with avoiding excessive complexity. Part VIII describes the process of specifying the market rate of interest for the purpose of calculating the economic benefit of a below-market interest rate loan.

I AN EMPLOYER-EMPLOYEE DEMAND LOAN EXAMPLE

To illustrate, suppose that (1) an employer loans an employee one million at zero interest, (2) the market interest rate is ten per cent, and (3) the loan is a demand loan, repayable at the lender’s demand. Under US law, the below-market interest loan is recharacterized as implicitly involving two separate (but reciprocal) payments for each year that the loan is outstanding. First, there is a non-loan payment from the employer to the employee of 100 000, an amount equal to interest at the market rate of ten per cent. Secondly, there is a payment of 100 000 in interest at the market rate by the employee to the employer.

This recharacterization does not depend on a court judgment but occurs as a matter of statutory law. Section 7872 of the US Internal Revenue Code states that for each year the demand loan is outstanding, the foregone interest is ‘treated as (A) transferred from the lender to the borrower, and (B) retransferred by the borrower to the lender as interest.’

Aside from recharacterizing the below-market interest loan, this provision does not otherwise prescribe specific tax results. Section 7872 treats the loan as implicitly involving reciprocal transfers of cash and describes the second transfer as the payment of interest. This provision, however, does not specify the character of the first implicit payment from the lender to the borrower. The character of this first payment depends on the relationship of the parties. If they are employer and employee, as in this example, and if the loan occurs as part of the employment relationship, then the first payment is characterized as compensation for the employee’s services paid for by the employer.

Nor does § 7872 prescribe the actual tax treatment of the two payments. That treatment depends on other provisions of the tax law. First, consider the employee. The payment to the employee of 100 000 in compensation is income. The tax treatment of the payment by the employee of 100 000 in interest depends on the circumstances. Provided that the interest is fully deductible, the income generated by the receipt of compensation is fully offset for tax purposes by a deduction for paying interest. Consequently, there is no net effect on the employee because there is no additional net income for the employee to report.

Second, consider the employer. The payment to the employer of 100 000 in interest is treated as income. The tax treatment of the payment by the employer of 100 000 in compensation also depends on the circumstances.

§ 7872(a). Except as otherwise indicated, all statutory references are to the United States Internal Revenue Code, Title 26, US Code. All references to regulations interpreting the Internal Revenue Code are to the US Code of Federal Regulations, Title 26.
Provided that the compensation is fully deductible, the income generated by the receipt of interest is fully offset for tax purposes by a deduction for paying compensation. Consequently, there is also no net effect on the employer because there is no additional net income for the employer to report.

The US statute imputing reciprocal transfers to below-market interest loans was enacted twenty-five years ago in 1984. Before 1984, the general view was that such loans from an employer to an employee could be disregarded. There was no need, it was thought, to treat the loan as bearing interest at the market rate, coupled with a payment from the lender to the borrower sufficient to fund the payment of interest at the market rate by the borrower. This recharacterization supposedly would involve fully offsetting income and deduction items for both parties. Imputing offsetting transfers would have no tax effect and therefore was unnecessary. For this reason, US courts steadfastly refused to treat either borrower or lender as realizing taxable income from a below-market interest loan.\(^5\)

This conclusion that below-market interest loans from an employer to an employee could be ignored thus depended on two critical assumptions. It was assumed that the interest expense of individuals was fully deductible. It was also assumed that the compensation expense of employers was fully deductible.

Before 1984, these assumptions may have been justified much of the time. Under US tax law, individuals could for the most part fully deduct interest expense without limit, even if incurred for a personal rather than a business or investment purpose. In addition, employers were generally permitted, with few exceptions, an immediate deduction in full for the costs of employee compensation. Given these assumptions, below-market interest loans would produce exactly offsetting effects for both lender and borrower as in the employer-employee demand loan example.

