

# Comments

## *PREPAID INTEREST-GIMMICKRY AND AN ANSWER* \*

Income tax has long been a branch of the law particularly suited to the tactical ingenuity of counsel. The ponderous tome that is the Internal Revenue Code of 1954 and its companion volumes, the Treasury Regulations, comprise a labyrinth of mystical terms, section numbers, and cross-references. Small wonder that taxpayers seek counsel to provide avenues of escape from the onerous burden of the tax scale.

Among the existing areas of refuge for the taxpayer are the numerous complex structures which inventive tax counsel have created to conform scrupulously to the statute's mandate. As long as such schemes do not run afoul of *Gregory v. Helvering*<sup>1</sup> and its progeny, the taxpayer may be reasonably certain that his deductions are deductible or his income is nonrecognized, as the case may be. Occasionally, additional channels of tax relief appear and win acceptance, usually through years of established practice, combined with Treasury acquiescence and congressional inaction. Often these windfalls to the taxpayer are founded solely on a dubious case of ancient vintage.

A rather glaring example of this form of tax relief is the deductibility of prepaid interest in the year of payment, regardless of the period for which the money was borrowed. This Comment will trace the development of this judicially-created phenomenon, and by so doing will attempt to demonstrate the need for corrective action by Congress, the courts, and the Internal Revenue Service. The focus of concern will be upon the distortion in income reporting which is caused by allowing taxpayers to abuse the provisions of the interest deduction statute and effectively to engage in income shifting tactics clearly violative of both the spirit and the letter of the Code.<sup>2</sup>

The courts have been rather active of late in the interest area generally; however, the cases have dealt primarily with sham transactions rather than with the prepayment feature. Nevertheless,

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\* On November 26, 1968, too late to be discussed in this Comment, the Treasury issued Rev. Rul. 68-643. This ruling indicates the Government's intention to curtail the deductibility of prepaid interest. This is the author's suggested first step for the solution of this problem. See text accompanying footnote 78 *infra*.

1. 293 U.S. 465 (1935).

2. Whether prepaid interest can ever exist at all has been much debated by accountants, educators, and attorneys. In order to accept the proposition that any amount "prepaid" on a loan is merely a reduction of indebtedness due and not interest requires one to define interest narrowly; i.e., the cost of using or borrowing money for a period of time. Thus, an amount returned to the borrower at the point of lending serves only to reduce the amount owed—the money is not yet being used. Only during the duration of the loan period can interest accrue, regardless of how the parties otherwise characterize the transaction. It is believed that the business community is not ready for so sweeping a revision which would not countenance prepaid interest as a tax phenomenon at all.

some have hailed the landmark case of *Knetsch v. United States*<sup>3</sup> as a harbinger of future concern with the validity of the precedents under Section 163(a).<sup>4</sup> *Knetsch* involved an individual who bought deferred annuity savings bonds from an insurance company by paying a small amount and giving notes for the balance. The company then allowed the taxpayer to borrow an amount up to one hundred thousand dollars in excess of the indebtedness owed, requiring only that the taxpayer prepay a year's interest. What in effect transpired was an exchange of moneys whereby the taxpayer was able to deduct interest payments and only be out of pocket a nominal sum in relation to the tax benefits secured. The insurance company in turn clearly came out dollars ahead from the "interest" it earned.

The Supreme Court held that these transactions were without substance, and were entered into solely for the purpose of securing for the taxpayer an interest deduction. The deductions were accordingly disallowed.<sup>5</sup> *Knetsch* thus resolved a conflict between circuit courts which had split on the question of the validity for tax purposes of such activities.

The now-famous "Livingstone" cases<sup>6</sup> also involved sham transactions designed to generate interest deductions at the lowest cost to the taxpayer. The intricate schemes of borrowings and repayments were generally less sophisticated than the one in *Knetsch*, but equally without substance. While *Knetsch* and the "Livingstone" cases addressed the interest field in general, however, they did not reach the less obvious and more difficult ploys which continue unrestrained today.<sup>7</sup>

## I

### AN ALLOWED DEDUCTION BECOMES AN INSTITUTION

In 1939, the Board of Tax Appeals became the first court to hold that a cash-basis taxpayer could currently deduct a prepaid interest

Rather, this Comment will follow the less ambitious route by merely pointing out the inequalities and the distortion created by allowance of the deduction in its present state under the law.

3. 364 U.S. 361 (1960). The case deals with the necessity for a true "business purpose" for a transaction, as distinguished from a "sham." See generally Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance*, 1961 SUP. CT. REV. 135; O'Connor, *Knetsch Means Interest Deduction Is Allowable Only If Loan Has Real Business Purpose*, 14 J. TAX. 160 (1961).

4. INT. REV. CODE OF 1954 § 163(a): "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

5. The decision dealt in part with INTERNAL REVENUE CODE OF 1954 § 264 which denies an interest deduction for amounts paid to carry single-premium insurance policies.

6. See notes 27-28 *infra*.

7. Until the "Livingstone" cases in the late 1950's, notes 27-28 *infra*, which culminated in the *Knetsch* decision, the primary emphasis in litigating interest deduction cases was on the bona fides of intra-family transactions. See also *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 (1967). See cases cited in BITTKER, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 189 (3d ed. 1964).

payment. The Board in *John D. Fackler*<sup>8</sup> allowed the taxpayer to deduct payments he made in 1934 for interest which would accrue in 1935 and 1936. The prepayments were the condition upon which the taxpayer could convert his demand note to a time note. The Commissioner argued that the interest was not due when paid, but the Board stated simply that since a bona fide indebtedness existed and since the taxpayer had paid interest on that indebtedness, he was entitled to the deduction. The Board then retrenched, however, by admitting that it would not allow a deduction in such a case if to do so would distort income in contravention of section 41 of the Revenue Act of 1934.

