Unfinished Symphony: A Comparison of the Tax Treatment of Interest-Free Loans from Corporations to their Shareholders in the United States and Israel

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I. Introduction

The precise nature of the relationship between a corporation and its shareholders is difficult to define. In one sense, the corporation is an independent legal entity, with its own rights and obligations, capable of forming contracts even with its own shareholders. In another sense, it is no more than a tool in the shareholders' hands. Legally, its property is its own. Economically, its property belongs to its shareholders.

This ambiguous relationship can present serious challenges for the law in general and for tax law in particular. The dilemma of lifting the corporate veil is one expression of the dual nature of the corporation-shareholder relationship. The question of whether the corporation should be considered an independent taxable entity is another.[1]

When one person lends money to another without charging interest, it is reasonable to assume either that the lender is doing so to procure some indirect economic advantage[2] or that his action is akin to a gift.[3] A corporation lending money to its shareholders without charging them interest does not fit neatly into either one of these categories. The reason that a corporation is willing to allow its shareholders to use its money interest-free is that, from an economic perspective, the corporation's money belongs to the shareholders: using

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1. "Generally, of course, a legal fiction allows a corporation to be viewed as an entity separate and apart form its shareholders, directors, and officers, but the courts sometimes ignore this fiction to accommodate other rights and interests. When departing from the fiction, judicial decisions have cleaved to no single doctrine, to the disappointment of philosophers and the despair of text writers."

BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.05[1] (7th ed. Supp. 2003).

2. *See, e.g.*, Greenspun v. Comm'r, 72 T.C. 931, 951 (1979), *aff'd*, 670 F.2d 123 (1982) (Howard Hughes lent money to a Las Vegas newspaper at a below-market interest rate in order to secure favorable press coverage).

3. *See, e.g.*, Dickman v. Comm'r, 465 U.S. 330 (1984).

the corporation's money is, in effect, using their own money, and paying interest to the corporation would merely involve moving money from one pocket to the other. Perhaps because of this, traditional principles of income taxation have proven remarkably ineffective in developing an appropriate model for the taxation of interest-free loans from corporations to their shareholders.[4]

This article will describe the struggles of both the American and the Israeli courts to contend with the tax issues arising from situations in which a corporation lends funds to its shareholders without charging them interest. One important difference between the two countries is that in the United States, taxation of below-market loans from corporations to their shareholders is now firmly regulated by the terms of section 7872 of the Internal Revenue Code, while in Israel the law appears to be still in its formative stages. Part II will review the development of American case law until the adoption of section 7872 in 1984. Part III will analyze in detail the seminal Israeli case in the field in an effort to determine where Israeli law stands at present. Throughout, I will attempt to explore the dilemmas that face the courts of both countries and to explain why it is that interest-free loans from corporations to their shareholders have proven so resistant to analysis by traditional principles of income taxation.

II. United States

American courts have been considering the tax implications of interest-free loans in the corporation-shareholder context since 1940. *Combs Lumber*[5] and *Society Brand Clothes*[6] each concerned a corporation that lent funds to its shareholders on interest-bearing notes but, in fact, had not charged any interest. In each case, the Commissioner attempted to tax the corporation on the interest it should have collected according to the terms of the note. In each case, the court rejected the Commissioner's position[7] and held that, as the corporation had not in fact collected any interest, it could not be taxed.

In and of themselves, the decisions in *Combs Lumber* and *Society Brand Clothes* are unexceptional. The fact that a person who waives income he could have received (or uses his property in such a way as not to generate any income) is not ordinarily subject to tax is a well-established principle.[8] It is difficult, therefore, to imagine that the court could have decided other than it did. The decisions are noteworthy, however, because of their import for the subsequent development of the law.

4. For some of the academic analysis of interest-free loans, see Michael D. Hartigan, *From Dean and Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans*, 60 NOTRE DAME L. REV. 31 (1984); Gregor S. Chvisuk, *Taxation of Loans Having Below-Market Interest Rates*, 21 IDAHO L. REV. 257 (1985); Brian D. Ward, *The Taxation of Interest-Free Loans*, 61 TUL. L. REV. 849, 888 (1987).

5. Combs Lumber Co. v. Comm'r, 41 B.T.A. 339 (1940).

6. Soc'y Brand Clothes, Inc. v. Comm'r, 18 T.C. 304 (1952).

7. The Commissioner's arguments in each case were confined to the factual and procedural realms. He claimed that the corporation had, in fact, received income and that in any case the corporation should not be permitted to introduce oral testimony that contradicted the note. The court rejected both arguments. On the procedural issue, it held the parole evidence rule inapplicable in proceedings before the Tax Court (or its predecessor, the Board of Tax Appeals). On the factual issue, it held that the corporation had not received any interest. Furthermore it held, as a matter of substantive law, that a corporation that loans money to its shareholders without collecting interest cannot be taxed.

8. Helvering v. Indep. Life Ins. Co., 292 U.S. 371 (1934); Comm'r v. Gianini, 129 F.2d 638 (9th Cir. 1942).

The other side of the coin concerns the consequences for shareholders stemming from the receipt of an interest-free loan from the corporation they control. These were first discussed in *Dean*.[9] The Commissioner, relying on earlier decisions that had held that the rent-free use of corporate property by shareholders constituted taxable income in their hands,[10] argued that the interest-free use of money should also be considered income.