In 1984, however, it was recognized that neither assumption remained valid as restrictions on the deductibility of both interest and compensation had begun to proliferate. These restrictions on deductibility under US law have become even more extensive today. For example, the US tax code limits the deduction of investment interest (defined as the interest on loans used to make investments) to investment income\(^6\) and prohibits individuals

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\(^5\) *Dean v Commissioner* 35 TC 1083 (1961); *Suttle v Commissioner* 625 F 2d 1127 (4th Cir 1980); *Martin v Commissioner* 649 F 2d 1133 (5th Cir 1981); *Beaton v Commissioner* 664 F 2d 315 (1st Cir 1981); *Commissioner v Greenspun* 670 F 2d 123 (9th Cir 1982); *Baker v Commissioner* 677 F 2d 11 (2nd Cir 1982); *Parks v Commissioner* 686 F 2d 408 (6th Cir 1982); *Hardee v Commissioner* 708 F 2d 661 (Fed Cir 1983). The US Supreme Court did hold that a pre-1984 below-market interest gift loan should be recharacterized for purposes of the gift tax: *Dickman v US* 465 US 330 (1984). Despite this decision, lower courts remained unwilling to recharacterize such loans for purposes of the income tax until required by the enactment of §7872: *Winter v US* 872 F 2d 1355 (Fed Cir 1992) (refusing to impute market-rate interest on a below-market interest loan extended before the 1984 enactment of §7872).

\(^6\) § 163(d).
from deducting most personal interest, except for interest on up to one million dollars of home mortgage debt. Moreover, the capitalization principle, requiring that costs producing significant multi-year benefits be deducted over a period of years, rather than immediately deducted in full, has been applied increasingly to payments of compensation for services. Businesses, for example, are required to capitalize rather than deduct currently the salaries of employees working full-time on capital construction projects.

Treating a below-market interest loan from employer to employee as involving reciprocal transfers results in additional net income for the employee whenever the employee’s interest payment is not fully deductible and therefore does not fully offset the receipt of compensation. Similarly, there is additional net income for the employer whenever the employer’s payment of compensation must be capitalized and therefore it does not fully offset the receipt of interest income.

If the imputed expense for either interest or compensation is not fully deductible, the consequence of failing to recharacterize below-market interest loans is to treat such expenses as if they were immediately deductible in full. In other words, to disregard the below-market interest loan when either implicit payment is not fully deductible is to mismeasure income and permit avoidance of the income tax.

Under South Africa’s income tax, an employee who receives a below-market interest loan from an employer is already treated as having additional income equal to the foregone interest except to the extent that the interest would have been deductible as incurred in the production of income. However, South African law does not treat the employer as paying additional compensation to the employee in the amount of the foregone interest and as receiving from the employee interest at the market rate. As noted above, to disregard the employer altogether is to treat the implicit payment of additional compensation as always immediately deductible in full. If instead the compensation expense should be capitalized, the employer’s income is mismeasured.

II THE SPECIAL CASE OF TERM LOANS
The example above assumes that the below-market interest loan is a demand loan, with the principal amount repayable at the lender’s demand. As a result, the economic benefit to the borrower arises over time from the use of the funds loaned without having to pay interest at the market rate. The US tax law accounts for this economic benefit arising over time on an annual basis. Each year the lender is treated as transferring the amount of foregone interest

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7 § 163(h).
9 § 263A.
to the borrower, and each year the borrower is treated as retransferring the same amount as interest to the lender.\(^{11}\)

With a below-market interest loan that is repayable only after a specified term, however, the borrower receives an economic benefit instantly as soon as the loan itself is provided. Because the borrower is charged a below-market interest rate, the nominal amount loaned to the borrower will exceed the present value of the future repayment obligations, discounted using interest at the market rate. The excess amount constitutes an immediate economic benefit to the borrower. The economic benefit occurs instantaneously rather than arising over time as is the case with a demand loan. (The demand loan borrower does not have income at the time the loan is first provided, since the borrower is under an obligation to repay the full principal amount loaned at any time, on demand.)