Section 41, like its counterpart in the 1954 Code, section 446(b), denied to the taxpayer the use of any accounting system which does not "clearly reflect income." The Board found no distortion and supported its holding by pointing to three cases<sup>9</sup> in which a current deduction was allowed for items covering an elapsed period of years. Only one of the three cases which the Board cited dealt with interest, however, and that case, *Central Valley National Bank*,<sup>10</sup> involved facts sufficient to distinguish it from *Fackler*. In *Central Valley*, the interest had accrued on unpaid taxes in prior years, so that the taxpayer's administrator had no choice but to pay. Mr. Fackler, on the other hand, arranged for the additional interest deduction by converting his demand loan to a time loan, ostensibly to prevent the lender from calling the loan at an early date. Therefore, it would appear that *Central Valley National Bank*, a case dealing with accrued interest, is dubious authority for the allowance of a deduction for an interest prepayment. This is especially so since the taxpayer in *Fackler* made a volitional choice to incur the additional expense whereas the one in *Central Valley* did not.

By its rather cavalier dismissal of a distinction between prepaid and accrued interest, the Board avoided the major obstacle to allowing the deduction. Unfortunately, the Board went on to state that it would be impermissible to "place petitioner on an accrual basis as to one item on his return and leave him on a cash basis as to the remainder"<sup>11</sup> again citing cases<sup>12</sup> dealing only with the inclusion of income items, not with the inconsistency of reporting income and expense items differently. In addition to citing cases which really did not support so broad a statement, the Board was technically inaccurate. It failed to consider, for

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8. 39 B.T.A. 395 (1939).

9. *Welch v. De Blois*, 94 F.2d 842 (1st Cir. 1938); *Central Valley Nat'l Bank*, 35 B.T.A. 489 (1937); *Jungkind Photo Supply Co. v. Rummel*, No. 8265 (E.D. Ark., Feb. 5, 1926).

10. 35 B.T.A. 489 (1939).

11. 39 B.T.A. at 399.

12. *John I. Chipley*, 25 B.T.A. 1103 (1932); *Merchants Nat'l Bank*, 6 B.T.A. 1167 (1927).

example, section 166 of the present Code, which allows a cash-basis taxpayer to use a bad debt reserve—a permissible method even before the Board had occasion to consider *Fackler*.<sup>13</sup> Furthermore, a cash-basis taxpayer may make certain payments which are not “expenses” at all, but—as in the case of capital outlays under section 263—merely expenditures.

Four years later, in the *Court Holding Company* case,<sup>14</sup> the Tax Court affirmed a taxpayer’s contention that an amount prepaid to a lender in consideration of the latter making a loan was interest and deductible as such. The court upheld the taxpayer on the strength of *Fackler* without discussing the relative merits of allowing a current deduction for the prepayment: “That the amount was prepaid and that it was paid in a lump sum rather than computed at a particular rate are facts which do not necessarily alter its character as interest.”<sup>15</sup> The court noted that the taxpayer’s accountant had testified that his client was on the accrual method of accounting, and observed that if this were true the prepayment might have to be amortized over the life of the loan. The court held, however, that the taxpayer was on a cash basis, since it had no books or records for the years in question with which to substantiate the testimony of its accountant.

There is clearly some question as to the accuracy of the court’s conclusion, which appears to be a concession to administrative convenience without reaching the merits. The Code clearly provides for occasions when an accrual-basis taxpayer may be placed on the cash-basis for specific purposes. For example, contributions,<sup>16</sup> medical expenses,<sup>17</sup> and child care expenses<sup>18</sup> all are deductions for which an accrual-basis taxpayer is effectively placed on the cash basis.

The Treasury Department acquiesced<sup>19</sup> in *Fackler*, which was admittedly a good case on its facts for the taxpayer, despite some questionable language in the opinion. However, it also acquiesced<sup>20</sup> in *Court Holding Company*, apparently on the theory that in order to obtain a reversal of the Tax Court in that case on the prepaid interest

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13. The Revenue Act of 1934, Ch. 277, 48 Stat. 680, under which *Fackler* was decided, contained in § 23(k) a provision for a reserve method of bad debt write-offs, as did the Internal Revenue Code of 1939, Ch. 2, 53 Stat. 1.

14. 2 T.C. 531 (1943). Neither the circuit court opinion in 143 F.2d 823 (5th Cir. 1944) nor the Supreme Court in 324 U.S. 331 (1945) mentioned the prepaid interest aspect of the case.

15. 2 T.C. at 536.

16. INT. REV. CODE OF 1954 § 170.

17. INT. REV. CODE OF 1954 § 213.

18. INT. REV. CODE OF 1954 § 214.

19. Rev. Rul. 9888, 1939-1 CUM. BULL. 11.

20. Rev. Rul. 11518, 1943 CUM. BULL. 5.

point it would have to convince the circuit court that *Fackler* was also bad law—which at that point in time it possibly was unable to do.