The Tax Court, however, distinguished between the two situations on the grounds that, had the shareholders paid interest to the corporation, that interest would have been deductible. The court held, therefore, that the interest-free use of corporate funds by the shareholders should not be considered income.[11]

As strongly argued in both a concurring and a dissenting opinion, the conclusion the Court arrived at does not follow from its premise. The fact that the interest might have been deductible and that no taxable income would accrue does not mean that the shareholder did not realize gross income. The concurring and dissenting opinions argued, therefore, that the question of whether the use of corporate funds by a shareholder constitutes gross income and the question of whether the shareholder should be entitled to an interest deduction should be considered separately. Had the shareholders, for instance, invested the funds in tax-free bonds, their interest expenses would not have been deductible. The Court's broad holding that the interest-free use of corporate funds by shareholders does not constitute gross income, they pointed out, would prevent the imposition of tax.[12]

Furthermore, as noted by the concurring opinion, the interest-free use of corporate funds is no different from the rent-free use of corporate property. For example, if shareholders who had received rent-free use of property were to rent the property out, they presumably would be entitled to a rent deduction.[13] Yet the court had agreed, and the precedents had proved, that the rent-free use of corporate property constitutes gross income in the hands of the shareholders. The majority was not persuaded. The court refused to view the use of corporate funds as generating gross income.

Twelve years after the Tax Court's decision in *Dean*, the Commissioner issued a non-acquiescence.[14] The courts, however, despite some misgivings, treated *Dean* as established law and refused to overturn the ruling.[15] They consistently held that, however they would

9. Dean v. Comm'r, 35 T.C. 1083 (1961).

10. Frueaff v. Comm'r, 30 B.T.A. 449 (1934); Reynard Corp. v. Comm'r, 30 B.T.A. 451 (1934); Rodgers Dairy Co. v. Comm'r, 14 T.C. 66 (1950); Chandler v. Comm'r, 119 F.2d 623 (3d Cir. 1941); Dean v. Comm'r, 187 F.2d 1019 (3d Cir. 1951) (apparently the same taxpayers as those in the main case discussed in the text).

11. "These cases bear a superficial resemblance to the present case, but reflection convinces us that they are not in point. In each of them a benefit was conferred upon the stockholder or officer in circumstances such that had the stockholder or officer undertaken to procure the same benefit by an expenditure of money such expenditure would not have been deductible by him. Here, on the other hand, had petitioners borrowed the funds in question on interest-bearing notes, their payment of interest would have been fully deductible by them under section 163, I.R.C. 1954."

Dean, 35 T.C. at 1090.

12. The concurring opinion, by Judge Opper, argued that the taxpayers had gross income and an offsetting interest deduction. *Dean*, 35 T.C. at 1090-91. The dissenting opinion, by Judge Bruce, carried the concurring opinion one step further, arguing that the burden to prove that the borrowed funds were not invested in tax-exempt bonds is on the taxpayer and that the taxpayer had neither pleaded nor offered any evidence to support such a contention. *Dean*, 35 T.C. at 1092.

13. *Dean*, 35 T.C. at 1091.

14. 1973-2 C.B. 4.

15. *Greenspun*, 72 T.C. at 951; Martin v. Comm'r, 649 F.2d 1133 (5th Cir. 1981); Hardee v. United States, 708 F.2d 661 (Fed. Cir. 1983).

have decided the issue on a case of first impression, only Congress could overturn the *Dean* rule.[16]

What is interesting to note, though, is that when challenging *Dean*, the Commissioner did not merely contend that the use of corporate funds constitutes gross income in the hands of the shareholders. He argued further that the shareholders should not be entitled to a corresponding interest deduction, on the grounds that the Code does not permit the deduction of interest that has neither been paid nor accrued.

Surveying the cases, one cannot help but wonder how the Commissioner could have pressed the argument that a shareholder who received interest-free use of corporate funds, and invested them in such a way that any interest, if paid, would have been deductible, realizes gross income on the one hand, yet is not entitled to a corresponding deduction on the other hand. Assume, for instance, that the shareholder had received an interest-free loan of $1,000 from the corporation when the relevant interest rate was 10 percent and had then lent the money to a third party at 10 percent interest. At the end of the year, the shareholder would have received from the third party $1,100 and would have repaid the corporation $1,000, realizing an accession to wealth of $100. The Commissioner's contention, however, was that, as a result of the transactions described, the shareholder would have realized taxable income of $200.[17] Is it any wonder, one might ask, that the courts rejected the position advanced by the Commissioner?[18]

Equally difficult to fathom is the Tax Court's ruling in *Dean*. Why should the fact that the shareholders might be entitled to an interest deduction affect the question of whether the interest-free use of corporate funds constitutes gross income? Particularly surprising are those cases in which the shareholders had, in fact, invested the funds in tax-exempt bonds, such that any interest expense would not have been deductible.[19] Here, too, the courts held that the use of corporate funds did not constitute gross income.

I would suggest that the roots of both the Commissioner's position and the *Dean* rule can be traced to the earlier cases of *Combs Lumber* and *Society Brand Clothes*, where the

16. Comm'r v. Greenspun, 670 F.2d 123, 125 (9th Cir. 1982) ("Although we can appreciate the Commissioner's argument, the fact of the matter is that Dean has been controlling precedent for almost two decades and has been relied upon by countless numbers of taxpayers."); *Hardee*, 708 F.2d at 666 ("This is not to say, therefore, that were we 'writing on a clean slate' we would reach the result reached in *Dean*. Perhaps we would, perhaps not.").

17. The Commissioner's position was that the shareholder would have $100 income from the use of corporate funds and an additional $100 interest income. The Commissioner would have refused a corresponding income deduction.

