TAXATION—PREPAID INTEREST DEDUCTION—NONREFUNDABLE INTEREST PREPAID BY CASH BASIS TAXPAYER CAN ONLY BE DEDUCTED AS IT ACCRUES OVER PERIOD OF LOAN—*Zidanic v. Commissioner*, 79 T.C. 651 (1982).

Over four decades ago, prepaid interest deductions inspired a tax shelter game between taxpayers and the Internal Revenue Service (the Service). This game, refereed by the courts and Congress, continued for some time. In the early years, the taxpayer was often victorious. Recently, however, statutory changes and favorable court rulings have helped the Service prevail. Now Congress, with the help of the Tax Court, has effectively ended this variation of the tax shelter game. In section 461(g) of the Internal Revenue Code (the Code), enacted as part of the Tax Reform Act of 1976,[1] Congress severely restricted prepaid interest deductions. The Tax Court first had occasion to construe section 461(g) in *Zidanic v. Commissioner*.[2] In that case the court upheld this restriction.[3]

Generally, a tax deduction is allowed for all interest on indebtedness paid or accrued within the taxable year.[4] The simple term "paid

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[1] Tax Reform Act of 1976, Pub. L. No. 94-455, § 208(A), 90 Stat. 1541 (codified at 26 U.S.C. § 461 (1976)). That section states, in part:

(g) Prepaid Interest—

(1) In General—If the taxable income of the taxpayer is computed under the cash receipts and disbursements method of accounting, interest paid by the taxpayer which, under regulations prescribed by the Secretary, is properly allocable to any period—

(A) with respect to which the interest represents a charge for the use or forbearance of money, and

(B) which is after the close of the taxable year in which paid, shall be charged to capital account and shall be treated as paid in the period to which so allocable.

(2) Exception—This subsection shall not apply to points paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer to the extent that, under regulations prescribed by the Secretary, such payment of points is an established business practice in the area in which such indebtedness is incurred, and the amount of such payment does not exceed the amount generally charged in such area.

[2] 79 T.C. 651 (1982).

[3] *Id.* at 652-53.

[4] I.R.C. § 163(a) (West 1978 & Cum. Supp. 1983). Since there is no limitation stated in this section, it does not matter whether the underlying obligation is a business or a personal one. There are numerous exceptions to this general rule within the Internal Revenue Code (the Code), however, such as § 264, restricting interest paid in connection with purchasing insurance policies and § 265, restricting interest paid for funds used to purchase items producing tax exempt income. For a discussion of the history of the interest deduction see Berger, *Simple Interest and Complex Taxes*, 81 COLUM. L. REV. 217, 218 (1981).

or accrued" has given rise to a variety of transactions involving prepaid interest.[5] These transactions, in turn, have precipitated both litigation and congressional action. "Paid or accrued" refers to the taxpayer's usual method of accounting.[6] The most common methods of accounting are cash basis[7] and accrual basis.[8] A taxpayer using cash basis accounting usually will include an item as income in the tax year in which it actually was received and deduct an expense for the year in which it actually was paid.[9] A taxpayer using accrual basis accounting will include an item as income in the tax year in which it is earned even if it has not been received and will deduct an expense when the liability for it becomes fixed even if it has not been paid during the taxable year in question.[10]

A taxpayer must choose one method of accounting, although it may be a hybrid method, and must use that method consistently unless the Commissioner gives permission for a change.[11] Code section 446(b) specifically requires, however, that the method chosen "clearly reflect the income" of the taxpayer.[12] The closer the income earned in

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[5] *See generally* Gabinet, *The Interest Deduction: Several New Installments in a Continuing Saga*, 21 CASE W. RES. L. REV. 36 (1970); Kanter, *Interest Deduction: Use, Ruse, Refuse*, 46 TAXES 794 (1968). Basically, these are transactions in which a large amount of interest, not yet due, is paid before the end of the tax year to provide for an artificially large interest deduction to offset an unusually large income item.

[6] I.R.C. § 446(a)(1) (West 1978 & Cum. Supp. 1983); see *infra* note 12 for the text of this statute. A " 'method of accounting' includes not only the overall method of accounting of the taxpayer but also the treatment given any item." Treas. Reg. § 1.446-1(a)(1) (1981).

[7] The cash receipts and disbursements method of accounting is one in which income items are "included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made." *Id.*

[8] The accrual method is one in which "income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.446-1(c)(ii) (1981). Deductions under this method are allowed "for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy." *Id.*

[9] *See* A. PARKER, E. KRADER, S. LEIMBERG & M. SATINSKY, J. STANLEY & R. KILCULLEN'S FEDERAL INCOME TAX LAW § 461, at 8-23 (1983) [hereinafter cited as STANLEY & KILCULLEN].

[10] *Id.* at 8-27.

[11] I.R.C. § 446(e) (West 1978 & Cum. Supp. 1983). Cash method and accrual method are the most commonly used accounting methods. Other methods include the installment method and the hybrid method, which uses cash method for some items and accrual method for others. *See* STANLEY & KILCULLEN, *supra* note 9, at 8-21.