The US income-tax statute recognizes the immediate economic benefit of a below-market interest term loan in the following manner. Assume that an employer lends an employee one million at zero stated interest for a term of five years. The present value of the repayment obligation is calculated using the market rate of interest. If that interest rate is ten per cent, the present value of the obligation to repay one million in five years is about 620 000. The amount nominally loaned, one million, is then bifurcated by the statute into two separate components.\(^ {12}\)

First, the lender is treated as transferring 380 000 (the excess of the nominal loan amount over the present value of the repayment obligation) to the borrower in a non-loan transaction. Again, the character of the non-loan payment depends on the relationship of the parties. If the lender and borrower are respectively employer and employee and if the loan is extended as part of their employment relationship, then this 380 000 amount is identified as compensation. Secondly, the lender is treated as loaning 620 000 at the market interest rate of ten per cent, with 380 000 of interest accruing over the loan’s five-year term and with payment of both the 620 000 principal and the 380 000 in accrued interest due in five years at the loan’s maturity.

Thus, US tax law still recharacterizes the loan as involving reciprocal transfers but treats the payments as occurring at different points in time.\(^ {13}\) The payment of compensation occurs as soon as the loan is extended, but market-rate interest on the loan accrues over the loan’s five-year term. Note that even if interest expense and compensation are fully deductible, the amounts are not offsetting for either the lender or the borrower because of these differences in timing.

\(^ {11}\) § 7872(a)(2).
\(^ {12}\) § 7872(b).
\(^ {13}\) If the term loan is conditioned on the continuing performance of services by the employee, so that if his or her employment terminates, the loan must be repaid immediately, then the demand loan rules rather than the term loan rules apply: § 7872(f)(5).
DOES BRUMMERIA SWEEP CLEAN?

At the time of the loan, the employer is treated as immediately paying and the employee is treated as immediately receiving 380,000 in compensation. However, interest on the loan, also a total of 380,000, accrues and is accounted for over a five-year period. Thus, even if compensation is fully deductible, the employer deducts 380,000 immediately and reports the 380,000 in interest income only as it accrues over five years. Similarly, even if interest expense is fully deductible, the employee reports 380,000 in compensation as income immediately but may deduct the interest expense only as it accrues over five years.\(^1\)

Unlike the US, South Africa’s income tax does not appear to treat employer-employee below-market interest term loans differently from demand loans. Assuming that the expenses for both compensation and interest are fully deductible, what is the consequence of not providing distinctive treatment for below-market interest term loans from an employer to an employee? In present value terms, the employee’s income is understated because the income item should be reported earlier than the deduction item. Similarly, the employer’s income is overstated because the deduction item should be reported earlier than the income item. Provided that both employer and employee are taxed at the same marginal rate, tax revenues will not be affected because the understatement of the employee’s income is exactly offset by the overstatement of the employer’s income. However, there is no assurance that their marginal tax rates will in fact be the same. If the employee’s tax rate is greater than the employer’s tax rate, undertaxation of the employee will not be offset by overtaxation of the employer, and consequently there will be a revenue loss.

III CORPORATION-SHAREHOLDER LOANS

Before the 1984 enactment of the below-market interest loan rules, the US tax law disregarded such loans from a corporation to a shareholder. In effect, it was as if the corporation reported the imputed payment of interest by the shareholder but was allowed — contrary to US law — to deduct the imputed payment of a dividend to the shareholder. This result contradicted the premise of the US corporate-shareholder tax system that corporate income should be subject to a two-level tax, first to the corporation as earned and secondly, to the shareholder when distributed as a dividend.