18. "The Government, contending that the interest-free use of corporate funds confers the same economic benefit as an increase in salary sufficient to secure an equivalent interest-bearing loan, would include the imputed value of the interest-free loan in income under section 61. But the Government is not so attentive to economic reality when it argues further that the taxpayer may not deduct that imputed value because it is not actually 'interest paid' within the language of section 163. When a borrower receives an interest-free loan, he receives the use of the principal without paying interest, but he does not receive the interest. He obtains no more than the recipient of additional salary retains after using the extra salary to pay the interest on an interest-bearing loan, i.e., the use of the principle. . . . It would be inequitable, therefore, to read section 163 as denying an interest deduction to a borrower of an interest-free loan who reports imputed interest as income, while allowing an interest deduction to a borrower who uses an increment of salary to borrow the same amount in the market."

Baker v. Comm'r, 677 F.2d 11, 12 (2d Cir. 1982).

19. In particular, *Hardee*, 708 F.2d 661.

courts had refused to attribute income to a corporation which had loaned money without interest. Because the Commissioner recognized that this was a battle he could not win, he turned his focus elsewhere. If the corporation received no interest, either actually or conceptually, then the shareholders must not have paid any interest, either actually or conceptually. If the shareholders did not pay any interest, they should not be entitled to any interest deduction. On the other hand, the interest-free use of corporate funds is no different than the rent-free use of corporate property, and the latter clearly constitutes income in the hands of the shareholders. Thus, an interest-free loan constitutes gross income with no potentially offsetting interest deduction. One can thus construct an argument that proceeds logically from the earlier cases to the position advocated by the Commissioner.[20]

The courts, as noted, rejected the Commissioner's position.[21] In circumstances where interest, had it been paid, would have been deductible, the courts could not accept that the use of the corporate funds could generate taxable income. It is possible, therefore, that the courts' line of reasoning went as follows. If there is no taxable income, then either there is no gross income or there is a corresponding deduction. If there is an interest deduction for the borrower, then there must be interest income for the lender. But it is established law that the corporation earns no income from the transaction. Therefore, the only way to prevent the shareholder from realizing taxable income is to hold that there is no gross income at all.[22]

One solution to the dilemma of how to tax interest-free loans from corporations to their shareholders would have been to overturn the earlier cases of *Combs Lumber* and *Society Brand Clothes.* If the corporation were viewed as having received interest, there would be no impediment, under the appropriate circumstances, of permitting an interest deduction to the shareholder. If an interest deduction were possible, then the courts would be able to consider the interest-free use of funds as gross income: where the notional interest payments were deductible, they would offset the gross income; where they were not, the shareholder would realize taxable income.

Eventually, Congress adopted just such a model. Section 7872 provides that, where a corporation loans funds to its shareholders at less than the market rate of interest, it will be considered as if the shareholders had paid the corporation the full market rate and the corporation had distributed the difference. Thus, the corporation is viewed as having received interest and distributed a dividend, while the shareholders are viewed as having received a dividend and paid interest. The most significant aspect of the section, as far as

20. See, for example, the dissenting opinion of Judge Nims in *Greenspun*:

> "The majority opinion, following the Dean rationale, in effect provides petitioner a constructive interest deduction with which to offset the conceded income. If this approach is pursued, the Court may expect to be eventually confronted with a case in which the Commissioner asserts imputed interest income to the lender—a quid pro quo for the constructive deduction allowed the borrower. One can easily visualize this occurring, for example, in the stockholder-controlled corporation context."

Greenspun, 72 T.C. at 957-58.

21. Notable, however, is *Dickman*, 465 U.S. at 338, wherein the Supreme Court held that interest-free use of money could be considered a gift for the purpose of gift tax.

22. *Hardee*, 708 F.2d at 666 ("Since we do not reach our result by imputing to the borrower an interest payment and a corresponding interest deduction, we are not theoretically constrained to impute income to the corporation."); *Dean*, 35 T.C. at 1090 ("We have heretofore given full force to interest-free loans for tax purposes, holding that they result in no . . . interest income to the lender . . . .").

corporation-shareholder loans are concerned,[23] is that Congress overturned the earlier decisions of *Combs Lumber* and *Society Brand Clothes* by providing that a corporation that lends funds to its shareholders at less than the market rate of interest nevertheless recognizes income at the full market rate. Once this principle is established, the rest follows quite naturally.

III. Israel

The seminal case of *Mintz and Silverstein*[24] concerns two taxpayers who were the sole shareholders and also served as salaried managers of a corporation that wished to purchase merchandise on credit. The seller indicated a willingness to extend the credit, provided that the taxpayers would personally guarantee the payment. Accordingly, the two taxpayers delivered to the seller their own personal checks, post-dated by approximately six months. In exchange, the taxpayers, upon delivering the checks, withdrew cash from the corporation equal to the face value of the checks. Thus, the taxpayers received money from the corporation approximately six months before the seller would present their checks for payment. Significantly, the rate of inflation at the time was 130 percent per year.

Regarding the arrangement as the equivalent of an interest-free loan from the corporation to the taxpayers and relying on the provisions of section 3(i) of the Income Tax Ordinance (ITO),[25] the Assessing Officer claimed that the foregone interest was taxable income and assessed the taxpayers accordingly. The taxpayers appealed.