[12] I.R.C. § 446 (West 1978 & Cum. Supp. 1983). That section states, in part:

> (a) General rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
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> (b) Exception.—If no method of accounting has been regularly used by the taxpayer, or *if the method used does not clearly reflect income*, the computation of

a year is matched with the expenses incurred in earning that income, the nearer the taxpayer comes to the "clear reflection of income" standard, although absolute matching is not required.[13]

Under the accrual accounting method, the taxpayer's ability to derive a tax benefit from the timing of payments or receipt of income is limited. This method defines when a payment will be treated as having been made, or when income will be treated as having been received, even if the money has not actually changed hands at that time.[14] Although the accrual accounting method more accurately matches income with expenses, section 446(c)(1) specifically allows for the use of the cash accounting method.[15] Courts have upheld the use of the cash method provided it does not materially distort annual income,[16] and cash basis accounting continues to be supported because of its simplicity, administrative convenience, and correlation with the taxpayer's cash flow.[17] While cash basis accounting is an acceptable method, its use by taxpayers seeking prepaid interest deductions has led to much litigation.

Prepaid interest on indebtedness is deducted by an accrual basis taxpayer as it accrues, ratably over the period of the loan.[18] Prior to 1945, a taxpayer using cash basis accounting could deduct prepaid interest in the taxable year in which it actually was paid.[19] This method, however, had a considerable effect upon taxpayers whose income varied widely from year to year. In a year in which such a taxpayer had an unusually large income item, and thus was subject to an unusually large tax assessment, the taxpayer's tax liability could have been lowered dramatically by deducting a large interest prepayment on existing indebtedness, thereby offsetting the large income item. This practice of allowing a cash basis taxpayer to take a deduction for any prepaid interest in the year of payment gave the taxpayer complete control over the timing of the deduction, encouraging signif-

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> taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Id. (emphasis added).

[13] *See* Fort Howard Paper Co. v. Commissioner, 49 T.C. 275 (1967) ("clear reflection" requires as much accuracy as possible).

[14] *See supra* note 8.

[15] I.R.C. § 446(c) (West 1978 & Cum. Supp. 1983).

[16] *See* Simon v. Commissioner, 1947 T.C.M. (CCH) ¶ 47,009, at 40-47, *aff'd*, 176 F.2d 230, 233 (2d Cir. 1949).

[17] *See* S. REP. No. 938, 94th Cong., 2d Sess. (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439.

[18] *See* Treas. Reg. § 1.461-1(a)(2) (1981); Rev. Rul. 68-643, 1968-2 C.B. 76 (deduction allowed only in period in which money is used and only to extent of interest costs for that period).

[19] *See infra* note 42 and accompanying text.

icant distortion in the matching of income with the expenses incurred in earning that income.[20]

The success of taxpayers in finding ways to use prepaid interest as a tax shelter led to gradually increasing restrictions on interest deductions for the cash basis taxpayer,[21] which culminated in the enactment of section 461(g) as part of the Tax Reform Act of 1976.[22] This section provides that cash basis taxpayers who prepay interest may not currently deduct any portion of the interest properly allocated to later tax years.[23] Instead, the taxpayer must capitalize the prepaid interest and deduct it as it accrues over the period of the loan.[24] In *Zidanic* the Tax Court upheld this rule, holding that the nonrefundable nature of an interest prepayment does not remove it from the scope of section 461(g), and required the payment to be ratably allocated.[25]

Joseph A. Zidanic, a cash basis, calendar year taxpayer, filed his 1977 Federal Income Tax Return with the Service in Cincinnati, Ohio.[26] In April 1980 he received a notice of deficiency for the 1977 tax year in the amount of $47,560.[27] Zidanic withheld payment and

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[20] See Kanter, *supra* note 5, at 798-801, for a discussion of the effect of this ability to control timing. The tax advantage is most significant for a taxpayer with widely fluctuating income and substantial borrowing power. *Id.* at 798. An example of an unsuccessful attempt to shelter income in this manner is Resnik v. Commissioner, 555 F.2d 634 (7th Cir. 1977) (four-year interest prepayment made by partnership in existence for one day within tax year materially distorted partnership income for that tax year). *See also* Fort Pitt Brewing Co. v. Commissioner, 210 F.2d 6, 9 (3d Cir.), *cert. denied*, 347 U.S. 989 (1954) (taxpayer should not have undue control over timing of income or deductions).

[21] *See, e.g., infra* notes 54-59 and accompanying text; *see also* S. REP. No. 938, 94th Cong., 2d Sess. (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439 (discussing development of tax treatment of prepaid interest).

[22] I.R.C. § 461(g) (West 1978 & Cum. Supp. 1983).

[23] *Id.* For example, the interest on a loan extending from Dec. 27, 1982 to Dec. 27, 1983 would be only 5/365's deductible in 1982 and 360/365's deductible in 1983 (since those are the respective number of days for which interest charges would have been paid for use of borrowed funds in each of those years).

[24] *Id.* Capitalization is "record[ing] an expenditure that may benefit a future period as an asset rather than . . . treat[ing] the expenditure as an expense of the period of its occurrence." BLACK'S LAW DICTIONARY 191 (rev. 5th ed. 1979). The interest is also subject to other limitations in the Code such as § 163(d) (West 1978 & Cum. Supp. 1983) (limiting deductibility of investment interest), §§ 704(d) (West 1978 & Cum. Supp. 1983) and 465 (West 1978 & Cum. Supp. 1983) (limiting deductions to amount at risk), §§ 56 (West 1978 & Cum. Supp. 1983) and 57(b)(1) (West 1978 & Cum. Supp. 1983) (minimum tax assessment), and § 189 (West 1978 & Cum. Supp. 1983) (requiring capitalization of construction period interest).

