Material Distortion of Income: A New Approach?

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Note

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I. INTRODUCTION

The history of the dispute over the proper timing of prepaid interest deductions by a cash basis taxpayer has been one of abrupt changes of position by the courts and the Internal Revenue Service ("Service"). The United States Tax Court's recent decisions in S. Rex Lewis¹ and Lewis's twin case Jackson B. Howard² continue this practice by taking an approach different from what was felt³ to be an essentially correct position set out in Revenue Ruling 68-643.⁴ Lewis and Howard establish as the prepaid interest deduction standard a deposit distortion test, thus marking a change from the approach used in previous prepaid interest case law.

The purpose of this note is threefold: 1) to give a brief history of the law in the prepaid interest area; 2) to discuss the facts and the court's analysis in S. Rex Lewis; and 3) to discuss the effect the case will have on prepaid interest deductions.

II. BACKGROUND AND HISTORY OF PREPAID INTEREST DEDUCTIONS

The starting point for the dispute over the cash basis taxpayer's timing of his interest deduction is section 163 of the Internal Revenue Code of 1954 ("Code") and the substantially identical provisions of the 1939 Code.⁵ Section 163(a) straightforwardly

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1. 65 T.C. 625 (1975).
2. P-H Tax Ct. Mem. ¶ 76,005 (1976). Howard involved Mr. Lewis's law partner and fellow real estate investor. Since the facts are the same for both cases, and since Howard was resolved in accordance with the opinion rendered in Lewis, this note will discuss only the Lewis case. However, a reference to the Lewis' case is also a reference to the Howard case in most circumstances.
5. INT. REV. CODE OF 1939, § 23(b).
states: “There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.”\(^6\) The Code does not provide a definition of interest, but the term has been held by the courts and the Service to mean “the amount which one has contracted to pay for the use, forbearance, or detention of money.”\(^7\) As long as the deduction arises from a genuine indebtedness\(^8\) and cannot be construed as a repayment of principal instead of interest,\(^9\) the interest deduction will generally be allowed.

Because of the broad scope of the statute\(^10\) and because of the cash basis taxpayer’s control over the timing of the deduction through his choice of the tax year in which he will pay the interest charge, section 163 presents him with a tempting tax planning device. If the taxpayer has a year in which his income is unusually high, he can shelter some of it by electing to prepay interest in that year.\(^11\) Likewise, prepaid interest may be a useful leverage tool, allowing the taxpayer to use largely tax deductible dollars to finance speculative land purchases with little or no downpayment.\(^12\)

A taxpayer foreseeing the need for a deduction in the year following the one in which the interest accrues may wish to delay payment until that following year. Whatever the tax planning device consists of, the brevity of section 163(a) and the accompanying regulation\(^13\) seemingly could be construed to authorize its use by the cash basis taxpayer.

However, again because of the nature of section 163(a) itself, the law of prepaid interest depends primarily on the positions taken

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\(^6\) Int. Rev. Code of 1954, § 163 (a) [hereinafter cited as Code].
\(^7\) Old Colony R.R. v. Commissioner, 284 U.S. 552 (1932); cf. Deputy v. Dupont, 308 U.S. 488 (1940); Rev. Rul. 72-315, 1972-1 Cum. Bull. 49. The Code also provides several limitations on the amount of the interest deduction. See, e.g., Code § 264 (interest incurred in connection with life insurance contracts); § 265 (interest arising in connection with tax-exempt interest income); and § 269 (interest deduction arising in connection with corporate acquisitions).
\(^8\) Knetsch v. United States, 364 U.S. 361 (1960).
\(^10\) For a discussion of the broad scope, see Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff’d on other grounds, 44 T.C. No. 284, (1965), vacating 23 CCH Tax Ct. Mem. 1651 (1964).
\(^12\) Asimow, supra note 3, at 41; Kanter, supra note 11, at 813-14; Roulac, Financing Ideas: The Economics of Prepaid Interest, 2 Real Estate L.J. 598 (1973). This role for prepaid interest is perhaps the most popular.
by the courts rather than on the words of the statute. As evidenced by the following discussion of the cases, these positions have been subject to rather abrupt change.