The relevant portions of section 3(i) of the ITO are as follows:

> 3(i)(1) [W]here a person receives a loan . . . and the loan is without interest or at an interest rate less than that established by the Minister of Finance . . . the difference shall be considered—
>
> (a) With regard to . . . a loan which was given in connection with an employer-employee relationship—as wage income;
>
> (b) With regard to . . . a loan which a person received from one to whom he supplies services—as income according to section 2(1) unless it is proven that [it] was given without regard to the services provided;
>
> (c) With regard to . . . a loan to which subparagraphs (a) and (b) are inapplicable and which was received by a controlling shareholder or his relative from a corporation under his control—as income according to section 2(4).

This section would appear to be controlling and to require the result argued for by the Assessing Officer. The problem with which the Assessing Officer had to contend, however, was that, although the appeal was filed in 1987, the tax years in question were 1980 and 1981. Subparagraph (c) was added in a subsequent amendment and was not in force prior

23. Section 7872 also refers to compensation loans, gift loans and loans one of the principle purposes of which is the avoidance of any Federal tax. The tax treatment of these types of loans is irrelevant to our discussion.

24. Tax Appeal (TA) 151/87 Mintz and Silverstein v. Assessing Officer for Large Enterprises, [1989] 17 P.D.A. 382; Civil Appeal 533/89 Assessing Officer for Large Enterprises v. Silverstein and Mintz, [1993] IsrSC 47(3) 376, 21 P.D.A. 345; Civil Further Hearing 3962, 3971/93 Mintz and Silverstein v. Assessing Officer for Large Enterprises, [1996] IsrSC 50(4) 817, 24 P.D.A. 415.

25. 1 LSI New Version 145 (1967) (as amended).

to 1985. Without subparagraph (c) to rely on, the Assessing Officer needed to find an alternative statutory basis for his contention that the interest differential was taxable. As a result, he argued that the taxpayers, in addition to being shareholders in the corporation, were also its employees and that subparagraph (a) was therefore applicable. Moreover, he argued that, whereas subsection (b) concerning an independent provider of services allows the taxpayer to escape taxation by proving that the loan was unrelated to the services provided, no such escape clause exists in subparagraph (a). Thus, argued the Assessing Officer, the simple and undisputed fact that the taxpayers were employees of the corporation is a sufficient condition to invoke the provisions of subparagraph (a).

The Tel-Aviv District Court rejected the Assessing Officer's argument. It held that invoking subparagraph (a) requires more than merely showing that the taxpayer was an employee of the lender. In order to invoke subparagraph (a), the district court ruled, it must be shown that the taxpayer received the loan in his capacity as an employee. Thus, where the taxpayer is both an employee and a shareholder, it is essential to determine whether he received the loan as an employee or as a shareholder.

In the case before it, the court noted that, although their salaries as managers were equal, the amount of the loan received by each taxpayer was proportional to the number of shares each held in the corporation. This fact would seem to indicate that the controlling relationship was the shareholder-corporation relationship and not the employer-employee relationship. Furthermore, the loans were given under an arrangement in which the taxpayers, in effect, personally guaranteed an obligation of the corporation, an act more appropriate for a shareholder that for an employee. These considerations and others led the court to determine that the loans were received by the taxpayers in their capacity as shareholders, and that subparagraph (a) was not applicable. Not finding any statutory basis for the Assessing Officer's position, the district court accepted the taxpayers' appeal.

In his appeal to the Supreme Court, the Assessing Officer abandoned his previous argument that the taxpayers, merely by virtue of the fact that they happened to be employees, were subject to the provisions of subparagraph (a). The Assessing Officer did not challenge the determination of the district court that the taxpayers had received the loans in their capacity as shareholders of the corporation and not as its employees. Indeed he abandoned section 3(i) altogether and argued that the economic benefit inherent in the interest-free loan was taxable under the general provisions of section 2 of the ITO, which defines the tax base as income deriving from any of the sources described therein.[26]

The Supreme Court, reversing the district court's opinion, held that the word "income," as that term is used in section 2 of the ITO, is broad enough to include the use of money. In other words, the interest-free use of funds by an employee, by a service provider, or by a shareholder would constitute a taxable benefit, even without the specific provisions of section 3(i).

Responding to the taxpayers' argument that such a construction would render section 3(i) superfluous and that the legislator must be assumed not to have enacted superfluous provisions, the Court held that section 3(i) has a dual function: to clarify that interest-free loans are indeed included within the definition of the term "income" and to quantify that income. The fact that section 3(i) may be inapplicable to a given interest-free or low-interest

26. ITO § 2 provides that "[i]ncome tax shall be paid ... on income ... derived ... from the following sources ...."

loan does not necessarily indicate that the economic benefit inherent therein is not taxable. Where the benefit derives from one of the sources described in section 2 of the ITO, it is subject to tax, as would be any other benefit in cash or in kind.

The Court thus swiftly settled an issue that, although superficially complicated, is conceptually quite simple: the interest-free use of money is no different than the rent-free use of property or any other non-cash economic benefit.[27] If the term "income" includes, as it must, income in kind, then the interest-free use of money must be considered income.

Having determined that the interest-free use of the corporation's funds constituted income in the hands of the taxpayers, the Court then went on to consider the source from which such income was derived. This issue turned out to be considerably more controversial. However, in order to explain the issue and the controversy surrounding it, it is necessary to present a brief overview of the basic structure of Israeli income tax law.

In the United States, income tax is imposed upon "income from whatever source derived."[28] This has been interpreted to mean that any accession to wealth, clearly realized and over which the taxpayer has complete dominion, constitutes income and is subject to taxation unless specifically excluded by statutory provision.[29] The source of the income is irrelevant.