[25] *Zidanic*, 79 T.C. at 655; *see supra* note 23 for example of ratable allocation.

[26] *Zidanic*, 79 T.C. at 652.

[27] *Id.* I.R.C. § 6212 (West 1978 & Cum. Supp. 1983) authorizes the sending of a notice of deficiency. Normally, before a notice of deficiency is sent, the following administrative process occurs: After completion of an audit, a dispute between a Service auditor and a taxpayer concerning a purported tax deficiency may be settled in a hearing before an appeals officer of the

brought suit in the Tax Court.[28]

The dispute concerned a building which Zidanic had purchased in 1977, using a non-recourse purchase money mortgage.[29] The lender, Third Federal Savings and Loan Association of Cleveland (Third Federal), was also the owner and sole occupant of the partially completed building.[30] No down payment was required; the loan principal was due in a lump sum one year after the closing date of the sale.[31] The purchase agreement, however, did require Zidanic to pay one year's interest on the loan at the closing of the sale.[32] When the sale was closed on October 18, 1977, Zidanic paid $92,375.33 to Third Federal, which treated the amount as income in that month.[33] Zidanic was not personally liable for the loan, and was not required to retain ownership of the building for the one year loan term.[34] Even if he sold the building within the year and paid off the loan, however, he was not entitled to any pro rata refund of the prepaid interest.[35]

Regional Commissioner's office. B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 1141, 1141-42 (1980). If no settlement is reached in this administrative appeal, a notice of deficiency is sent to the taxpayer pursuant to Code § 6212. *Id.* Although the *Zidanic* decision did not outline this procedure it is presumed that these steps occurred.

[28] *See supra* note 27. Upon receiving a notice of deficiency, the taxpayer may pay the disputed amount and sue for a refund in district court or the Court of Claims, or he may withhold payment and take the matter to Tax Court. *See* B. BITTKER & L. STONE, *supra* note 27, at 1141.

[29] *Zidanic*, 79 T.C. at 652. The original asking price was $1,500,000 and the final sale price was $1,150,000, with the mortgage for this full amount. A purchase money mortgage is defined as "[a] mortgage or security device taken back to secure the performance of an obligation incurred in the purchase of the property." BLACK'S LAW DICTIONARY 1111 (rev. 5th ed. 1979).

[30] Petitioner's brief at 2, *Zidanic*, 79 T.C. 651. The real estate in question was a five story office building in which 20-25% of the space was finished and occupied by Third Federal. *Id.*

[31] *Zidanic*, 79 T.C. at 652. Petitoner's brief indicates that, since there was no down payment, Third Federal requested the prepaid interest as a security device. Petitioner's brief at 3, *Zidanic*, 79 T.C. 651. *But see* Lewis v. Commissioner, 65 T.C. 625 (1975) (nonrefundable portion of prepaid interest payment treated as prepayment penalty and deductible as interest); Lawler v. Commissioner, 78 F.2d 567 (9th Cir. 1935) (prepayment treated as option).

[32] *Zidanic*, 79 T.C. at 652. Prior to the enactment of § 461(g), prepaid interest for not more than 12 months after the end of the tax year in which the payment was made would have been subject to a case by case analysis to determine its deductibility. *See infra* note 65.

[33] *Zidanic*, 79 T.C. at 652. Some reasons a seller may accept or encourage prepaid interest (ordinary income) rather than a higher sale price (capital gain) include the need to offset losses, the fact that the property sold may not have been held long enough to qualify for capital gain treatment, or the position of the seller as a tax exempt organization. *See* S. REP. No. 938, 94th Cong. (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439; *see also* Asimow, *Principle and Prepaid Interest*, 16 UCLA L. REV. 36, 42 (1969) (comprehensive examination of history and uses of prepaid interest deductions); Kanter, *supra* note 5, at 814.

[34] *Zidanic*, 79 T.C. at 653.

[35] *Id.* The question of refundability of prepaid interest has been important in several cases. *See, e.g.*, Sandor v. Commissioner, 536 F.2d 879 (9th Cir. 1976) (fully refundable prepaid interest treated as nondeductible deposit); Lewis v. Commissioner, 65 T.C. 620 (1975) (nonrefundable prepaid interest payment deductible).

Zidanic contended that the full amount of the interest paid should be deducted in the year of payment because of its nonrefundable nature.[36] The Service argued that the taxpayer should have allocated the payment between the two tax years involved, pursuant to section 461(g), and the Tax Court upheld the Service's position.[37]

Deductions for interest payments have been authorized by Congress throughout the history of the federal income tax.[38] Interest is defined most commonly as "compensation for the use or forbearance of money."[39] An interest deduction was first mentioned specifically in 1864.[40] By 1870 the deduction was limited by the requirements that the interest not be accrued and that any nonbusiness-related interest be offset against and limited to the amount of the taxpayer's interest income.[41] Code revisions in 1894 authorized interest deductions for both corporate and individual taxpayers, whether the interest was paid during the tax year or accrued.[42]

The present Code states that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."[43] In 1939 the Board of Tax Appeals,[44] in the leading case of *Fackler v. Commissioner*,[45] interpreted similar language as allowing the current deduction of prepaid interest by a cash basis taxpayer. In *Fackler*, more than $8,300 of a $46,900 interest payment was attributable to a later tax year.[46] The payment clearly had a business purpose: it transformed a demand note into a "time note which could not be called during the time for which the interest was prepaid."[47] In

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[36] *Zidanic*, 79 T.C. at 654.