A. Pre-1968

One of the first cases to deal with prepaid interest was R. L. Blaffer, a 1937 memorandum decision by the Board of Tax Appeals. In Blaffer a "cash receipts and disbursement" taxpayer had deducted from his gross income in 1932 interest amounting to $18,675 due on March 31, 1933, but which he prepaid on December 31, 1932. The court stated:

Clearly, the item in controversy is in the nature of prepaid expense, which pertained to the earning of income in 1933, and to allow it as a deduction in 1932 would distort the income for that year, whether the taxable income be computed on the basis of cash receipts and disbursements or by the accrual method.

The court allowed the Commissioner to use his section 41 authority to recompute the taxpayer's net income and avoid its distortion.

The Blaffer ruling was changed radically only two years later when the leading case of John D. Fackler was decided by the Board of Tax Appeals. The taxpayer in Fackler was allowed to deduct the 1935 and 1936 interest he prepaid in 1934 because:

... distortion of the petitioner's income would not result here from the deduction of this prepaid interest payment any more than it would from the payment of one of the current taxable years for interest covering an elapsed period of more than those years.

The court held that imposing the accrual method for a single accounting item when the taxpayer was on the cash basis method as to the remaining items was not allowable. It neither explicitly distinguished nor overruled the Blaffer prepaid expense approach,

15. Earlier cases than Blaffer dealing with prepayments may be found. However, in those cases the prepayments were not characterized as interest, but as capital expenditures. This eliminates these cases from this note's consideration, because even under the cash basis method of accounting, capital expenditures must be allocated over the life of the asset created. See, e.g., Oscar G. Joseph, 32 B.T.A. 1192 (1935); Julia Stow Lovejoy, 18 B.T.A. 1179 (1930); Evalena M. Howard, 19 B.T.A. 865 (1930); J. Alland & Bros., Inc., 1 B.T.A. 631 (1925).
17. INT. REV. CODE OF 1932, § 41.
19. Id. at 398.
but did make a point of the fact that the taxpayer's prepayments had a valid business purpose since they transformed a demand note into a time note which could not be called during the time covered by the prepayment and also secured a reduction in the interest rate from five per cent to three per cent.

The distortion of income theory and the theory that prepayment created an asset that should have been capitalized, both of which had been advocated by the Commissioner and followed by the Blaffer court, were thus apparently disapproved by Fackler. The court's holding that there was no distortion, at least in comparison to postpaid interest, and that there could be no capitalization of what was found to be a business expense laid the foundation for an era in which prepaid interest was an integral part of many tax shelters.

Despite the holding of the Fackler case and ruling in Court Holding Company in 1943, which again upheld a cash basis taxpayer's right to deduct a prepayment of interest, the cautious tax planner at that time would not have been prepared to recommend prepayment of interest as a tax planning device for large transactions, because the major cases dealt only with short prepayment periods, small amounts, and, at least in Fackler, a business purpose.

But the proverbial dam broke in 1945 with the issuance of Income Tax Unit Ruling ("I.T.") 3740 which stated:

.. [W]here 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, but where the accrual basis of accounting is used in reporting income, interest is deductible for the year in which the liability to pay accrues regardless of when payment is actually made.

The ruling effectively opened the door for long-term prepaid interest deductions of apparently unlimited amounts. Several cases upheld the ruling, although various methods were used by the courts to disallow the deduction when the payment had no economic reality except to gain a tax benefit. These affirmative

20. 2 T.C. No. 531 (1943).
24. Bridges v. Commissioner, 325 F.2d 180 (Ct. Cl. 1969) (sham transaction); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (interest has no purpose or substance apart from the tax consequences).
judicial precedents coupled with I.T. 3740 firmly established the prepaid interest deduction as a tax planning device that was to be abused by overzealous tax planners. In Kapel Goldstein the court responded to these abuses and tolled the death knell of I.T. 3740 by declaring:

The rule is well established that prepaid interest is deductible by a cash basis taxpayer in the year payment is made, even though it covers a period or periods extending beyond the current year of payment . . . . The rule appears to be contra where the amount prepaid is for insurance . . . or for rent . . . . The courts, in the above cases, have held that where a cash basis taxpayer prepays rent or insurance, he must prorate deductions with respect to such prepayment. The rule thus applicable to prepaid rent and insurance seems to be based on much more persuasive logic than that with respect to prepaid interest; and if 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 benefited. 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.