Subsequently, the Treasury Department further entrenched itself in the position of accepting the current deductibility of prepaid interest by issuing I.T. 3740<sup>21</sup> in 1945. That ruling stated that cash-basis taxpayer could deduct a prepayment of five-years' interest in the year of payment, but that an accrual-basis taxpayer can only deduct interest for the year in which the liability to pay arises. The text of the ruling contained citations to the distortion of income provision of the 1939 Code<sup>22</sup> and the Regulations appertaining thereto,<sup>23</sup> but without discussion. It is significant to note that the distortion of income provision was cited, since it indicates an uneasiness about the position the Service was taking in respect to a deduction for prepaid interest. However, the unmistakable clarity of the Board's opinion in *Fackler*, coupled with the unfairness resulting from the disallowance of a deduction to a cash-basis taxpayer in the year of payment (thereby forever barring the deduction since there is no provision for deferral), apparently were sufficient to persuade the Service not to dispute the matter further.

The next case to raise the question of interest prepayments was *Joseph H. Konigsberg*,<sup>24</sup> a 1946 case in which a bank required a cash-basis taxpayer to prepay five-years' interest on a loan. The Service made a feeble argument to the effect that what the taxpayer had labelled as interest was in fact only a discount which he had to amortize over the life of the loan.<sup>25</sup> The Tax Court properly ignored this contention in a brief, one-paragraph opinion upholding the taxpayer by citing *Fackler* without discussion.

Finally, the last case to address itself squarely to the prepayment feature was *L. Lee Stanton*,<sup>26</sup> in which the Tax Court held that a taxpayer who prepaid interest as part of an overall scheme to purchase and sell a large amount of Government short-term notes could deduct the interest currently although the prepayment overlapped a two-year period. The majority opinion did not refer to the prepayment as such, but held the amount paid deductible solely on the strength of the finding that the indebtedness was genuine. The court held to this effect despite a

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21. 1945 CUM. BULL. 109.

22. INT. REV. CODE of 1939, Ch. 2, 53 Stat. 1, § 43 (now INT. REV. CODE of 1954 § 46).

23. Treas. Reg. 111, § 29.43-2 (1941).

24. 5 CCH Tax Ct. Mem. 48 (1946).

25. Loan fees must be amortized over the life of the loan, *Sayers F. Harman*, 4 T.C. 335 (1944).

26. 34 T.C. 1 (1960). *Clifford H. Hood*, 20 CCH Tax Ct. Mem. 1140 (1961), was decided a year after *Stanton*, but is virtually indistinguishable on its facts. The Tax Court sustained the deduction in that case on the authority of *Stanton*.

showing by the Service of a mathematical certainty that the taxpayer could not avoid an economic loss in one of the transactions.

The court held the *Stanton* case distinguishable from the "Livingstone" cases.<sup>27</sup> The majority felt that neither *Knetsch*, nor *Goodstein v. Commissioner*<sup>28</sup> (the prototype of the "Livingstone" variety) ruled the case since those cases involved sham borrowing gimmicks, while the facts in *Stanton* showed substance. Interestingly, only Judge Pierce in dissent felt any real concern for the possible manipulative aspect of the prepayment feature.<sup>29</sup>

Since *Fackler*, the cases have either treated the fact of prepayment as not in question, or have not considered the matter at all. *Fackler*, the Service's position in I.T. 3740, and the number of cases which have unquestioningly cited these as authority have combined to establish the validity of the prepaid interest deduction as a postulate of current tax law.<sup>30</sup>

## II

### MRS. GOLDSTEIN BUYS SOME BONDS

After the tax community had absorbed the "Livingstone" cases and *Knetsch*, further rumblings of dissent were heard from the bench. In 1964, in an opinion it later withdrew, the Tax Court said:

[I]f the matter of the year for a cash basis taxpayer to deduct prepaid interest were before us now for the first time, we would be disposed to require proration of deductions for prepaid interest over all the periods benefitted. However, the rule allowing full deduction in the year of payment of prepaid interest having become rather firmly imbedded, we may assume for present purposes that it will continue to be adhered to.<sup>31</sup>

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27. There are a great number of cases which can be called "Livingstone" cases by virtue of Livingstone's personal involvement or inspiration. The following are generally considered the leading cases within this category: *Leslie Julian*, 31 T.C. 998 (1959), *aff'd sub nom. Julian v. Commissioner*, 273 F.2d 867 (2d Cir. 1959); *George G. Lynch*, 31 T.C. 990 (1959), *aff'd sub nom. Lynch v. Commissioner*, 273 F.2d 867 (2d Cir. 1959); *Eli D. Goodstein*, 30 T.C. 1178 (1958), *aff'd sub nom. Goodstein v. Commissioner*, 267 F.2d 127 (1st Cir. 1959). It is interesting to note that Livingstone received a favorable ruling from the Internal Revenue Service before proceeding with his transactions. *Eli D. Goodstein, supra*, at 1191. See generally *Doukas, Tests for Deductibility of Interest Payments: Is Business Purpose Necessary?*, N.Y.U. 19TH INST. ON FED. TAX 1259 (1961); Note, *The "Business Purpose" Doctrine And Interest Deductions*, 39 ST. JOHN'S L. REV. 77, 80 (1964).

28. 267 F.2d 127 (1st Cir. 1959).

29. The majority was greatly concerned with the presence or absence of a business purpose behind the borrowings, and did not even allude to the prepayment feature.