[37] *Id.* at 655; see *supra* note 1 for text of Code § 461(g).

[38] *See* Berger, *supra* note 4 (thorough history of interest deduction). A provision allowing for the deduction of "all interest paid or accrued on indebtedness" was adopted in 1918, and identical language appears in the current Code. *Compare* Revenue Act of 1918, ch. 18, § 214(a)(2), 40 Stat. 1057 (1919) *with* I.R.C. § 163(a) (West 1978 & Cum. Supp. 1983).

[39] United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965) (quoting Deputy v. duPont, 308 U.S. 488, 498 (1940)); *see* Kanter, *supra* note 5, at 804-08, for a discussion of other possible characterizations of payments ostensibly defined as "interest," such as options, deposits, or down payments; *see also* La Croix v. Commissioner, 61 T.C. 471 (1974) (payment held to be deposit rather than interest).

[40] *See* Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223 (amended by Act of March 3, 1865, ch. 78, § 1, 13 Stat. 469) ("[W]hen any person . . . pays interest upon any actual incumbrance . . . the amount actually paid for . . . interest shall be deducted.").

[41] *See* Act of July 14, 1870, ch. 255, § 9, 16 Stat. 256 (repealed 1872) ("[T]here shall be deducted from the . . . income of any person . . . the amount of interest paid during the year.").

[42] *See* Tariff Act of 1894, ch. 394, 28 Stat. 509 (repealed 1895) ("In computing incomes . . . shall be deducted . . . all interest due or paid within the year . . . on existing indebtedness."); *see also* Berger, *supra* note 4, at 219-20.

[43] I.R.C. § 163(a) (West 1978 & Cum. Supp. 1983).

[44] Prior to 1942 the Tax Court was known as the Board of Tax Appeals.

[45] 39 B.T.A. 395 (1939), *acq.*, 1939-1 C.B. 11, *acq. withdrawn*, 1968-2 C.B. 76.

[46] *Id.*

[47] *Id.*

addition, it reduced interest on the indebtedness from five percent to three percent.[48] The court based its approval of the deduction on two factors. First, a deduction for an actual payment of a deductible expense by a cash basis taxpayer must be allowed in the year paid unless the cash basis accounting method does not clearly reflect income. A deduction for postpaid interest would be allowed in the year paid, and prepaid interest does not distort income any more than postpaid interest. Therefore, the deduction for prepaid interest should also be allowed.[49] Moreover, disallowing a current deduction for prepaid interest would place a cash basis taxpayer on an accrual basis for only that item, but hybrid accounting systems were not permitted in 1939.[50]

The Commissioner argued in *Fackler* that the Code required the taxpayer's method of accounting to reflect income clearly, that the current deduction of a prepaid interest expense by a cash basis taxpayer distorted income, and that the Code therefore authorized the Commissioner to require a change in accounting methods as to that item.[51] Four years later, in *Court Holding Co. v. Commissioner*,[52] the court was presented with the same issue. In both cases the court rejected the argument and allowed the deduction. The Service acquiesced in the court's allowance of a current deduction for prepaid interest by a cash basis taxpayer, but limited the deduction to a five year prepayment by issuing Income Tax Ruling 3740 in 1945.[53]

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[48] *Id.* at 396.

[49] *Id.* at 398.

[50] *Id.* at 399. At that time, the accounting method had to be either cash or accrual; no hybrids were allowed. Code § 446(c) now expressly permits hybridization:

> (c) Permissible methods.—subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—
> (1) the cash receipts and disbursements method;
> (2) An accrual method;
> (3) Any other method permitted by this chapter; or
> (4) Any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

I.R.C. § 446(c) (West 1978 & Cum. Supp. 1983).

[51] *Fackler*, 39 B.T.A. at 398-99.

[52] 2 T.C. 531 (1943), *acq.*, 1943 C.B. 5, *acq. withdrawn*, 1968-2 C.B. 76.

[53] I.T. 3740, 1945 C.B. 109 (1945). The Ruling states in part:

> It is held that where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disbursements basis, interest paid in advance for a period of five years constitutes an allowable deduction for Federal income tax purposes for the year in which paid.

Id.