Although the Goldstein memorandum decision was withdrawn and decided on other grounds, on appeal from the Tax Court's revised decision, the Second Circuit stated that the interest deduction was not available unless the transactions had "purpose, substance or utility apart from their anticipated tax consequences." "Mixed motives" were required.

Because of cases like Goldstein, the usefulness of the prepaid interest device in tax planning had gradually declined from its I.T. 3740 utility. And it became totally vulnerable with the issuance of Revenue Ruling 68-643 in 1968.

B. Revenue Ruling 68-643

Revenue Ruling 68-643, as amplified by Revenue Ruling 69-582, revoked I.T. 3740 after nearly a quarter century of service.

25. The famous Livingstone cases, named for the tax planner involved in the separate cases, illustrate the fatal attractiveness and abuse of I.T. 3740. For a list of the Livingstone cases, see those cited in Brown v. United States, 396 F.2d 459, 462-63 (Ct. Cl. 1968). See also Rev. Rul. 68-643, 1968-2 CUM. BULL. 76.


27. Id. at 1659.


and also withdrew the acquiescences in *Fackler* and *Court Holding Company*. Reacting to the abuses that had grown out of I.T. 3740 and with cognizance of the Tax Court's withdrawn decision in *Goldstein*, the Service promulgated a new set of rules involving prepaid interest deductions by adopting the theory that the prepayment could lead to a distortion of income. If this occurred, the deduction would be disallowed pursuant to the Commissioner's authority under section 446(b) to change the taxpayer's method of accounting if such method does not clearly reflect income. Prepayment of interest for a period beyond the end of the taxable year succeeding the year of prepayment would be automatically disallowed as a distortion of income.\(^{32}\)

In situations where the twelve month rule was not violated, the Service concluded that the distortion of income issue had to be analyzed on a case-by-case basis, stating:

> Some of the factors to be considered in determining whether the deduction of prepaid interest gives rise to a material distortion of income include but are not limited to the amount of income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason for prepayment, and the existence of a varying rate of interest over the term of the loan.\(^{33}\)

With the state of the prepaid interest art thus having made a 180 degree turn from *Fackler* and I.T. 3740, two issues arose in subsequent challenges to Revenue Ruling 68-643: 1) whether the Commissioner had the authority to exercise the discretion given him in Revenue Ruling 68-643; and 2) what standards were to be used to determine when a material distortion of income existed.

The most striking facet of the post-1968 cases which dealt with these questions was the distinct absence of judicial reliance on the revenue ruling in spite of possible congressional sanction of it, as indicated by a House Ways and Means Committee statement.

> Your committee's attention was also called to the matter of deductions for prepaid interest. On November 28, 1968, the Internal Revenue Service issued a ruling which held that any prepayment for prepaid interest which would materially distort income . . . should be allowed only on the accrual basis. This ruling is in accord with the treatment given other prepayments of expenses and

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32. Commonly known as the "12-month rule."

is in accord with your Committee's concept of the law. Thus, it does not seem necessary to include a provision in the bill to deal with this problem.\textsuperscript{34}

However, since such a committee statement does not have the force of law, the courts have apparently felt free to interpret and test\textsuperscript{35} Revenue Ruling 68-643 until Congress' position is more clearly delineated by further legislative action.\textsuperscript{36}

C. Post-1968

The first post-1968 cases dealing with prepaid interest deductions involved facts that led the courts to conclude, as they had in many pre-1968 cases,\textsuperscript{37} that the interest transaction was either a sham\textsuperscript{38} or actually a downpayment on the property.\textsuperscript{39} Because of this, the holdings did not rely upon Revenue Ruling 68-643 or upon a determination that a material distortion of income ("MDOI") existed. In light of this, the cases added nothing of interest to the Revenue Ruling 68-643 theory of prepaid interest, although several indicated that had the deduction been allowed, there may have been MDOI.\textsuperscript{40} Consequently, the Tax Court's first review of the area of prepaid interest under the theory of Revenue Ruling 68-643 which occurred in \textit{Andrew A. Sandor}\textsuperscript{41} was viewed with great interest.