30. See, e.g., Chief Judge Murdock's cryptic opinion in *Joseph H. Konigsberg*, 5 CCH Tax Ct. Mem. 48, 49.

31. *Kapel Goldstein*, 23 CCH Tax Ct. Mem. 1651, 1659 (1964) (opinion withdrawn). The

This resigned acceptance of the status quo is unfortunate in that it gives this area of the law a gloss of legitimacy which is quickly dimming. The recent stir caused by *Knetsch* has prompted the Service to reconsider the position it took in the issuance of I.T. 3740.<sup>32</sup> Certain authorities<sup>33</sup> have taken the position, however, that if a reversal in position is to come, it should originate in Congress. This sounds very much like the voice of the practitioner to whom the deduction is a valuable tool in tax planning. It has historically been difficult to persuade Congress to close tax loopholes, and it is very conceivable that this body may be content to let the courts and the Service arrange this matter. In any event, as long as I.T. 3740 states the current position of the Service on the question of prepaid interest, it is somewhat disingenuous to expect congressional action to the contrary.

Meanwhile, the courts have not been idle. In 1966, the Second Circuit created considerable consternation when it handed down three decisions,<sup>34</sup> each of which affirmed the Tax Court in denying a prepaid interest deduction. The focus of concern in each case was not the propriety of prepayments, but rather whether the respective taxpayers had a "business purpose" for borrowing.

In *Ippolito v. Commissioner*,<sup>35</sup> an Irish Sweepstakes winner purchased one million dollars in Treasury notes, borrowing the full purchase price in late December of 1955. He prepaid 11-months' interest in December, and claimed a deduction for that amount on his return for that year. In January of the following year he sold the notes at a minimal gain, had his unearned prepaid interest refunded, dutifully reported it as income in 1956, and had his loan cancelled. The Second Circuit affirmed the Tax Court's finding that the only possible reason for the taxpayer to have borrowed the money was to secure the deduction in the year in which he had earned an inordinate amount of income. In the absence of an independent "business purpose," the court held the transaction a mere sham to reduce taxes, and therefore denied the deduction.

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opinion was written by Judge Pierce, who also dissented in *Stanton*.

32. Letter from Lester W. Utter, Chief, Individual Income Tax Branch to author, June 28, 1967 (on file with the *California Law Review*).

33. Webster, *Prepaid Interest—Tax and Local Law Considerations for the Payor and Payee*, 19TH SO. CAL. TAX INST. 381, 431 (1967) and authorities cited therein at n.125. Mr. Webster's article at the time of this writing is the most complete work done on the subject.

34. *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965), *cert. denied*, 385 U.S. 1005 (1967); *Barnett v. Commissioner*, 364 F.2d 742 (2d Cir. 1966), *aff'g* 44 T.C. 261 (1965); *Ippolito v. Commissioner*, 364 F.2d 744 (2d Cir. 1966), *aff'g* 24 CCH Tax Ct. Mem. 894 (1965).

35. 364 F.2d 744 (2d Cir. 1966), *aff'd* 24 CCH Tax Ct. Mem. 894 (1965).

*Barnett v. Commissioner*<sup>36</sup> presented essentially the same issues as *Ippolito*. Again, the appellate court agreed with the Tax Court that the taxpayer could not have realized a gain on the transaction, and that his only purpose in borrowing the money must have been to reduce his tax liability. Accordingly, the court here too characterized the transaction as a sham and appropriately denied the deduction.

Finally, *Goldstein v. Commissioner*<sup>37</sup> represents the logical extension of the series of cases beginning in 1960 with *Knetsch*. Whereas the taxpayer in *Knetsch* was involved in an intricate maze of borrowings and repayments, and those in *Ippolito* and *Barnett* merely borrowed in one month and repaid in the next, the Goldsteins were held to have created a bona fide debt. In fact, the Second Circuit specifically disagreed with the Tax Court's finding that *Goldstein* should be decided as a sham case. Rather, the court pointed to the pledging of securities with a lender, the assumption of personal liability, and the length of time involved as indicia of a bona fide transaction.

Nevertheless, the court examined numerous projections of income prepared by the taxpayer's son, a certified public accountant, and found that the transactions could not realistically have yielded a profit.<sup>38</sup> It then concluded:

[S]ection 163(a) . . . should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction. . . . Indeed, to allow a deduction for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction from income, would frustrate Section 163(a)'s purpose; allowing it would encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress. . . .<sup>39</sup>

The *Goldstein* case breaks new ground<sup>40</sup> in this area by denying an interest deduction notwithstanding the admitted existence of real debt. Courts no longer have to label a transaction "sham" in order to disallow

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36. 364 F.2d 742 (2d Cir. 1966), *aff'g* 44 T.C. 261 (1965).

37. 364 F.2d 734 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965), *cert. denied*, 385 U.S. 1005 (1967).

38. The taxpayer borrowed funds at a rate of four percent to buy securities which were to yield at most only two percent. *Id.* at 739.

39. *Id.* at 741-42.