Despite the apparent simplicity of Income Tax Ruling 3740, litigation continued as taxpayers explored its limits.[54] The "Livingstone" cases, named after the promoter of the artificial indebtedness scheme involved therein, articulated the requirement that the indebtedness underlying the interest deduction be an actual indebtedness, not just a "sham" paper transaction in which no indebtedness actually occurred.[55] *Goldstein v. Commissioner*,[56] as well as its companion cases, *Ippolito v. Commissioner*[57] and *Barnett v. Commissioner*,[58] emphasized the requirement of an economic purpose in incurring the indebtedness apart from obtaining an interest deduction. In all three cases the taxpayers had incurred indebtedness specifically to obtain a prepaid interest deduction with which to offset a large award of prize money received in that year, and in each case the Court of Appeals for the Second Circuit disallowed the interest deduction.[59]

While invalidating these deductions, the court seemed to reaffirm the deductibility of prepaid interest by the cash basis taxpayer in the year of payment, as long as the loan transaction was not a "sham," and had some economic purpose other than obtaining the interest deduction.[60] The availability of this deduction led to a dramatic expansion of its use in real estate transactions.[61] In his article "Principle and Prepaid Interest,"[62] Professor Asimow extensively discussed the tremendous impact of this deduction on the real estate industry in Southern California in the 1960's. A high income taxpayer could easily and openly purchase property in a transaction specifically designed to

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[54] *See* Gabinet, *supra* note 5 (discussion of progression of cases leading to withdrawal of I.T. 3740, 1945 C.B. 109 (1945)); Kanter, *supra* note 5.

[55] *See, e.g.*, Goodstein v. Commissioner, 30 T.C. 1178 (1958), *aff'd*, 267 F.2d 127 (1st Cir. 1959). Livingstone conceived of a scheme in which a loan was purportedly made to Goodstein for the purchase of $10,000,000 of U.S. Treasury notes, but no money other than a $15,000 down payment changed hands. *Id.* at 1179-80. The notes were bought and resold within an hour and the remainder of the transaction consisted of "paper shuffling" to make the transaction appear more substantial. *Id.* at 1179-88. The Tax Court denied Goodstein's deduction of prepaid interest on the illusory $10,000,000 loan. *Id.* at 1190.

[56] 364 F.2d 734 (2d Cir. 1966) (not sham transaction, but no "purposive activity" in incurring indebtedness other than tax deduction), *cert. denied*, 385 U.S. 1005 (1967).

[57] 364 F.2d 744 (2d Cir. 1966) (interest deduction disallowed for Dec. 23rd loan repaid 25 days later), *cert. denied*, 385 U.S. 1005 (1967).

[58] 364 F.2d 742 (2d Cir. 1966) (per curiam) (interest deduction disallowed for Dec. 20th loan repaid on Jan. 20th).

[59] *See Goldstein*, 364 F.2d at 736-37; *Ippolito*, 364 F.2d at 743; *Barnett*, 364 F.2d at 745-46.

[60] *Id.*

[61] *See* Kanter, *supra* note 5, at 813-18.

[62] *See* Asimow, *supra* note 33.

give rise to a prepaid interest deduction.[63] In a typical transaction, a taxpayer purchased property with no down payment, but prepaid interest for five years. No principal payments were due until the sixth year, after which the taxpayer agreed to make principal and interest payments yearly until the tenth year, during which a balloon payment was due. By the time a payment on principal was due, the taxpayer very likely could sell the appreciated property and obtain a capital gain while limiting both his cash outlay and his risk of economic loss.[64]

In response to this expanded use of prepaid interest as a tax shelter, the Commissioner in 1968 withdrew Income Tax Ruling 3740 and issued Revenue Ruling 68-643.[65] This Ruling provided for a presumption of material distortion of income for interest prepaid for a period of more than twelve months after the end of the tax year in which the payment was made.[66] Payments for less than twelve months might be deductible, but such determinations were to be made on a case by case basis. Prepaid interest deductions not currently deductible under Revenue Ruling 68-643 were required to be accrued over the period of the loan.[67]

The Tax Court held in *Sandor v. Commissioner*[68] that the Commissioner had the authority under section 446(b) to adjust accounting

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[63] Advertisements for the sale of real estate featured the availability of prepaid interest terms as part of the transaction. A large percentage of land sales, especially in California, were of this nature. *Id.* at 37-38.

[64] *Id.* at 37-41.

[65] Rev. Rul. 68-643, 1968-2 C.B. 76, 77 states, in part:

> A deduction for interest paid in advance [by a cash basis taxpayer] on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made will be considered on a case by case basis to determine whether a material distortion of income has resulted . . . . If interest is prepaid for a period extending more than 12 months beyond the end of the current taxable year, the deduction of such prepaid interest in the taxable year of payment will be considered as materially distorting income. Where a material distortion of income has been found . . . the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest in order to allocate it over the taxable years involved.

Id.

[66] The presumption of material distortion permitted the Commissioner, through the power granted him by Code § 446(b), to require the accrual of the interest over the term of the loan. I.R.C. § 446(b) (West 1978 & Cum. Supp. 1983). For arguments against Rev. Rul. 68-643, see Gabinet, *supra* note 5, at 472-76. For arguments in favor of the revenue ruling, see Asimow, *supra* note 33, at 50-57.

[67] Rev. Rul. 68-643, *supra* note 65. Factors considered in determining whether income was materially distorted included the taxpayer's income in the current and previous taxable years, the amount of prepaid interest, the time of payment, the reason for prepayment, and the existence of varying rates of interest over the term of the loan.