How do the below-market interest loan rules prevent avoidance of the corporate-level tax and otherwise affect loans from a corporation to its shareholders? Suppose that a corporation loans its sole shareholder one million at zero stated interest and that the market interest rate is ten per cent. If the loan is a demand loan, the rules operate as follows. First, each year the corporation is treated as paying the shareholder 100,000. Given the relation—

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14 Whether the lender or borrower ordinarily uses the cash method of accounting, US law requires both to account for interest income and interest expense for tax purposes as the interest accrues: §§ 163(e)(1), 1272(a)(1) and 7872(b)(2).
ship of the parties, this payment is identified as a dividend. Secondly, each year the shareholder is treated as paying market rate interest on the loan of 100,000.

If the interest expense is fully deductible, the US shareholder has two offsetting items, dividend income of 100,000—unlike South Africa, the US tax law does not exempt dividends from tax—and an interest expense deduction of 100,000. Consequently, the shareholder has zero additional net income. On the other hand, if the interest payment is not deductible, there will be additional net income for the US shareholder to report. The corporation, moreover, will always have additional net income. The corporation’s receipt of 100,000 in interest generates additional income but its payment of a dividend is not deductible under US law.

If the loan is a term loan rather than a demand loan, the recharacterization occurs in the same manner as in the employer-employee term loan example, with the one million nominal amount of the loan bifurcated between two components. Using the same numbers as in that example, the corporation is treated as making an initial non-loan payment of 380,000, which is identified as a dividend, and lending the shareholder 620,000 with 380,000 in market rate interest accruing on the loan over the next five years. The shareholder initially reports 380,000 in additional dividend income and, if the interest is deductible, deducts 380,000 over five years as the interest accrues. The corporation is not entitled to any deduction for its dividend payment and reports as income the 380,000 in interest accruing over five years.

If these rules were applied in South Africa, the treatment of the shareholder would be different because of the income-tax exemption for dividends from domestic corporations. The shareholder would ordinarily have no additional income to report but might have a deduction for interest expense, depending on whether or not the interest is deductible. As for the corporation, the additional income (attributable to the receipt of imputed interest without an offsetting deduction for the imputed dividend payment) would have two consequences under South African law. First, there would be additional corporate-level income subject to the corporate income tax. Secondly, since the corporation’s imputed interest income is treated as re-transferred to the shareholder as a dividend, it should be subject to South Africa’s secondary tax on companies, which applies to corporate income that is distributed to shareholders as a dividend rather than retained by the corporation for reinvestment.16

15 However, for the years 2002-2010, dividends are taxed at a maximum rate of fifteen per cent in the US. Thus, the tax burden of dividend income will be more than offset by the tax benefit of paying interest provided that the interest is deductible.

16 South Africa’s income tax already provides for the second consequence but not the first. A below-market interest loan to a shareholder is treated as producing a deemed dividend subject to the secondary tax on dividends: ss 64C(2)(g) and 64C(4)(d) of South Africa’s Income Tax Act. The language of the statute, however,
IV GIFT LOANS

A gift loan is defined as a loan in which the lender provides a below-market interest rate as a gift. Before enactment of the below-market interest loan rules, gift loans were used in the US to shift the taxation of income from a higher marginal rate taxpayer, such as a parent, to a lower marginal tax rate taxpayer, such as a child. If a parent made a below-market interest loan to a child, the parent would not report receiving interest income and the child would not have the possibility of a deduction for interest expense. Thus, the income produced by the amount loaned would be taxed to the child rather than to the parent, contravening US tax-law rules against such shifting of the taxation of income from higher to lower marginal rate taxpayers.

How do the below-market interest loan rules prevent a below-market interest gift loan from being used for tax avoidance? Whether as a formal matter such a loan is a demand loan or a term loan, the demand loan rules apply. In other words, all gift loans for a term are treated as if they were demand loans. Given the familial or other personal relationship likely to exist between lender and borrower, the term loan’s technical requirement that the principal be paid only at the end of a specific term of years is considered not to bind the parties.

Suppose that a parent lends his or her child one million at zero interest and that the market interest rate is ten per cent. First, each year the parent is treated as paying the child 100 000. Given the relationship of the parties, this payment is identified as a gift. Secondly, each year the child is treated as paying market rate interest on the loan of 100 000.