40. Although the case does not cite *Stanton*, see note 30 *supra* and accompanying text, the two decisions are irreconcilable. *Stanton* was a case in which the Tax Court allowed a deduction without the taxpayer having to show any "business purpose" or "mixed motives" other than tax incentive. *Goldstein* expressly holds that such a showing is a prerequisite to a deduction.



a deduction which the taxpayer did not incur as a result of "purposive activity." Rather, the principle first announced in *Knetsch* that taxpayers should not take section 163(a)'s broad scope as a carte blanche for figmentary schemes has now been refined and articulated so that it is applicable to less outrageous situations than the one presented in that case. While it is true that the court's use of such terms as "purposive activity"<sup>41</sup> and "mixed motives"<sup>42</sup> is less instructive than confusing to the tax bar in advising their clients, the basic message is clear: The Second Circuit, at least, will not tolerate the purchase of interest deductions.<sup>43</sup>

### III

#### THE PROBLEM STILL REMAINS

The importance of *Goldstein* in the prepaid interest area is that it indicates that courts may be willing to reexamine the position taken in *Fackler*. For although *Knetsch* bars the door to pure shams, and *Goldstein* purports to do the same to attempts at purchasing deductions, there is still a productive gray area where taxpayers are perpetrating abuses by means of interest prepayment.

#### A. How It's Done

Three examples of the legacy of *Fackler* and I.T. 3740 will illustrate the nature of the problem. These examples range from a commonly accepted business practice to an illusory, but not inconceivable, situation verging on fraud. By no means does this discussion exhaust the many possibilities available to tax counsel—*Goldstein*, *Knetsch* and the "Livingstone" cases notwithstanding.

The first example is taken from the Sacramento area in California;<sup>44</sup> the same situation could develop in other locations where industry is heavily concentrated and where builders expect a large influx of population. In the early years of this decade, a strong surge in apartment house construction took place in and around the state capitol, largely due to the expectation that Sacramento would become another boom area as industry expanded in the Central Valley of California.

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41. 364 F.2d at 741.

42. *Id.*

43. Although *Goldstein* has not been followed or rejected yet by any other circuit court of appeal, it is probable that the prestige of the Second Circuit as the most important commercial court enhances the likelihood of the case being followed.

44. The author had personal experience with such transactions during his association with the Oakland, California office of a national certified public accounting firm. Further information was obtained from interviews held in Oakland with E.A. Gwilliam, CPA, former Tax Manager of that office.

Unfortunately, many apartment buildings remained from 25-90 percent vacant.<sup>45</sup> As a result, the various individuals and combines which had promoted the buildings found themselves unable to continue making payments on the mortgages held by numerous savings and loan associations (S & L) in the area. Foreclosures ensued, and the lending institutions were saddled with titles to unsalable properties. At this point, lending officers were willing to allow financially responsible individuals to profit from what appeared to be patently unfavorable terms for the S & L.

The arrangements were roughly as follows: The buyer prepaid at least five-years' interest to the S & L on the loan which the latter had just foreclosed. The note which the buyer assumed was nonrecourse and included a provision for interest-only payments at the option of the buyer. One clause, however, provided that should the property produce a profit for the buyer after the five years had elapsed, principal payments would begin. If, on the other hand, the property remained unproductive in the hands of the buyer, no principal at all would be due. The buyer might or might not be personally liable on the note,<sup>46</sup> and usually reserved the right to turn the property back to the S & L after the five year period had elapsed.

The S & L had thus rid itself of the unproductive property and was at least receiving interest payments. The buyer, in turn, had the benefit of a current deduction for interest and for any taxes which were due, as well as for substantial depreciation. For the taxpayer who had income-bunching problems which the income-averaging provisions<sup>47</sup> did not alleviate, this arrangement was ideal in that it provided him with the optimum in tax shelter at the minimum of risk.<sup>48</sup>

A prominent California attorney<sup>49</sup> reports a second example as a frequent practice among real estate brokerage firms in Southern California. The program in this case involves an agreement between a

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45. The vacancy factor varied widely, but in no instance did it approach a level which would have allowed the operations to function profitably.

46. The Supreme Court held long ago that personal liability on a note was not a factor to be considered in determining the tax consequences of such a transaction. *Crane v. Commissioner*, 331 U.S. 1 (1946). Furthermore, the Tax Court has recently held in *Manuel D. Mayerson*, 47 T.C. 340 (1966), that a taxpayer who made only a minimal initial principal payment (balance due in 99 years) could nevertheless claim depreciation. The court held that on the authority of *Crane, supra*, the fact that the taxpayer had made virtually no dollar expenditure was irrelevant.

47. INT. REV. CODE OF 1954 §§ 1301-05.

48. INT. REV. CODE OF 1954 §§ 1245, 1250—the recapture of depreciation provisions—will offer a serious impediment to this otherwise exotically happy scheme. In addition, there may also be a risk of income inclusion in subsequent years of the amounts of prepaid interest which had been paid but remain unearned.

49. Webster, *supra* note 37, at 411-12.

buyer and a seller of real estate to pass on to a third party the prepaid interest deduction which the buyer has already claimed.