In \textit{Sandor}, the facts showed that a cash basis taxpayer, interested in securities investments, in 1968 had prepaid $38,041 of interest payments that would have accrued over the life of a five year, seven and a half per cent note. The taxpayer missed being covered by I.T. 3740 in 1968,\textsuperscript{42} but decided to make the prepay-

\begin{itemize}
\item \textsuperscript{34} H.R. REP. No. 91-413 (Part I), 91st Cong., 1st Sess. 73 (1969). See also G. Douglas Burck, 63 T.C. No. 558 (1975).
\item \textsuperscript{35} Revenue rulings may be used as precedent in tax cases, but are not binding on the courts. Stubbs, Overbeck & Associates, Inc. v. United States, 445 F.2d 1142 (5th Cir. 1971); United States v. Hall, 398 F.2d 383 (8th Cir. 1968).
\item \textsuperscript{36} For proposed legislation, see the \textit{Tax Equity Act of 1975}, H.R. 1040, 94th Cong., 1st Sess. (1975), which would allow the deduction of interest only as it accrued for the cash basis taxpayer.
\item \textsuperscript{37} See note 24 \textit{supra}.
\item \textsuperscript{38} Estate of Martin Melcher, 29 CCH Tax Ct. Mem. 1010 (1970).
\item \textsuperscript{39} 61 T.C. No. 471 (1974); 57 T.C. No. 315 (1971).
\item \textsuperscript{40} \textit{Id.} See also 29 CCH Tax Ct. Mem. 1010 (1970).
\item \textsuperscript{41} 62 T.C. No. 469 (1974).
\item \textsuperscript{42} \textit{Id.} at 472. Evidently the taxpayer paid the interest on December 31, 1968. Revenue Ruling 68-643 allowed payments for prepaid interest made before November 26, 1968 to be covered by I.T. 3740, as Revenue Ruling 68-643 would not apply retroactively under authority granted by Code § 7805(b).\end{itemize}
ment under Revenue Ruling 68-643 regardless. The provisions of the loan were such that if it had been paid early, the taxpayer would have received a refund of the unearned portion of the prepaid interest, less a minimum charge of ninety days' interest as a penalty for early payment.43

The Commissioner used Revenue Ruling 68-643 and his authority under section 446 to challenge the 1968 interest deduction, arguing that the deduction would materially distort taxable income for 1968. He advocated that the taxpayer allocate the interest over the five year period and deduct in 1968 only the amount of interest allocable to 1968.44 The taxpayer responded by contending that his deduction did not materially distort 1968 taxable income, and that Revenue Ruling 68-643 was not a proper exercise of the rulemaking authority of the Commissioner.45 The court, after reviewing the background and history of section 446, upheld the Commissioner's theory.

The Sandor case was significant since it affirmed the right of the Service to test the deductibility of prepaid interest against the standard of material distortion of income. It is also notable for advancing a deposit theory, which in effect required the interest deduction to be capitalized over the life of the loan.46 It is important to note, however, that despite the use of the revenue ruling, the Sandor court did not endorse Revenue Ruling 68-643 without qualification.

While we have indicated that respondent's Rev. Rul. 68-643 would not be an abuse of his authority if applied in this case, we do not intend to place a stamp of approval on everything said in the ruling or on the application of that ruling to all cases.

....

We agree that the allowance of a deduction of 5 years of prepaid interest in this case would distort income, but we are not prepared to say that a deduction of any prepaid interest extending beyond a period of 12 months following the year of payment would distort income under all circumstances and justify changing a taxpayer's method of accounting with respect to the prepaid interest items

43. Id.
44. Id. at 473.
45. Id. at 470.
46. The court made this statement on the basis of comparisons with prepaid feed cases such as Tim W. Lillie, 45 T.C. No. 54 (1965) and Shippy v. United States, 199 F. Supp. 842 (D.S.D. 1961), aff'd, 308 F.2d 743 (8th Cir. 1962). Cf. John Ernst, 32 T.C. No. 181 (1959); Rev. Rul. 75-152, 1975-1 CUM. BULL. 144, at 15. Note that the deposit theory was not the basis of the decision, but a supporting argument to buttress the material distortion of income conclusion. 62 T.C. at 482. See also Willingham & Kasmir, Prepaid Feed Deduction: How to Cope with IRS' Restrictive New Ruling, 43 J. TAX. 230 (Oct. 1975).
We believe the Revenue Service may be called upon to support its determinations in some such cases.\textsuperscript{47}

\textit{Sandor} then specifically rejected the use of \textit{Fackler} and \textit{Court Holding Company} as a basis for the proposition that Revenue Ruling 68-643 was an abuse of discretion by the Service. The court advocated instead a case-by-case analysis to establish whether or not MDOI existed. If MDOI were not found, then an abuse of discretion a fortiori existed, regardless of the period covered by the prepaid interest.