Under US tax law, the parent will always have additional net income to report. The parent’s receipt of 100 000 in interest generates additional income but the gift is a non-deductible personal consumption expense. For the child, however, there will never be any additional income to report, and there may be a deduction. The gift of 100 000 is excluded from the child’s income, but the interest payment may be fully or partly deductible.

If the below-market interest rate rules applied in South Africa, the treatment of both parent and child would be different because of the income-tax exemption for interest income up to a ceiling amount and because of limits on the deduction of interest on related party loans. To the extent that the interest income is tax-exempt, the parent will of course have no additional income to report. In addition, even if the child’s interest expense would otherwise be deductible, a deduction should be disallowed if the interest income of the parent, a related party, is exempt from taxation.

V APPLYING THE US RULES TO BRUMMERIA

What happens when the US rules on below-market interest loans apply to Brummeria-like transactions? Again assume that the initial loan amount is one

appears to treat as a deemed dividend the entire amount loaned, rather than the amount of the foregone interest on the loan.

\(^{17}\) § 7872(a).
million, that the nominal interest rate is zero, and that the market interest rate is ten per cent. The loan is effectively a demand loan, since it must be repaid, not at the end of a specified term, but whenever the lender vacates the housing. Thus, each year the lender is treated as transferring 100 000 to the company, and each year the company is treated as retransferring 100 000 in market-rate interest on the loan back to the lender.

Whilst the second imputed payment is described as interest by the US statute, the categorization of the first payment depends on the relationship of the parties. In *Brummeria*, the relationship is not that of employer and employee, corporation and shareholder, or parent and child. Assuming that the lender and borrower are tenant and landlord, the implicit transfer from the lender to the company will be considered a payment of rent for housing in the retirement village. If the below-market interest rate rules apply, the transaction is recharacterized as involving the payment of 100 000 in rent by the lender to the company followed by the company's payment of 100 000 in interest expense to the lender.

Focusing on the company, the taxpayer in the *Brummeria* case, are these amounts offsetting for income-tax purposes? The 100 000 in rent received by the company clearly constitutes income. If the interest expense paid by the company is currently deductible in full, then the income and deduction items are fully offsetting, and the company has no additional net income to report. Recall that the writer of the editorial in *The Taxpayer*, criticizing the *Brummeria* judgment, described it as imposing 'double taxation.' A more precise critique would instead note that the company should not have additional net income, as the judgment implied the company would, provided that its interest expense is fully deductible.

However, according to the contract between the parties in *Brummeria*, the loan was incurred in order to finance construction of the housing unit in the retirement village that the lender would occupy. Under both US and South African tax law, the interest is subject to capitalization and may not be deducted during the construction period. US law refers to such interest as construction period interest. South African law refers to it as pre-production interest. In both countries, capitalization means that the company's interest expense is treated as a construction cost of the housing unit being financed and is not currently deductible. As a result, during the construction period, the company has rental income without an offsetting interest deduction and therefore does have additional net income to report.

What about the lender, who admittedly is not before the court in *Brummeria*? With the characterization of the loan as involving reciprocal transfers, the lender receives market-rate interest of 100 000, which under US law is always taxable income. Moreover, the payment of rent is not deductible under US law since rent is a personal consumption expense.

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18 § 263A(f).
19 Section 11(bA) of South Africa's Income Tax Act.
20 § 262.
Thus, the imputed amounts are never offsetting under US law if we focus on the other party, the lender, in the Brummeria transaction. The lender clearly has additional net income to report.

Under South African law, however, the treatment of the lender may differ because of the income-tax exemption for interest income up to a ceiling amount. To the extent that the interest income is tax exempt, the lender will have no additional income to report.