The mechanics of the transaction are simple: The seller conveys the property to a buyer and receives a note and a payment for prepaid interest from him. The parties agree, either formally in the contract, or informally, that if the buyer resells the property to a third party, the latter will assume the original buyer's note and also will prepay interest to the seller. The seller then will refund the unearned portion of the original buyer's prepayment to him.<sup>50</sup> This three-cornered transaction is known as "trading" on the prepaid interest deduction. The original buyer has successfully engaged in income-shifting which is patently illegitimate in this context. Whether the Service can then come into the picture and successfully argue that there never was a business purpose for the entire arrangement other than to secure the same deduction for two separate buyers is questionable, even assuming that *Goldstein* is good law in circuits other than the Second.<sup>51</sup>

A third and common example of income-shifting by use of the prepaid interest ploy is for a buyer of real property to prepay interest in year one, and then transfer the encumbered property to a corporation of which he (the buyer-transferor) is at least an 80 percent stockholder. Under the provisions of section 351, relating to transfers of property to a corporation controlled by the transferor, neither the taxpayer nor the corporation should realize any gain on this aspect of the transfer. In addition, the taxpayer has obtained an interest deduction, has been relieved of the obligation to pay principal, and has achieved the advantages of corporate form to shield himself on the note payable. The transferor taxpayer has "bought" a deduction for the price of incorporation and, of course, the interest itself which is largely offset by the tax benefit obtained.

In sum, the opportunities for exploiting the prepaid interest deduction are many—the number of variations is subject only to tax counsel's imagination and ingenuity.<sup>52</sup> It is vital that the Service, the

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50. On the strength of *Seven-Up Co.*, 14 T.C. 965 (1950), there is no problem of the seller having to report double income; the case held that there is no tax consequence to the seller because of an obligation to repay a like amount back to the original buyer. *But see* Rev. Rul. 58-209, 1958-1 CUM. BULL. 19, dealing with similarly centralized organizations.

51. See *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688, 692 n.9 (1967) (citing *Goldstein*).

52. In recent years, the financial community found that convertible preferred stock and convertible debentures were ideal investments in that the investor needed only to pay 20 percent of the purchase price and borrow the remainder on margin. In connection with this borrowing, the lender was to receive prepaid interest immediately on the balance due. This provided the borrower with an interest deduction as well as with a sound investment in a rising market. When the Federal Reserve Board in August 1967 acted to bring the margin requirements of convertible issues in line with other securities, however, it was clear to all that the halcyon days were largely over.

courts, and Congress realize that the revenue loss which such income-distortion causes is too meaningful to be justified any further by merely pointing to the administrative convenience of allowing cash-basis taxpayers current deductions for interest prepayments. It is submitted that allowing taxpayers whose economic position permits them flexibility to shift and to allocate income violates the letter and the spirit of the statute. This is so notwithstanding the clear language of section 163(a) to the effect that all interest paid during the year is deductible. This section, as well as all sections of the Code, is subject to section 446(b) which states a congressional policy of requiring all taxpayers to make annual returns on a basis which clearly reflects income; there appears to be no excuse for a continued failure to implement this policy.

In addition, a threshold question must be answered which has heretofore been relegated to a theoretical status, and thus deemed not worthy of consideration by those in practice: Is section 163 really applicable to prepayments? Section 163(a) requires "interest," and it is arguable that no interest is involved when the borrower takes with one hand and refunds with the other. For example, if *A* borrows 100 dollars from *B*, and returns to *B* 10 dollars, which the two agree to treat as interest, what in effect has transpired is that *A* has borrowed only 90 dollars, the interest on which is due when the principal is due. In other words, the "interest prepayment" is actually only a reduction of the total indebtedness, and since interest is the cost of borrowing money, there appears to be no logical reason for allowing an interest deduction for the cost of borrowing 100 dollars, if in fact only 90 dollars is made available to the borrower.

As a corollary argument, it follows that the amount of interest the borrower pays when the debt falls due is the amount which is deductible, and no other amount. Clearly this argument is one which cannot be answered by a casual shrug of the shoulders to indicate that theory and practice are two separate items. Following the language of section 163(a), one is led to the conclusion that perhaps what has been called interest is actually not that at all, and that the time is nigh for a reappraisal.

#### *B. A Look at Analogous Prepayments*

It is instructive to focus upon related prepayments and to determine how they have been treated by the courts and the Service. In attempting to survey other areas of prepaid expenses, it is logical not to consider those expenses which are considered by the courts to be subject

to the "ordinary and necessary" test of section 162(a).<sup>53</sup> Expenses which are required to meet this test in order to be deductible have been accorded separate treatment by the courts.<sup>54</sup>

Nonbusiness interest must satisfy only the mandate of section 163 to be deductible; taxes likewise are deductible if they meet the conditions of section 164; medical expenses are deductible under section 213 subject to percentage of income limitations. However, rent,<sup>55</sup> alimony,<sup>56</sup> supplies,<sup>57</sup> insurance,<sup>58</sup> and salary or other compensation<sup>59</sup> all must meet standards and requirements which so set them apart that any comparison of the two groups would be misleading.

The two areas which are most comparable to interest are taxes and medical expenses. The leading case in the prepaid taxes area is *Lillian Bacon Glassell*,<sup>60</sup> which allowed a current deduction for a prepayment of personal income taxes. Pursuant to section 164(a), the Tax Court properly allowed a deduction since that section clearly states, as does section 163(a), that current payments are deductible. Although this decision would appear to be wholly incompatible as a question of logic with a disallowance of prepaid interest as a deduction, it is a far more tolerable one. This is so because although the same degree of distortion in the reporting of income results in both cases, the possibilities for exploiting the prepaid taxes deduction are not on a scale comparable to those that exist with regard to the interest deduction. In addition, there are only a finite number of taxing authorities to whom payments would qualify under the rather specific mandate of section 164(a). An interest deduction-seeking taxpayer, however, staying within the confines of the *Goldstein* decision, may find an almost infinite number of possibilities.