Israeli income tax, on the other hand, is based on a schedular system. Income is taxable if and only if it derives from one of the sources enumerated in section 2 of the ITO. The sources of income, several of which are relevant to our discussion, are as follows:

(1) Business, trade or commercial transactions;
(2) Wages;
(3) [Cancelled];
(4) Interest and dividends;
(5) Pensions and annuities;
(6) Income from land;
(7) Income from personal property;
(8) Income from agriculture;
(9) Income from sale of a patent, a copyright, or a design by the producer of such property; or
(10) Income from any other source.[30]

At first glance it might appear that section 2(10), taxing income from any other source, in effect transforms the schedular system into a comprehensive system. Such an impression, however, would be erroneous. While a thorough analysis of this issue is unnecessary for the purposes of this discussion, it should nevertheless be noted that the term "source" in section 2(10) must be understood in its technical sense as a means of production or as

27. It could be that the confusion derives from the well-established principal that a loan does not, due to the corresponding obligation to repay the money received, constitute income in the hands of the borrower. The claim that the loan could constitute income to the borrower might appear to conflict with this well-established principle. The point, however, is that what is being taxed is not the principal, but rather the temporary use of the principal.

28. I.R.C. § 61 (2006).

29. Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955), reh. den. 349 U.S. 925 (1955).

30. ITO § 2.

something capable of producing income over time.[31] Therefore, despite the apparently wide net thrown by section 2(10), accessions to wealth such as windfalls, gifts, bequests, and capital gains, none of which derive from a source in the technical meaning of the term, are not taxable under the provisions of section 2.[32]

As we saw earlier, the Supreme Court in *Mintz and Silverstein* held that interest-free loans may be taxed directly under the provisions of section 2 and that section 3(i) merely clarifies this fact and quantifies the income.[33] The Court, as noted, then went on to consider identifying the source, in the technical meaning of the term, from which this income derives.

Where the controlling relationship between the lender and the borrower is that of employer-employee, the Supreme Court stated, the source of the income will be section 2(2). This is reflected in section 3(i)(1)(a), which clarifies that the interest differential in such a case is considered wage income. Where the controlling relationship is that of a provider and a receiver of services, the interest differential is taxable income from business or trade under section 2(1). As the Court pointed out, the proper source is identified in section 3(i)(1)(b).

Where the controlling relationship is that of a corporation and its shareholders, one would therefore expect that the interest differential would be considered a dividend in the hands of the taxpayers. This, too, is apparently indicated in section 3(i): subparagraph (c) identifies the source of income as section 2(4). Thus, it is surprising to discover that the Court declared the income received by shareholders to be in the nature of interest.[34]

The Court's identification of the income concerned as interest has been widely and understandably criticized.[35] It would appear that the Court erred by confusing the source

31. To the best of the author's knowledge, only one reported case has ever relied exclusively on section 2(10) in holding income to be taxable: Civil Appeal 136/67 Barzel v. Assessing Officer, Petah Tikvah, [1967] IsrSC 21(2) 69 (family member appointed as co-executor of estate held liable for income tax on the receipt of fees that he had neither requested nor expected).

32. Capital gains are taxed under the provisions of the Land Taxation (Appreciation, Sale and Purchase) Law, 5723-1963, 405 SH 156 (as amended) (capital gain deriving from sale of land) and of Part V of the ITO (capital gain deriving from the sale of assets other than land). Certain prizes are taxed under the provisions of section 2A of the ITO. Gifts and bequests are not taxed.

33. With regard to quantification of the income in *Mintz and Silverstein*, the Assessing Officer argued that, as section 3(i) was inapplicable, the taxpayers' income should be calculated according to the market rate of interest which, at the time, was higher than the rate of interest as determined by the Minister of Finance for the purpose of section 3(i). The Supreme Court, however, rejected the argument on procedural grounds. Since the assessments which the taxpayers were appealing had been calculated according to the section 3(i) interest rate—recall that the Assessing Officer had originally based his claim for taxability on section 3(i)(1)(a)—the Court refused to allow the Assessing Officer to claim that the income should be higher.

34. "It appears to me that section 3(i)(1) has a dual purpose: clarification and quantification. The provision clarifies that the liability to tax for notional income applies also to the particular case of interest-free loans—according to section 2(2) of the Ordinance if an employee received it from his employer, according to section 2(1) if a service provider received it from the service recipient and according to section 2(4) if a controlling shareholder received it from the corporation. The source for liability is section 2, and section 3(i)(1) merely clarifies this. . . . Accordingly, in the instant case the respondents are liable for tax under the terms of section 2(4) of the Ordinance, *which establishes 'interest' as a source.*"

Silverstein and Mintz, IsrSC 47(3) at 385 (emphasis added).

35. *See, e.g.*, Aharon Yoran, *Double Taxation or Notional Expense*, 6(2) TAXES A-1, A-6–A-7 (1992) (pre-dating and anticipating the Supreme Court's ruling in *Mintz and Silverstein*); Yitzchak Hadari, *Notional Income, Notional Expense and Dividend*, 8(5) TAXES A-13, A-17–A19 (1993); Yoram Margaliot, *Section 2 of the Ordinance as a Source for Taxing "Notional" Income (Following the Rimon and the Mintz and Silverstein Rulings)* 7(6) TAXES A-63, A-71–A72 (1994).

of income with its form. The source of the income is the taxpayer's shares in the corporation. The form of the income is the use of money. In other words, while it is true that payment for the use of money is defined as interest, here the income discussed is not consideration for the use of money but rather the use of money itself without payment of interest. Furthermore, interest income can, by definition, only be derived by one whose money is used by another; here, by contrast, it is the taxpayer who is using the money of another.