[68] 62 T.C. 469 (1974), *aff'd*, 536 F.2d 874 (9th Cir. 1976).

methods to reflect income clearly, and thus the authority to issue Revenue Ruling 68-643.[69] The court also held that the facts in *Sandor* justified the conclusion that the deduction of interest prepaid for more than twelve months after the end of the tax year resulted in material distortion of income.[70] While other courts have reached the same result,[71] the Tax Court has stated repeatedly that these results do not constitute judicial approval of the Revenue Ruling per se.[72] The *Sandor* court specifically suggested that, since the Ruling was advisory only and not binding on the court, the Service might be required to prove material distortion of income, rather than relying on the presumption stated in the Ruling, even in cases involving prepaid interest of more than twelve months.[73]

To halt the conflict between the Service and the courts which resulted in constant litigation over prepaid interest, Congress enacted section 461(g) as part of the Tax Reform Act of 1976.[74] In enacting section 461(g), Congress apparently concluded that there is no compelling argument for treating cash method taxpayers differently from accrual method taxpayers for the purpose of prepaid interest deductions.[75] The lawmakers cited as the impetus for the change the need to stem abuses of prepaid interest deductions as a tax shelter by cash method taxpayers, especially those in high tax brackets.[76] Congress also saw a need to decrease prepaid interest litigation and to make deductibility more predictable than it could be when decided in a case by case fashion.[77]

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[69] *Id.* at 479. "[T]here is no reason to doubt . . . the right of the Commissioner to disallow a deduction for prepaid interest on the basis that it did not clearly reflect income." *Id.* In addition, the *Sandor* court traced the case law development supporting the Commissioner's § 446(b) discretion. *Id.* at 476-77.

[70] *Id.* at 481.

[71] *See, e.g.*, Anderson v. Commissioner, 568 F.2d 386 (5th Cir. 1978); Resnik v. Commissioner, 66 T.C. 74 (1976), *aff'd*, 555 F.2d 634 (7th Cir. 1977); Burck v. Commissioner, 63 T.C. 556 (1975), *aff'd*, 533 F.2d 768 (2d Cir. 1976); Cole v. Commissioner, 64 T.C. 1091 (1975), *aff'd*, 586 F.2d 747 (9th Cir. 1978), *cert. denied*, 441 U.S. 924 (1979).

[72] *Sandor*, 62 T.C. at 481-82; Cole v. Commissioner, 64 T.C. 1091, 1104 (1975).

[73] *Sandor*, 62 T.C. at 481-82.

[74] Tax Reform Act, 26 U.S.C. § 461 (1976); *see supra* note 1 for text of Code § 461(g).

[75] S. Rep. No. 938, 94th Cong., 2d Sess. (1976), *reprinted in* 1976 U.S. Code Cong. & Ad. News 3439. The committee report notes that simplicity and avoidance of complex records are the primary benefits of the cash method, but that requiring use of the accrual method in prepaid interest transactions does not create undue complications since the loan agreement itself constitutes a sufficient record to allow for accurate allocation of prepaid interest.

[76] *Id.* at 3538.

[77] *Id.* at 3539. The Senate report notes that:

> [A] deduction of prepaid interest by the same taxpayer might be allowed in one year and perhaps not in another year. Also, prepaid interest might be deductible by one taxpayer who has a large amount of income in a given year after the deduction (so

The *Zidanic* court did not consider the deductibility of the interest prepayment itself, but only whether the interest deduction should be taken when paid, or prorated over the term of the loan.[78] The parties agreed that the $92,375 paid by Zidanic represented interest,[79] and that no additional interest was due during the first year of the loan.[80] Although no part of this interest payment would have been refunded if the loan principal had been paid before it was due,[81] Judge Sterrett noted that the interest payment was computed on the basis of a full year and held that it must be allocated over that period.[82]

The court reviewed the congressional intent underlying section 461(g), and determined that the purpose of that section was "to prevent cash basis taxpayers from deferring taxes on their other sources of income by prepaying interest."[83] The court noted that permitting a taxpayer to escape the effects of section 461(g) merely by designating the prepaid interest as nonrefundable would undermine that purpose, and so held that Zidanic could not deduct the full amount of the interest in the year in which it was paid.[84]

Zidanic illustrates the Tax Court's intent to strictly interpret section 461(g) when considering attempts by high income taxpayers to use prepaid interest deductions as a tax shelter. While prepaid interest

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> that the deduction arguably does not "distort" his income) but possibly not be deductible by another taxpayer who has little or no taxable income after taking the deduction.

Id.

[78] *Zidanic*, 79 T.C. at 652.

[79] *Id.* at 654. Interest prepayments also have been characterized as down payments, options, or, if refundable, as deposits. *See* Kanter, *supra* note 5, at 804-08.

[80] *Zidanic*, 79 T.C. at 654-55.

[81] *Id.* at 653. One commentator has suggested that refundability of a prepaid interest payment might be critical to a finding that it is not deductible. *See* Asimow, *supra* note 33, at 72; *see also* Lewis v. Commissioner, 65 T.C. 625 (1975) (refundable portion of prepaid interest not deductible).

[82] *Zidanic*, 79 T.C. at 655. Zidanic's interest payment was made for the 12 month period from Oct. 15, 1977 to Oct. 15, 1978. The court found that only the interest allocable to the period from Oct. 15 through Dec. 31, 1977 was deductible in tax year 1977, and that the balance could be deducted only in the following tax year. *Id.*

[83] *Id.* In so finding, the court relied on part of the legislative history which stated that "Congress believed that the creation of a tax shelter with prepaid interest could not be justified even under the cash method of accounting." JOINT COMM. EXPLANATION OF TAX REFORM ACT OF 1976, 94th Cong., 2d Sess., *reprinted in* 1976-3 C.B. 97 [hereinafter cited as JOINT COMM. EXPLANATION]. The committee also noted that "prepaid interest has been extensively used in many types of tax shelters to defer tax on income which would otherwise be taxable in higher marginal tax brackets." *Id.* at 98; *see also* Berger, *supra* note 4, at 237 n.142 and accompanying text.