The field of prepaid medical expenses has been stringently limited

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53. "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

54. See discussion in *Commissioner v. Heninger*, 320 U.S. 467 (1944).

55. INT. REV. CODE OF 1954 § 162(a)(3).

56. INT. REV. CODE OF 1954 § 215.

57. Treas. Reg. § 1.162-3; Webster, *supra* note 33, at 397, and cases cited at 397 nn. 46, 47, all of which make the distinction between "ordinary and necessary" *ergo* deductible and nondeductible expenditures.

58. The business insurance cases are in conflict. *Waldheim Realty & Inv. Co. v. Commissioner*, 245 F.2d 823 (8th Cir. 1957), *rev'g* 25 T.C. 1216 (1956), allowed the deduction whereas the later case of *Louise K. Herter*, 20 CCH Tax Ct. Mem. 78 (1961) is *contra*. The Tax Court in *Herter* noted that its decision was squarely contrary to the Eighth Circuit in *Waldheim*, implying that the latter case was wrong. *Cf.* *Commissioner v. Boylston Market Ass'n*, 131 F.2d 966 (1st Cir. 1941).

59. INT. REV. CODE OF 1954 § 162(a)(1).

60. 12 T.C. 232 (1949). For a cogent analysis of this area, see Irwin, *Prepayments By A Cash Basis Taxpayer*, 15th So. CAL. TAX INST. 547, 583-87 (1963).

by the decision of the Tax Court in *Robert S. Basser*,<sup>61</sup> which denied deductibility for a prepayment on the grounds that the obligation to pay had not yet arisen. The decision in that case is justifiable on its facts, but appears to be a rather harsh one, since it forever barred the deduction—there being no provision in the present Code for deferring such deductions. The same objection is raised by proponents of the prepaid interest deduction, who would seek to argue by analogy.

However, the principal objection to eliminating the current deduction of all prepaid interest is simply that the words of section 163(a) appear to expressly allow the deduction of all interest paid or accrued in the taxable year.<sup>62</sup> As a logical corollary, the argument continues, it is not the function of the courts to change what appears to be rather explicit congressional intent.<sup>63</sup> The answer to this forthright argument is that whatever Congress intended when it enacted section 163(a) and its predecessors, it did not intend to sanction the income shifting which manipulation of the prepayment feature makes possible. Furthermore, the fact that the practice is so well established in the business community lends further weight to the urgency of remedial steps.

The courts must read the clear words of section 163(a) in conjunction with the equally clear language of section 446(b). The distortion which is arguably sanctioned by the allowance of inflated current deductions for prepaid interest under section 163(a) is unequivocally blocked by section 446(b) as not accurately reflective of income. Neither the quantum nor the variety of distortion is here in question: The statute espouses an unmistakable policy of nondistortion, and the time is far overdue for an intelligent reappraisal of the situation.

Defenders of the deduction have presented two other arguments in support of the current status quo. Neither of these addresses the question of distortion, which no one seriously doubts exists under the present practice. The first of these was briefly alluded to in connection with the discussion of prepaid medical expenses.<sup>64</sup> This argument is the same appealing one which probably led to the result in *Fackler*: To disallow the prepayment in the year in which the dollars were spent is tantamount

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61. 26 T.C. 619 (1956).

62. Cf. Webster, *supra* note 33, at 431: "While it is true that some distortion of income results from a current deduction of interest prepayments . . ."

63. Deductions from gross income do not depend on general equitable considerations, and are only allowed when provided by statute. However unappealing this may be, the doctrine that deductions are a matter of "legislative grace" was announced long ago by the Supreme Court. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). Admittedly, though, the same argument holds true for the disallowance of deductions.

64. See text accompanying note 69 *infra*.

to forever barring the deduction as there is no provision in the current Code for the amortization of the expenditure over the life of the obligation. This is both unfair and in contradiction to the words of section 163(a) since the expenditure is indeed for interest, which the statute clearly allows as a deduction from gross income.

The immediate answer to this argument of unfairness is that it did not convince the Tax Court in the *Basset* case,<sup>65</sup> dealing with medical expenses. There is no question, however, that the hardship of such a decision is compelling and that so facile an answer is insufficient to do substantial equity to both taxpayer and Government. This seems a fertile area for legislative action either to allow taxpayers to amortize or otherwise to permit them to deduct the expenditure in the period to which the interest applies, rather than to wait for some circuit court to take as brave a step as did the Second Circuit in *Goldstein*.

If, however, Congress moves at its customary pace, there is ample precedent for the judiciary to provide that which is needed. For example, courts in the past have required taxpayers to capitalize and amortize the following expenses: loan fees,<sup>66</sup> certain legal fees,<sup>67</sup> brokerage commissions,<sup>68</sup> and expenses in connection with the obtaining of a lease.<sup>69</sup> It is noteworthy that the courts took action in these cases without the imprimatur of Congress.

The last argument points to the Supreme Court's key decisions<sup>70</sup> in the prepaid income field which hold, in essence, that the taxpayer recognizes prepaid income at the earliest moment after he realizes it, commercial accounting principles to the contrary notwithstanding. Since the Supreme Court found no distortion in requiring taxpayers to report income as soon as it is available to them, the argument runs, it seems that the expenses should be treated the same way in the interests of equality of administration. Or, in the alternative, although the Court was not specifically dealing with expenses in either the *American Automobile Association v. United States*<sup>71</sup> or the *Schlude v. Commissioner*<sup>72</sup> cases, they are both of some evidentiary value in determining in advance how the Court would react if it were faced with

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65. 26 T.C. 619 (1956).