Returning to the court’s judgment in Brummeria, the problem with its analysis is evident. The court correctly treats the lender as implicitly making a non-loan payment to the borrower of an amount equal to market-rate interest. Yet, the court fails to recognize the corresponding implicit payment of market-rate interest from the company to the lender. The court consequently does not consider whether the payment of interest by the company is or is not deductible and therefore whether the payment would or would not offset the income arising from the economic benefit to the company of the interest-free loan.

Of course, the only issue before the court was whether the company had to report an additional income item. The court did not have before it the specific question of whether the company, if treated as receiving rental income equal to market-rate interest, should also be treated as paying market-rate interest. Nevertheless, this additional element is a necessary part of the analysis.

Moreover, the Brummeria court’s failure to treat the company as paying interest on the loan may obscure the tax consequences for the other party to the transaction, the lender. Unless the implicit receipt of interest by the lender is tax-exempt, the lender should have additional net income to report.

VI THE SPECIAL US EXEMPTION FOR CONTINUING CARE FACILITIES

A continuing care facility is a retirement village in which residents live independently but have access to nursing care as needed. Continuing care facilities in the United States may resemble the retirement village in Brummeria if the village furnishes nursing care to residents.

In 1984, when the US Congress was considering enactment of the below-market interest rate rules, retirees fiercely opposed the application of the rules to a loan made to a continuing care facility by an occupant of the facility. Because of this opposition, the US Congress provided a special exemption for loans to such a facility by an occupant. The original 1984 exemption applied only to loan amounts not in excess of $90 000, adjusted annually for inflation, which resulted in a ceiling for exempted loans of up to

\[ \text{VI § 7872(g)(4) and 7872(h)(3).} \]
\[ \text{\'Senators and congressmen rally to prevent taxation of the elderly’ 25 Tax Notes 599 (1984).} \]
\[ \text{§ 7872(g).} \]
nearly $155 000 in 2004. Beginning in 2005, moreover, the exemption was extended to all such loans, regardless of the amount.

What is the exemption's effect? If the below-market interest loan rules did apply, there would be no additional net income for the borrower, the continuing care facility, provided that the implicit interest payment is fully deductible. In that event, there would be two fully offsetting payments for tax purposes. The additional income arising from the imputed non-loan payment in an amount equal to foregone interest would be fully offset by a deduction for the reciprocal payment of interest expense. On the other hand, the assumption that the interest payment is fully deductible is often not valid, principally when the interest expense is construction period interest, subject to capitalization. As noted above, the exemption of loans to a continuing care facility from the below-market interest loan rules is equivalent to permitting an immediate deduction in full for interest payments that may otherwise be subject to capitalization and deduction over a period of years rather than all at once.

There is also a potential tax-avoidance problem with the lender, who is the occupant of a living unit in the continuing care facility. The lender should have additional income arising from the receipt of imputed interest income. Moreover, the imputed transfer from the lender to the facility should be identified as a payment for the services, which includes a combination of rental housing and nursing care, neither of which is fully deductible. The payment for rental housing is clearly a non-deductible personal consumption expense, and the payment for nursing care is only partly deductible under US law. Yet the exemption of loans to a continuing care facility from the below-market interest loan rules is equivalent to treating payments for both housing and nursing care as fully deductible.

Can this special tax benefit for residents of continuing care facilities be justified? In 1984, it was argued that the below-market interest loan rules would harm retirees who had relied on prior law that did not treat the retirees as receiving interest income as a result of extending below-market interest loans. As a result, retirees who had ceased working and were dependant on fixed incomes, would be exposed to undue hardship if the below-market interest rate rules applied to increase their income and hence their taxes.