Identifying the income as interest is analogous to describing as capital gain the income of a lawyer who provides a service in exchange for a capital asset. While the form of income may be a capital asset, the source of income is the lawyer's services, and the income should therefore be considered as deriving from a trade or business and not as capital gain.

The Court's misidentification of the source of the income was apparently assisted by the fact that section 3(i)(1)(c) refers to section 2(4), which taxes both dividends and interest. The legislative intent undoubtedly referred to dividends, but the fact that the section referred to includes both dividends and interest allowed the Court to hold as it did.

The identification of the income as dividend or as interest is not merely an academic exercise. While interest from a closely-held corporation is ordinarily subject to the taxpayer's marginal rate of tax, the tax rate on dividends is substantially lower. In fact, as we shall see, the taxpayers in *Mintz and Silverstein* raised the alternative claim that the benefit they received, if considered income, should be taxed as dividends and not as interest.

The different rates of taxation applied to interest and dividends, it is important to note, is a function of the Israeli corporate tax structure. In Israel, corporate income is subject to tax in the hands of the corporation and then again to tax in the hands of the individual shareholder when it is distributed as a dividend.[36] Nevertheless, it would be incorrect to say that corporate income is double-taxed, as the combined tax at the corporate and shareholder levels is geared to approximate the highest marginal individual rate.

To avoid unnecessary side issues, I will demonstrate by reference to the tax rates, which are scheduled to come into effect in 2010. The corporate tax rate is due to be gradually reduced by that year to 25 percent.[37] The tax rate on dividends in the hands of a substantive shareholder will also be 25 percent.[38] The total tax burden on distributed corporate earnings will thus be 43.75 percent.[39] In parallel, the top individual tax rate is scheduled to be reduced by the year 2010 to 44 percent.[40]

Therefore, it usually makes little difference whether payments from a corporation to its shareholders are described as dividends or as interest. If they are described as dividends, the total burden would be 43.75 percent. If they are described as interest, the payment would ordinarily be a deductible expense for the corporation and would be subject to a tax rate of 44 percent in the hands of the individual shareholder.

36. Inter-corporate distributions are ordinarily exempt from tax: ITO § 126(b).

37. ITO § 126(a).

38. ITO § 125B(2). A substantive shareholder is defined as a shareholder who holds at least 10 percent of any of a number of rights in the corporation. ITO § 88. The tax rate on dividends in the hands of a non-substantive shareholder is 20 percent. ITO § 125B(1).

39. The total tax burden will be 43.75 percent and not 50 percent because the shareholder-level tax is only applied to what is left over after the payment of corporate-level tax. Thus, were a corporation to earn NIS 100, it would have only NIS 75 remaining after tax to distribute. The shareholders would pay tax at the rate of 25 percent, or an additional NIS 18.75. The total tax liability would thus be NIS 43.75.

40. ITO § 121.

Returning, however, to the facts of *Mintz and Silverstein*, the difference between classifying the income in the hands of the taxpayer as a dividend, on the one hand, or as interest, on the other hand, would have had far-reaching consequences. Were the benefit to be classified as a dividend, the total tax burden would have been 25 percent. Thus, the Court's determination that the income was in the nature of interest and not a dividend may not have been a simple case of misidentification, but rather may have been an attempt to avoid a construction which, although technically correct, would have resulted in an unacceptably low tax burden.

As noted, the taxpayers in *Mintz and Silverstein* raised an alternative argument that the benefit they received, if taxed, should be construed to be a dividend and subject to a tax rate of 25 percent. Here, the Court faced a dilemma. Technically, the taxpayers' argument was correct; however, substantively, it is unacceptable. The Court, therefore, refused to consider the issue, declaring as follows:

> The claim that the benefit should be taxed as a dividend, subject to the tax rate of 25 [percent], was not considered by the court of first instance. This argument subsumes complicated questions of law and fact. As the argument was not clarified in the district court, I will not consider it here.[41]

Again, the Court's position is technically indefensible. The question of whether the benefit should be classified as a dividend or as interest was not considered in the district court simply for the reason that the district court had held the benefit not to be income at all. If the Supreme Court felt that it could not consider the issue without a prior determination by the district court of the applicable law and fact, it should have reversed and remanded for further deliberations in the lower court.

Furthermore, it is not clear what complicated questions of law or fact remained to be determined. The Supreme Court had already held that the taxpayers, by virtue of their status as controlling shareholders, had received a taxable economic benefit from the corporation they controlled. This would seem to be sufficient, under Israeli tax law, to allow the benefit to be classified as a dividend. It is unclear, on the face of it, what other issues of law or fact would need to be clarified.

The Court soon had a chance to clarify its position. Due to the novelty and import of the issue, a rehearing was scheduled before an expanded panel of judges.[42] Following the rehearing, the Court unanimously reaffirmed its previous decision and, once again, refused to consider whether the income should be classified as a dividend. However, recognizing that its refusal to classify the income as a dividend had been universally criticized in academic circles,[43] the Court added a few words on the issue. It wrote:

> Although there is much to be said for the position of the academic community, I do not believe that the Court's previous decision warrants our intervention. I, too, believe that the factual record is insufficient to determine that the "notional income" is a dividend. I only need to note

41. *Mintz and Silverstein*, IsrSC 47(3) at 386.