Furthermore, the court refused to use the standards for determining the existence of MDOI which were advocated in Revenue Ruling 68-643 and instead made its own determination that a material distortion had occurred. Although using a checklist of reasons, the one fact apparently leading to the court's determination that MDOI existed was that the only reason the taxpayer agreed to prepay the five years' interest was to use the deduction to reduce his taxable income and consequently his tax liability. Any further reason behind the court's finding of MDOI was hidden in the simple assertion that "[W]e agree with respondent that the deduction of 5 years of prepaid interest by petitioners in 1968 would distort their income."\textsuperscript{48} Setting more certain rules, the court felt, would "be ruling in advance without any knowledge of the facts and circumstances."\textsuperscript{49}

\textit{G. Douglas Burck}\textsuperscript{50} followed the \textit{Sandor} decision in the prepaid interest chronology of cases. In \textit{Burck}, the Tax Court disallowed the deduction of one year's prepaid interest by a cash basis taxpayer on the ground that it led to a material distortion of the taxpayer's taxable income. The case, following the tests as set forth in \textit{Sandor} and Revenue Ruling 68-643, further restricted the possible use of prepaid interest deductions and raised the question of when, if ever, prepaid interest could be deducted.

The \textit{Burck} facts are similar to those of \textit{Sandor}. The taxpayer, through a seven per cent secured promissory term note, borrowed $3,000,000 from a Michigan banking corporation for certain investments. The facts do not indicate whether any of the $377,202 prepayment of interest on the first year's interest charges made on December 30, 1969 were refundable. It is also unknown whether there was a penalty if the note were paid early. The use of the

\textsuperscript{47} 62 T.C. at 481-82.
\textsuperscript{48} Id. at 481.
\textsuperscript{49} Id. at 482.
\textsuperscript{50} 63 T.C. No. 556 (1975).
deduction reduced the taxpayer's taxable income from $418,585 to $41,383 for 1969.\(^\text{51}\)

The court held that the Commissioner had the power to force the taxpayer to use the accrual method of accounting for the prepaid interest without having to use it for any other financial items.\(^\text{52}\) Section 446 was held to give the Commissioner broad powers to adjust accounting methods to reflect income clearly, including the treatment of any individual item. Revenue Ruling 68-643 was also cited, and although the Burck court held that the ruling was not binding, they proceeded to use five of the six factors mentioned in it as a checklist in determining when MDOI existed. The court concluded:

> After reviewing all of the facts and circumstances of the matter at hand we hold that a deduction for the prepayment of interest would result in a distortion of the taxable income for the year of payment. We make this determination by noting, inter alia, the following: In 1969 petitioner realized a long-term capital gain in the amount of $968,186.00, an amount far in excess of the gross income of petitioner in the two prior years; the prepayment of interest in the amount of $377,202.00 on December 30, 1969 based on loans to petitioner one day earlier in the amount of $5,388,600.00; and, in addition, petitioner has conceded that one of his motivations in borrowing the funds was the interest deduction he would receive by the prepayment of interest.\(^\text{53}\)

Despite this listing of factors, the lack of analysis by the Burck court made interpretation, application, and prediction in other fact situations difficult. In addition, as noted in at least one article,\(^\text{54}\) the ambiguities of the decision which are evident upon close analysis made it difficult after Burck for the tax planner to recommend the use of interest prepayments in substantial amounts, especially if the taxpayer were aware of the possible tax ramifications of the transaction before he made it.