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25 § 7872(h).
26 In fact, however, evasion of the capitalization requirement should generally be prevented by a different provision of the US tax law. A taxpayer is required to capitalize construction period interest either to the extent that a loan is used directly to finance construction outlays or to the extent of any other outstanding liabilities of the taxpayer that could have been used to provide such financing. Thus, even if the below market-interest loan rules did not apply, the continuing care facility would have to capitalize the interest expense on other outstanding loans during the construction period up to the amount of construction expenditures: § 263A(f).
27 § 213(a). Such expenses are deductible under US law only to the extent they exceed 7.5 per cent of the taxpayer's adjusted gross income.
The reliance argument, however, can be used to object to any change in the tax law that attempts to prevent tax avoidance. Moreover, even if such reliance merits relief, it justifies only an exemption for occupants who made loans before the below-market interest loan rules were enacted in 1984, rather than the blanket exemption in the law, which covers both past and future below-market interest loans.

It was also argued that future retirees would be unable to afford to live in continuing care facilities unless their loans were exempted from the below-market interest rate rules. The US Congress was in effect asked to enact the exemption in order to subsidize expenditures for long-term care for retirees.

Even if a subsidy can be justified, however, the exemption for loans to continuing care facilities is a perverse way to distribute government assistance. Because the exemption has the effect of permitting a deduction for expenses that would otherwise not be deductible, the financial benefit depends on the marginal tax rate of the retiree. The higher the tax rate, the greater the benefit of deducting a given amount. An individual facing a twenty per cent tax rate gets in effect a twenty per cent subsidy for each dollar implicitly paid, while an individual with a fifty per cent tax rate gets a fifty per cent subsidy. Since tax rates rise with income, higher income individuals receive a larger subsidy per dollar than lower income individuals. Moreover, higher income individuals are likely to make larger loans and therefore have larger dollar amounts of implicit expenses than lower income individuals.

Like other subsidies furnished through an income-tax deduction, the result is upside-down, with better-off individuals, whose need is presumably less, getting a larger subsidy than worse-off individuals, whose need is relatively greater. If a subsidy is needed, it should be means-tested, that is, correlated negatively with income, so that those with greater need receive a relatively larger subsidy rather than a relatively smaller subsidy, as is the case with the current exemption.

Would an exemption for continuing care facilities in South Africa also result in a perverse subsidy? The issue is more complicated because of the exemption of interest income up to a ceiling amount and because of varying limits on the deductibility of medical expenses. For 2008, the first 18 000 rand of interest income is exempt from tax for individuals under sixty-five years of age, and the first 26 000 rand of interest income is exempt for individuals sixty-five years of age or older. Moreover, medical expenses in excess of a specified amount (referred to a capped amount) are deductible only to the extent such expenses exceed 7.5 per cent of otherwise taxable income of individuals under sixty-five years of age, but such expenses are deductible without limit for individuals sixty-five years of age or older.

For some occupants, the below-market interest loan could be disregarded because taxable interest income (if any) would be fully offset by deductible expenses.
medical expenses. For other occupants, however, the below-market interest
loan should produce additional net income. For example, assume that an
occupant lends the facility one million rand, that the nominal interest rate is
zero, and that the market interest rate is ten per cent. Applying the
below-market interest loan rules, each year the occupant should be treated as
paying 100 000 rand for the facilities services and receiving from the facility a
payment of 100 000 rand in interest income. Suppose that the interest
income would be taxable — perhaps because the lender has other interest
income at least equal to the exemption amount — and that of the 100 000
implicitly paid for the facility’s services, 30 000 is for deductible medical
deductions but 70 000 is for non-deductible rent. The below-market interest
rate rules would cause the lender to have 70 000 of additional net income to
report. Exempting the loan from the rules has the effect of permitting the
occupant a deduction for 70 000 in expenditures for rent that should
otherwise not be deductible.

Such a deduction is hard to justify as an appropriate subsidy because of the
upside-down effect, with better-off individuals, whose need is less, getting a
larger subsidy than worse-off individuals, whose need is greater. If South
Africa decides to replicate the US rules on below-market interest loans, it
may therefore be desirable to reject the misconceived US exemption for
below-market interest loans to continuing care facilities.