42. Section 30 of the Courts Law [Amalgamated Version], 5744-1984, 1123 SH 198, provides that where a panel of three justices of the Supreme Court rules on an issue, the President of the Court may order a rehearing before an expanded panel if, in his opinion, the ruling is inconsistent with prior decisions of the Court or if a rehearing is justified due to the importance, difficulty or novelty of the issue.

43. *See* Yoran, *supra* note 35.

that not in all cases is a corporation allowed to distribute dividends and that the necessary factual inquiry was not undertaken.[44]

As opposed to its original decision, the Court's decision following the rehearing at least attempts to explain why the factual record was insufficient to allow a determination that the income received by the shareholders was a dividend. Nevertheless, the attempt is hardly convincing. What does it matter that "not in all cases is a corporation allowed to distribute dividends?" Let us assume that the corporation distributed profits among its shareholders in violation of the relevant laws. It is a well-established principle that the legality of income is irrelevant to its taxability. The corporation and possibly its shareholders might, in other words, face civil or criminal penalties for the illegal act, but even an illegal dividend is still a dividend for tax purposes.

Alternatively, the Court might not have meant that the corporation is prohibited from distributing dividends, but that it is incapable of doing so. For example, if the corporation had no profits, a distribution might be classified, for tax purposes, not as a dividend, but as a return of capital.[45] While this construction is feasible, it nevertheless begs the essential question of whether such a distribution would constitute income in the hands of the shareholders. On the face of it, the shareholders would have a reasonable argument that the distribution, as a return of capital, is not income as this term is used in section 2 of the Ordinance, and that if it is taxable at all, it would only be within the framework of the capital gains regime. Holding, as the Court did, that the benefit constitutes taxable income in the hands of the shareholders but that the corporation might not have been capable of distributing a dividend would appear disingenuous.

Furthermore, recall that Israeli income tax is based on a schedular system. It is not sufficient to declare that a certain benefit constitutes an accession to wealth in the hands of the taxpayer; imposing tax requires showing that the income is derived from one of the sources listed in section 2. This the Court did not do. Questioning whether the benefit could be considered a dividend leaves open the possibility that it may not be taxable at all.

As noted, it is this author's opinion that the *Mintz and Silverstein* Court was simply unwilling to allow the economic benefit, which the taxpayers derived through their corporation, to bear a total tax burden of only 25 percent. It sought, therefore, a way to avoid characterizing the benefit as a dividend, even though such a characterization would appear unavoidable.

While the technical analysis of the Court is apparently indefensible, its policy considerations were laudable. Dividends are subject to a reduced tax rate of 25 percent because the tax on distributed corporate earnings is merely the second tier of a two-tier tax. The corporate-level tax, combined with the shareholder-level tax, is supposed to approximate the ordinary individual tax rate. Yet, in the facts of *Mintz and Silverstein*, the benefit received by the taxpayers was not earnings net of corporate tax. The corporation had not previously paid tax on the benefit, which it distributed to its shareholders.

In contrast, compare what would have happened if, instead of loaning the funds to the taxpayers at no interest, the corporation had loaned the money to a third party and had then distributed the interest, net of corporate taxes, to its shareholders. Assume further that

44. *Mintz and Silverstein*, IsrSC 50(4) at 836.

45. This issue has not yet arisen in Israeli tax law. For a review of the American law on the subject, *see* Bittker & Eustice, *supra* note 1, at 8.02-8.03.

the shareholders had then used the dividend they had received to pay interest on a commercial loan. In such a situation the distribution, having been paid out of earnings that had previously been subject to corporate tax, would properly bear an additional tax of only 25 percent. Similar is a situation in which the corporation was to have lent the money to the taxpayers at interest and then distributed to them its net profits from the transaction.

Under the facts of *Mintz and Silverstein*, however, the corporation, by not charging interest on the loan, was able to avoid the corporate-level tax. The Court, apparently, was unwilling to allow the shareholder, in such a situation, to enjoy the lower rate of tax reserved for dividends.

IV. The Two-Transaction Approach

An alternate proposal, similar to the one enshrined in section 7872 of the Internal Revenue Code, has been raised in the academic literature.[46] It has been suggested that the loan could be viewed as two separate transactions, which have been collapsed into one. An interest-free loan from a corporation to its shareholders is the economic equivalent of the corporation lending money to its shareholders at the market rate and distributing to them the funds necessary to pay the interest. As the two structures are economically equivalent, it is argued that the tax consequences should be the same. The single transaction, in other words, should be broken down into its two component transactions and each should be taxed accordingly. Thus, the corporation should pay corporate tax on the interest it received in the first transaction, while the shareholders should pay income tax at the rate of 25 percent on the dividend they received in the second.[47]

Like the *Mintz and Silverstein* ruling, the two-transaction approach is unwilling to allow the economic benefit inherent in an interest-free loan to bear a total tax burden of 25 percent. While the Supreme Court in *Mintz and Silverstein* tackled the issue by imposing tax on the shareholders at the full individual rate, the two-transaction approach allows the shareholders to pay 25 percent on the dividend, but adds to that a corporate tax so that the total burden is equal to that imposed on distributed corporate earning.

From a policy perspective, the two-transaction approach is appropriate. However, it encounters technical obstacles no easier to overcome than those the Court so strongly criticizes in the *Mintz and Silverstein* approach.

A corporation lends its shareholders money without interest. The corporation, in such a situation, derives no income from the transaction. In the absence of a specific provision, there would appear to be no statutory authority upon which to base a claim that the corporation may be taxed.