The final case to be noted is James V. Cole,\(^\text{55}\) which involved cash basis taxpayers who had prepaid forty months' interest on a trust deed note financing newly purchased apartments. The taxpayers argued first, and unsuccessfully, that their legal obligation

\[\text{51. Id. at 309. The taxable income before the deduction is recomputed by adding back the interest prepayment to the taxpayer's reported taxable income: $41,383 plus $377,202 equals $418,585, less the 3/365 x the $377,202 actually allowed, so that recomputed 1969 taxable income equals $415,485.}\]

\[\text{52. Id. at 310.}\]

\[\text{53. Id. at 311.}\]


\[\text{55. 64 T.C. No. 1091 (1975).}\]
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on the note arose on November 25, 1968, thus allowing the favorable provisions of I.T. 3740 to cover their transaction instead of Revenue Ruling 68-643. The court found no legal obligation as of November 26, 1968, however, and consequently held the taxpayers subject to Revenue Ruling 68-643.\(^5\)

The major issue in Cole arose from the head-on collision between the taxpayers' assertion that no MDOI had occurred from the prepayment deduction and the Commissioner's argument that it was MDOI and as such created a valuable asset that must be prorated over the term of the loan. The court, after retracing the history of prepaid interest from Fackler to Sandor, reasserted the holding that the Commissioner had broad discretion under section 446 to determine what method of accounting clearly reflected income\(^5\) and that the taxpayer had a heavy burden in overcoming that determination.\(^6\) The court also reaffirmed its decision in Sandor not to "place its stamp of approval on everything said" in Revenue Ruling 68-643.\(^5\)

The Cole court found that in this fact situation MDOI did exist. It noted that the transaction had a significant impact on the overall income picture,\(^6\) that the case was similar to Sandor in that the taxpayer "sought out a transaction which would produce an

\(^{56}\) Id. at 1100. The taxpayers also advanced an equitable estoppel argument that Revenue Ruling 68-643 as applied to them was retroactive and so grossly unfair as to estop the Commissioner from denying the deduction. The court held that the ruling was not being applied retroactively, and even if it were, the Commissioner could retroactively correct mistakes of law even where the taxpayer had relied to his detriment on the Commissioner's mistake. See, e.g., Automobile Club of Mich. v. Commissioner, 333 U.S. 180 (1957); Manhattan Gen. Equip. Co. v. Commissioner, 297 U.S. 129 (1936).

\(^{57}\) See also Commissioner v. Hansen, 360 U.S. 446 (1959); Fort Howard Paper Co., 49 T.C. No. 275 (1967).

\(^{58}\) See also 49 T.C. No. 275 (1967); Photosonics, Inc., 42 T.C. No. 926 (1964).

\(^{59}\) 64 T.C. at 1103-06.

\(^{60}\) The court stated:

There is no question that petitioner's income picture was materially affected by the large interest deductions in 1968. The deduction of $58,947.60 by James and Esther Cole and of $39,292.50 by Clifford and Elizabeth Cole represented interest prepaid for a period of forty months. Although only eight days out of the entire 1223 day period (40 months) for which interest was prepaid fell within 1968, all of the interest attributable to this period was deducted in 1968. We believe that, at least under the circumstances herein, this is enough to demonstrate that petitioners' accounting of the prepaid interest here involved does not clearly reflect income.

\(^{64}\) Id. at 611.
unusually large deduction in a high income year,” that the lack of refundability of the interest upon early payment of the principle had no effect on whether MDOI existed or not, and that the distortion was beyond that which “might normally be expected in the commercial world, even under the cash method . . . absent the utilization of a particular tax consequence as a central feature of the transaction.” The combination of these factors, when compared to the court’s checklist, led it to hold that MDOI did exist in Cole.

III. S. REX LEWIS: THE FACTS AND THE TAX COURT’S DECISION

S. Rex Lewis involved a partnership called Howard and Lewis Investments ("HLI"), formed by the petitioner and his law partner, Jackson B. Howard, to invest in real estate. After a series of negotiations that culminated in a three-party real estate exchange, HLI and another company known as Anchorage Development Company planned to build and operate as a partnership a 118-unit apartment complex on land located in Ventura County, California. HLI and Anchorage each had a fifty per cent interest in the investment, with Anchorage to receive four per cent of the gross rentals for its services in managing the project.

To finance the construction of the complex, Anchorage and HLI applied for and received a $900,000 loan from the Trans-Coast Savings and Loan Association of Oxnard, California. The note, signed on December 28, 1970, provided for interest to be payable at the rate of nine per cent per annum, with the interest through June 15, 1971 to be paid only on the amounts actually disbursed during construction. After June 15, 1971, interest was to be payable on the full amount of the loan. In all, $48,228.75 in interest became payable in 1971 under this agreement. As of January 15, 1972, monthly payments of $7,553 were to be made until principal and interest were paid in full.