[84] *Zidanic*, 79 T.C. at 655.

transactions serve to minimize a buyer's cash outlay and risk of financial loss,[85] they have been especially effective in balancing an income that varies widely from year to year.[86] For example, a taxpayer could use a prepaid interest deduction during a year in which his income was unusually high, and include as income a prepayment refund during a year in which his income was significantly lower, thus minimizing the tax disadvantages of such fluctuations.[87] Even if the prepaid interest is not refundable, taking the prepaid interest deduction in one tax year and including the income or appreciation from an asset in a different tax year benefits a taxpayer whose income fluctuates widely. The *Zidanic* court's strict interpretation of section 461(g) as requiring the accrual of prepaid interest payments effectively eliminates the tax benefits of these transactions.[88]

Section 461(g) does not, however, extend to postpaid interest.[89] Taxpayers could thus create a tax shelter by paying interest in a year later than that to which it is properly allocable. Although it is possible to do some balancing of income between tax years by postpaying interest,[90] it seems that taxpayers usually prefer a current deduction to a deferred one. In addition, lenders may be reluctant to defer receipt of the payment. If postpaid interest becomes a problem, the Service could use section 446 to require a change in accounting methods for

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[85] *See* Asimow, *supra* note 33, at 39 (chart comparing cash flow for conventional financing and prepaid interest financing; prepaid interest financing requires less out of pocket expenditures by taxpayer throughout entire investment period).

[86] *Id.* at 40. Any attempted use of prepaid interest transactions is subject to thorough scrutiny, however, especially concerning whether there is *bona fide* indebtedness and whether the transaction had any purpose other than tax avoidance. *See, e.g.*, *Ippolito*, 364 F.2d at 746; *Goldstein*, 364 F.2d at 740.

[87] The use of prepaid interest transactions to balance widely fluctuating yearly incomes was especially advantageous prior to 1982, when the taxpayer in the highest tax bracket was taxed at a rate of 70%, rather than the current rate of 50%. *See* I.R.C. § 1 (West 1978 & Cum. Supp. 1983) (as amended by the Economic Recovery Tax Act of 1981, § 101).

[88] *See* Berger, *supra* note 4, at 236 (example of prepaid interest transaction in partnership context). Another commentator has noted that "there is usually no business purpose for making a prepayment of interest rather than a down payment of principal." Asimow, *supra* note 33, at 72 n.173.

[89] See *supra* note 1 for text of Code § 461(g).

[90] For example, the taxpayer can increase the promissory note by the amount of principal due plus the accrued interest liability in order to postpone the deduction until a later tax year. Merely increasing the primary debt obligation is not considered "payment" by a cash basis taxpayer. Thomason v. Commissioner, 31 B.T.A. 576 (1935). This strategy might be used when a taxpayer has more deductions than income in a given year. *See also* Kanter, *supra* note 5, at 798-800.

that particular item.[91] As an alternative, Congress could amend section 461(g) to include postpaid interest.

Another way to circumvent the effects of section 461(g) might be to use the statutory exception it creates for the deduction of "points" paid in the purchase of the taxpayer's residence.[92] This, however, affords little opportunity for use as a tax shelter,[93] since the exception is carefully limited by requiring (1) that the granting of points be an established business practice in the area where the residence is purchased; (2) that the number of points be limited to those generally charged in that area; and (3) that the indebtedness be secured by the taxpayer's principal residence.[94] "Principal residence" implies one per taxpayer, and thus the possibility for abuse is extremely limited.[95]

The absolute ban of section 461(g) on the current deduction of prepaid interest by a cash basis taxpayer will thus almost certainly be effective in eliminating the use of prepaid interest as a tax shelter. In many prepaid interest transactions the "interest" expense is not really interest, and therefore is not properly a section 163(a) interest deduction.[96] The courts have recognized this and have suggested that such prepayments could be seen as deposits,[97] down payments,[98] options,[99]

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[91] See *supra* note 12 for text of Code § 446; *see also* Asimow, *supra* note 33, at 58 (describing Commissioner's use of § 446 power to alter accounting method for prepaid interest).

[92] *See* JOINT COMM. EXPLANATION, *supra* note 83, at 102 ("Points are additional interest charges which are usually paid when a loan is closed and which are generally imposed by the lender in lieu of a higher interest rate.").

[93] *See* Code § 461(g)(2), *supra* note 1 (allowing current deduction of points subject to certain conditions). Note, however, that points also can be a substitute for financing fees, commitment fees, or service fees, and as such may not be deductible as interest. *See generally The Deductibility of Commitment Fees, Financing Fees and Points*, 31 TAX LAW. 888 (1978) (discussing factors influencing deductibility as interest of these fees incurred in securing loan).

[94] *See* Code § 461(g)(2), *supra* note 1. The legislative history explains the rationale behind the enactment of subsection (2) as follows:

> Where points are paid as compensation for the use of borrowed money (and thus qualify as interest for tax purposes) rather than as payment for the lender's services, the points are substituted for a higher stated annual interest rate. As such, points are similar to a prepayment of interest and under the Act are generally to be treated as paid over the term of the loan.