Proponents of the two-transaction approach point out that the corporation *could* have charged interest on the loan and *could* have distributed to its shareholders sufficient funds to pay the interest. Again, the sentiment guiding such a construction is unassailable; nevertheless, the fact that a person *could* have earned income is not, under Israeli tax law, a sufficient reason to impose income tax.[48]

46. *See generally* Yoran, *supra* note 35.

47. Depending upon what they did with the borrowed funds, the shareholders may be entitled to an interest deduction. Under Israeli law, interest is deductible if it is paid for income-producing capital. ITO § 17(1).

48. Civil Appeal 340/62 Poskalinski v. Assessing Officer, Tel Aviv, [1963] 17 IsrSC 794.

It is important here to emphasize a fundamental difference between interest-free loans in the corporation-shareholder context, on the one hand, and interest-free loans in the employer-employee or the service provider-service recipient contexts on the other. The term "interest-free," when describing a loan from an employer or a service recipient, is a misnomer. It is better described as a barter transaction—services in exchange for the use of money. Thus, in the employer-employee context, the services the lender receives from her employee constitute taxable interest in her hands. From the point of view of the employee, the use of his employer's funds is taxable compensation.

As the *Mintz and Silverstein* Court pointed out, no special statutory provision is needed to reach this conclusion. The term "income" is nowhere limited to money. Income in kind—whether in the form of property or services—falls within its scope. Section 3(i) refers only to the use of funds by the borrower and clarifies that this use of an employer's money is taxable income. It does not refer to the services—interest in kind—received by the employer in exchange for lending money to her employee. Nevertheless, it would appear that this income is taxable under the general provisions of section 2.[49]

With regard to interest-free loans from a corporation to its shareholders, the situation is quite different. There is no barter transaction. The corporation receives no services from the shareholders in exchange for allowing them to use its money. As with a cash dividend, a dividend in kind is simply the transfer of economic resources from a corporation to its shareholders.

Thus, the two-transaction approach suffers from the same technical flaw as does the Court's approach in *Mintz and Silverstein*. While the commendable goal of each is to subject the economic benefit inherent in the interest-free use of corporate funds to the full tax burden, each would appear to lack the necessary statutory authority to do so. Perhaps the Knesset will eventually have to enter the fray and, as Congress did in section 7872 of the Internal Revenue Code, provide a legislative solution.

V. Concluding Thoughts

Both the American and the Israeli courts have struggled arduously with the problems inherent in the taxation of interest-free loans from corporations to their shareholders. As the courts of both countries discovered, it is a phenomenon which traditional principles of income taxation do not seem to be capable of handling. I posited that the root of the problem could be traced to the fact that traditional principles of taxation do not consider a corporation which loans money to its shareholders interest-free to have earned any income. Unlike the case of a barter transaction, in the corporation-shareholder context there is, in fact, no interest, either in cash or in kind, which the corporation receives in exchange for allowing shareholders the use of its funds.

The solution adopted by the Israeli Supreme Court, while technically suspect, nevertheless produces satisfactory results. Because Israel's model of corporate taxation is based on the principle that the total tax burden on distributed corporate profits should be similar to that faced by individuals on income they derive from unincorporated activity, the failure to tax the corporation on the income it could have received can be compensated for by taxing

49. In most cases, however, the employer will be entitled to a deduction for salary paid equal in amount to the income in kind so that no taxable income would accrue.

the shareholders at the full individual tax rate instead of the reduced dividend rate. The Israeli courts, however, have not yet confronted the question of the deductibility of interest expenses in the context of corporate-shareholder no-interest loans.[50] It is not easy, therefore, to surmise whether they would be willing to allow the shareholder an interest deduction absent any interest income in the hands of the corporation.

American courts seem to have had a much more difficult time grappling with the phenomenon than have their Israeli counterparts. The difficulty they encountered may be traceable to the fact that when questions regarding the taxability of no-interest loans first arose, interest expenses were almost always deductible. The courts, therefore, could not confine their discussions to the simpler question of gross income, but had to confront immediately the issue of interest deductions. They found themselves in the position either of declaring that the shareholders had no gross income even though the interest-free use of funds clearly constitutes an economic benefit, or of recognizing gross income and denying an interest deduction even when such a deduction would be appropriate.

Eventually, Congress had to step in and remove the primary impediment to reaching an acceptable solution by providing that the corporation could be taxed on the interest it could have received. Israel also might eventually need such a legislative solution.

50. The Israeli courts had an opportunity to consider the issue of interest deductions in the case of an interest-free loan received by a service provider. Civil Appeal 32/86 Rimon v. Assessing Officer, Tel Aviv 1, [1992] IsrSC 46(1) 537. The taxpayer was a corporate insurance agent. It collected premiums from its clients and was allowed to keep the funds for a period of time before transferring them to the insurance companies. During this time it deposited the funds in an interest-bearing bank account. The Assessing Officer, viewing the taxpayer as a provider of services to the insurance companies and the arrangement between them as an interest-free loan, invoked ITO section 3(i)(1)(b). In its appeal to the Supreme Court after the district court had accepted the Assessing Officer's position, the taxpayer agreed that section 3(i)(1)(b) applied, but argued that, as the funds were invested and produced taxable income, it should be entitled to a notional interest deduction. The Court sidestepped the issue. It ruled that the Assessing Officer could invoke the provisions of section 3(i)(1)(b) or he could impose tax on the actual interest earned, but that he could not do both.