The borrowers had the right of prepayment on any of the loan installments. The Savings and Loan, however, was entitled to a prepayment penalty of 180 days’ interest on the original principal if the aggregate amount of all prepayments in any successive twelve

61. Id.
62. Id. n.5.
63. 65 T.C. 625 (1976).
64. Id. at 628.
65. Id. at 627.
66. Id.
month period plus regular installment payments equalled or ex-
ceeded twenty per cent of the principal. 67

Anchorage and HLI had agreed that HLI would be responsible for the first $80,000 of interest on the loan. S. Rex Lewis and his partner, Howard, each having individually borrowed $40,000, paid $18,000 apiece for four "points" 68 charged by the lenders as a prerequisite to making the loan, and the remainder ($22,000 apiece) in a voluntary prepayment of interest due on the loan for 1972. All of the payments were made on December 28, 1971.

The following represent the partnership and the petitioner's individual tax returns for 1968-1970: 69

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Loss Reported</td>
<td>$7,085.63</td>
<td>$1,974.17</td>
<td>$81,549.95</td>
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<tr>
<td>Petitioner's distributive share</td>
<td>3,542.82</td>
<td>987.09</td>
<td>40,774.97</td>
</tr>
<tr>
<td>Interest Deduction</td>
<td></td>
<td>80,000.00*</td>
<td></td>
</tr>
</tbody>
</table>

*Equals the $36,000 point charge and the $44,000 interest payments.

Lewis' Returns:

| Taxable Income       | 22,123.16     | 39,589.04     | 2,710.85      |

The Tax Court's decision was divided into three parts: 1) the loan fee (points); 2) the prepaid interest; and 3) the allocation between HLI and Anchorage of the interest deduction.

The first issue, involving the deductibility of the $36,000 loan fee, arose from a conflict between the taxpayer and Commissioner over allocation of the fee over the term of the loan. The parties agreed that the points were interest under section 163(a) and that the payment was made in 1970, the year in question. However, the taxpayer argued that a cash basis taxpayer is entitled to deduct an interest payment in the year in which it is made, especially where the fee is not refundable.

The Commissioner contended that the fee was amortizable, relying on the decision in Anover Realty Corp., 70 which held that costs incurred in procuring a loan must be amortized over its term. The court disagreed with this argument, however, stating:

Interest paid in the form of a loan fee was not, however, at issue in that [the Anover] controversy; and there is more recent author-
ity to the effect that such an item need not necessarily be amor-
tized. See James v. Cole, 64 T.C. No. 105 (1975). 71

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67. Id. at 355.
68. For purposes of this note, "points" are the fees paid by the borrower to the lender as an additional charge for the use of money. Rev. Rul. 69-188, 1969-1 Cum. Bull. 54. One point is equal to one per cent of the amount borrowed.
69. 65 T.C. at 628.
70. 33 T.C. No. 671 (1960).
71. 65 T.C. at 629.
Despite this, the *Lewis* court was not quite ready to let go of the issue, stating that even though *Anover* was not applicable, the fees may still be allocable over the term of the loan if to deduct such an item in the year of payment would result in MDOI. Citing *Burck* and *Sandor*, the court said that if MDOI was found, the Commissioner would rely on section 446(b) and require that the taxpayer's accounting of the term be changed so that it would more clearly reflect income.\(^2\)

The court rejected the idea of MDOI existing in reference to the "points," however, giving the following definition of when MDOI exists:

> Existing authority does not define precisely what constitutes a material distortion of income; but such a distortion is likely to be found when the amount of an interest expense item is substantially in excess of what might normally be expected in an arm's-length transaction structured without special regard to tax consequences.\(^3\)

Since points are commonly required as a precondition in making a loan, and since the taxpayers were dealing with the lender at "arms-length," the court held that no MDOI would result if the $36,000 was deducted in 1970.\(^4\)

The second issue in *S. Rex Lewis*, the question of the prepaid interest deduction, was treated in more detail than the first. Its resolution depended upon the determination of several factors. The court examined whether the $44,000 payment was actually "interest" under section 163. Basing its decision largely on its holdings in *General American Life Insurance Co.*\(^5\) and *R.D. Cravens*\(^6\) (despite a reversal by the Tenth Circuit) the Tax Court held that the payment was interest to the extent of the penalty which would have been imposed if the entire loan had been paid early, as specified by the terms of the obligation.\(^7\) The reasoning was that any amount that could possibly be refunded was not interest under section 163. It was a deposit which could not be deducted in the year paid but must be allocated over the term of the loan, according to *Cravens*. Since the early payment penalty in *S. Rex Lewis* would have equaled $40,500,\(^8\) $3,500 of the $44,000 prepayment was thus a deposit, and $40,500 was held to be interest.