JOINT COMM. EXPLANATION, *supra* note 83, at 102.

[95] See Treas. Reg. § 1.1034-1(c)(3) (1981) for a discussion of the factors used to determine the location of a taxpayer's principal residence.

[96] For example, if a loan is for $1000 at 10% interest, with the principal payable at the end of a 10 year term, and the borrower prepays the interest, in essence the loan is for $900 at slightly more than 10% interest, and all the interest will be paid at the end as part of the "principal."

[97] *See* La Croix v. Commissioner, 61 T.C. 471, 480 (1974).

[98] *Id.*

[99] *See* Lawler v. Commissioner, 78 F.2d 567 (9th Cir. 1935).

or discounted loans.[100] Since section 461(g) prevents the current deduction of prepaid interest, the incentive for characterizing deposits, down payments, and other financial arrangements as interest is minimized. This should significantly decrease litigation in this area.

One commentator suggests that Congress enacted section 461(g) in response to an emerging disagreement between the Service and the Tax Court concerning the interpretation of Revenue Ruling 68-643.[101] If so, section 461(g) goes further than did either the Revenue Ruling or the Tax Court decisions in restricting prepaid interest deductions. It not only closes tax loopholes, but also hinders cash basis taxpayers who are legitimately attempting to match income with expenses incurred in earning that income.

A cash basis taxpayer who, for example, negotiates a loan for a ten year period might invest the money with the expectation that the benefits also will accrue over that period. If, instead, he receives an unexpectedly high income from that investment midway through the loan period, he may want to deduct some of the cost of producing that income by prepaying interest.[102] Under these circumstances, allowing a deduction of the prepaid interest would give the taxpayer the flexibility to make sound business decisions without being penalized for using the cash method of accounting. A cash basis taxpayer is also penalized when prepaid interest is used primarily to secure more favorable loan terms, as was done by the taxpayer in *Fackler*,[103] or when he regularly prepays interest in advance as part of periodic loan payments.

A law that absolutely requires the accrual of prepaid interest by a cash basis taxpayer may decrease litigation and limit tax shelters, but it also seems implicitly to deny the validity of cash basis accounting for all but the most unsophisticated taxpayer. If this is the view of Congress, then section 446 should be changed to reflect that understanding. If not, then section 461(g) should permit a prepaid interest deduction in routine business transactions made for bona fide business purposes and possibly in nonbusiness transactions where the deduction is *de minimis*, and the prepayment is not for the purpose of sheltering income.

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[100] *See* Bartolme v. Commissioner, 62 T.C. 821 (1974).

[101] *See* Berger, *supra* note 4, at 237.

[102] Growing client-based service businesses such as law firms and advertising agencies may find themselves receiving unexpectedly large income from their investment early in the loan period. Although the taxpayer could use the funds to pay off the loan, he might prefer to reinvest the money in his business by retaining the loan, since it is probably at a more favorable interest rate than he could presently secure.

[103] *See supra* text accompanying notes 44-50.

To discourage improper use of the deduction, a formula could be used which allows for only partial current deduction depending on the length of time covered by the prepayment. For example, the loan term could be divided into tenths. A payment due in the final tenth, but made in the preceding tenth, would be ninety-six percent currently deductible with the other four percent accrued over the remaining life of the loan. If the same interest was prepaid in the eighth of the ten loan periods it would be ninety-two percent currently deductible; if made in the seventh loan period it would be eighty-eight percent currently deductible, and so forth. The extreme would be tenth period interest prepaid in the first period; that would be sixty-four percent currently deductible, with the remaining thirty-six percent accrued over the balance of the loan period. Naturally, any interest paid when due would be one hundred percent deductible if not restricted by other Code sections.

Allowing the current deduction of a portion of prepaid interest, when used to offset income produced specifically with the borrowed funds, would leave some latitude for sound business planning, while still curtailing use of the deduction as a tax shelter. In the formula outlined above, the further in advance a prepayment of interest was made, the smaller the portion of the prepayment that would be currently deductible. This relationship would discourage abuse of the deduction since prepayment of interest well in advance of its due date would, like section 461(g), have the effect of allocating the prepaid interest over the remaining life of the loan. The desired matching of income with expenses incurred in producing that income is encouraged by requiring that the income being offset by the deduction be income produced by the use of the borrowed funds on which the interest was prepaid.[104]

While it is clear that the prepaid interest deduction was being exploited by taxpayers to shelter income,[105] it also was being used in routine business transactions with legitimate business purposes.[106] The rigid elimination of the use of prepaid interest deductions by cash basis taxpayers, mandated by section 461(g), coupled with the strict interpretation of that statute by the Tax Court in *Zidanic*, restricts not only the abuse of the deduction but also its legitimate business use. A formula such as the one discussed above, which allows a partial

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[104] *See supra* notes 11-13, 15-17 and accompanying text.

[105] *See supra* text accompanying notes 61-64.

[106] *See supra* text accompanying notes 44-47.

current deduction of prepaid interest expenses on borrowed funds when used to offset income produced specifically by those funds allows the taxpayer some latitude in matching income with the cost of producing that income. Were such a formula employed, cash basis accounting would remain a valid option for the business taxpayer.

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