VII OTHER EXEMPTIONS FROM THE US RULES

By statute the US below-market interest loan rules apply to employer-
employee loans, corporation-shareholder loans, gift loans, and other (unspecified) tax-avoidance loans. There are statutory exemptions, however, for loans between a lender and borrower aggregating to $10 000 or less. Moreover, the statute provides that if the aggregate amount of gift loans between a lender and a borrower is $100 000 or less, the imputed payments for any year are limited to the borrower’s investment income for the year. Interpretive regulations (issued by the US Department of the Treasury) exempt from the rules additional specified categories, including ordinary bank deposits, subsidized government loans, employee relocation loans, gift loans to a charity in an amount not exceeding $250 000,
and pre-payments made in a manner consistent with normal commercial practices.\(^{40}\)

These exemptions reflect a legislative judgment that the rules should not apply when the amounts at stake are relatively small and unlikely to justify the costs of compliance. For example, when loans between a particular lender and borrower total $10,000 or less, the amounts at stake are generally considered too small to justify the added burden of complying with the special below-market interest rules. Similarly, pre-payments for goods and services consistent with normal commercial practices are considered unlikely to result in systematic tax avoidance and are therefore exempted.

Of course, this judgment about which transactions to exempt from and which transactions to subject to the below-market interest rules is debatable. Other national tax systems, such as South Africa’s, may reach a different judgment about the proper balance between preventing tax avoidance and avoiding complexity. It is moreover a judgment that courts making decisions on a case-by-case basis are ill-equipped to make and that is better left to legislative or administrative determination.

VIII SPECIFYING THE MARKET RATE OF INTEREST

In order to apply the US rules on below-market loans, it is necessary to specify the market rate of interest. In reality, the market interest rate depends on the creditworthiness of the particular borrower and therefore will vary from borrower to borrower even if loans have otherwise identical terms. Individualized determinations of market rate interest based on the creditworthiness of the particular borrower, however, would pose a heavy administrative burden and involve highly subjective judgments.

US law resolves this problem by treating the market interest rate for all borrowers as equal to the ‘applicable federal rate’, defined as the interest rate the US government pays on a debt with a similar maturity.\(^{41}\) However, the US government is able to borrow at lower interest rates than even the most creditworthy private borrower. Using the US government rate as a benchmark for private borrowers inevitably understates the amount of the reciprocal transfers implicit in a below-market interest loan.

Nevertheless, the mismeasurement of income is considerably less than if the below-market loan were disregarded completely. The mismeasurement would be reduced further if the applicable federal rate were adjusted upward to take account of the government’s special credit position, for example, by using the federal rate increased by the extra amount of interest charged the most creditworthy private borrowers. It is worth noting that \textit{Brummeria} measures the amount of foregone interest by ‘the weighted prime overdraft rate of banks’.\(^{42}\) This measure may be more accurate than the ‘applicable

\(^{40}\) Prop Reg § 1.7872-2(a)(1).
\(^{41}\) § 1274(d)(1)(B).
\(^{42}\) Paragraph 6.
federal rate' standard of US law in specifying the foregone interest in a below-market interest loan to a private borrower.

CONCLUSION
Before the 1984 enactment of below-market interest loan rules, US courts steadfastly refused to treat either the borrower or the lender as realizing taxable income. The Supreme Court of Appeal judgment in Brummeria is a significant improvement and does a better job of recognizing the economic benefit to the borrower of a below-market interest loan. Nevertheless, the recharacterization of below-market interest loans under the income tax is complex and multifaceted, implicating multiple taxpayers, some of whom will not be before the court in a given controversy. In addition, resolution of the problem requires an appropriate balance between preventing tax avoidance, on the one hand, and keeping the income-tax law from becoming overly complex, on the other. It does not make sense to expect courts to deal adequately with the issues, and it is unsurprising that courts do not do a good job. Certainly the record of US courts is not reassuring. The problem really calls for a legislative or an administrative (rather than a judicial) solution.