66. *Sayers F. Harman*, 4 T.C. 335 (1944).

67. *Adelaide D.J. Burgwin*, 31 T.C. 981 (1960), *aff'd in part and rev'd in part*, 277 F.2d 395 (3d Cir. 1960).

68. *Helvering v. Winmill*, 305 U.S. 79 (1938).

69. See *Henry Boos*, 30 B.T.A. 882 (1934).

70. *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961).

71. 367 U.S. 687 (1961).

72. 372 U.S. 128 (1963).

the other side of the coin.

The arguments are faulty, however, in that there never has been any necessary correlation between the treatment which related income and expense items receive.<sup>73</sup> Furthermore, courts have consistently refused to treat equally for tax purposes the payor and the payee of the same item.<sup>74</sup> Hence, the entire discussion of prepaid income seems to be irrelevant to the question of interest deductions. The underlying policy against income distortion applies equally to both income and expenses, and should be paramount to other considerations.

#### IV

##### A PROPOSAL FOR REFORM

Congress should take action to prevent the abuses that taxpayers daily perpetrate by means of the prepaid interest deduction. The action can best come in the form of an amendment to present Code section 163 to accommodate the following changes. First, the Code may regard interest prepayments in connection with an acquisition of property as an option to buy. The taxpayer can capitalize this option to the cost of the property if he ever actually acquires the property. If amortization of this option qualifies as an "ordinary and necessary" expenditure, the option can be amortized over the useful life of the property as part of the cost basis.<sup>75</sup> Should the buyer decide not to exercise the option (he can exercise it by paying principal to the seller) he can then write off the cost of the option as a capital loss. This treatment should effectively eliminate some of the marginal practices earlier described in this Comment, including "trading" on the deduction and staggering prepayment of interest and principal.

In order to avoid income-shifting, the amendment should specifically provide for the amortization of interest which is prepaid on a loan over the life of the loan. The treatment would then be consistent with that the courts now accord other expenses of obtaining loans.

The amendment should also codify the principle of *Central National Bank of Cleveland*<sup>76</sup> wherein the court held that interest paid for past-due obligations is deductible. There is no conflict between proscribing deductions of prepaid interest and allowing the postpaid deduction; attempts at abuse of the latter area have been judicially

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73. *Zeunen Corp. v. United States*, 227 F. Supp. 952 (E.D. Mich. 1964).

74. *E.g., Field Enterprises, Inc. v. United States*, 348 F.2d 485 (Ct. Cl. 1965).

75. If the expenditure amortized does not qualify as ordinary and necessary, an adjustment to the taxpayer's basis in the property may be in order.

76. 35 B.T.A. 489 (1937). See note 10 *supra* and accompanying text.



controlled<sup>77</sup> and of course will remain subject to the *Goldstein* test of "business purpose." The following is a suggestion for a possible draft of the statute to embody the salient points of this proposal.<sup>78</sup>

#### SEC. 163—INTEREST

(a) GENERAL RULE—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. However, if the payment on such indebtedness represents interest for all or part of a taxable year other than the one in which payment is made, then—

(1) payments for prior taxable years shall be deductible in the year of payment subject to a determination by the Secretary or his delegate that the reason for delaying payment was not for the purposes of tax avoidance;

(2) payments for future taxable years shall be deductible in the year of payment only to the extent that the taxpayer can sustain the burden of proof that interest is currently due; the remainder shall be deductible pro-rata in the taxable period to which it applies;

(3) payments for future taxable years on indebtedness pertaining to real or personal property shall be treated as options to purchase, amortizable over the useful life of the property.

(A) The deductibility of amortization from gross income as determined under this subsection shall be subject to sections 162 and 212 of this Code.

(B) Gains and losses from the sale or exchange of options described in subsection (3) shall be considered to be gains or losses from the sale or exchange of capital assets.

#### V

#### CONCLUSION

The first meaningful steps toward correcting the present state of affairs in the field of prepaid interest must be taken by the Internal Revenue Service. The Service must repeal I.T. 3740 and withdraw its acquiescences to *Fackler* and to *Konigsberg*. In this way, the courts can avoid having to play the devil's advocate in the face of both established precedent to the contrary and the position of the Internal Revenue Service.

Judicial reappraisal of the present rule is well under way, and the

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77. See, e.g., *Howell Turpentine Co.*, 6 T.C. 364, 394 (1946), *rev'd on other grounds*, 162 F.2d 319 (5th Cir. 1947). There, the taxpayer purposely held off paying interest until a year when it was felt by its principal shareholders that an interest deduction was needed. The court there correctly denied the deduction and it can be expected that the same result will obtain should similar excesses be attempted.

78. On November 26, 1968, too late to be discussed in this Comment, the Treasury issued Rev. Rul. 68-643, 1968 INT. REV. BULL. No. \_\_\_, at \_\_\_. This ruling indicates the Government's intention to curtail the deductibility of prepaid interest.

Service, as has been noted, is now reconsidering its position on this question. However, in an area much blurred by dicta on the part of the courts and by a half-thought-out position taken by the Service, it seems evident that Congress must act to clarify the “clear” language of section 163(a) in such a way that it does not do damage to the overall structure of the tax law. If the courts must continue to resort to judicial legislation, they will no doubt further obfuscate a field not known for its clarity.

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