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72. *Id.*
73. *Id.* at 629.
74. *Id.* at 630.
75. 25 T.C. No. 1265 (1956).
77. 65 T.C. at 630.
78. This is computed from the face amount of the loan: $900,000 × 180/360 × 9%. In 1970, a 360 day year was commonly used for computing interest.
The Tax Court, however, did not hold the $40,500 entirely deductible in the year of prepayment simply because it was interest under section 163, even though ordinarily a cash basis taxpayer could take the deduction. It agreed with the Commissioner's argument that if the interest prepayment resulted in MDOI in the year of payment, it should be allocated over the loan life.\(^7\)

The Service then contended, on the basis of Revenue Ruling 68-643, that because in *S. Rex Lewis* the prepayment related to a period exceeding twelve months, the prepayment automatically constituted MDOI. The court disagreed with the Service's twelve-month rule, however, holding that while the period to which the prepayment relates is a factor of considerable weight, "it is by no means dispositive of the issue."\(^8\)

The item now under consideration can in no event exceed the interest which would become payable on the construction loan in a period of approximately one-half year's duration. Respondent nevertheless contends that a material distortion may result from the cumulation of that item and the loan fee. We disagree; for stated interest relating to a period of one year or less and a loan fee might typically be paid in a single year in a transaction structured without regard to tax consequences.\(^9\)

Thus the Tax Court again found no MDOI to exist due to the "lack of regard for tax consequences" and held $40,500 of the $44,000 prepayment deductible in 1970, the year of payment.\(^10\)

The final issue the court faced was whether HLI would be allowed to deduct the interest prepayment in whole, or whether, because of the partnership with Anchorage, it would be forced to deduct only fifty per cent of the entire partnership income and losses. The Commissioner argued, of course, that since HLI was a partner whose distributive share of income and losses was fifty per cent, HLI should be entitled to deduct only one-half of the deductible interest prepayments.

The Tax Court rejected the Service's position, referring to an economic burden exception to the general rule that a partner's distributive share of a partnership deduction is determined by his distributive share of income or loss.\(^11\) The court found that because of the special agreement between HLI and Anchorage, HLI had borne the entire economic burden of the interest prepayment and as such should be allowed the entire deduction.

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79. 65 T.C. at 631.
80. Id. at 632.
81. Id. at 631-632.
82. Id. at 632.
83. Id.
A particular deduction may, however, be specially allocated to the partner who bears the economic burden of the expenditure underly ing the deduction. See Stanley C. Orrisch, 55 T.C. 395 (1970), aff'd. per curiam (9th Cir. 1973).\textsuperscript{84}

\section*{IV. THE NEW APPROACH AND ITS EFFECT}

\subsection*{A. The Change in Approach}

As stated earlier,\textsuperscript{85} the major battles in the prepaid interest deduction field have been fought over two issues: 1) whether the Commissioner had the authority to exercise the discretion given him in Revenue Ruling 68-643; and 2) the standards by which to determine whether MDOI exists in given fact situations. The Lewis court apparently accepted without question the Sandor and Burck rulings on the authority question,\textsuperscript{86} allowing the Commissioner the power to reallocate the interest deduction over the applicable time period if in the year of payment it did not “clearly reflect income” or, in other words, was MDOI.\textsuperscript{87} Consequently, the Lewis decision focuses on the second major issue, i.e., deciding when MDOI exists.

\textit{S. Rex Lewis} is significant because of its change in approach to the MDOI problem. The definition of MDOI as a distortion “likely to be found when the amount of an interest expense is substantially in excess of what might normally be expected in an arm’s-length transaction structured without regard to the tax consequences,”\textsuperscript{88} while perhaps not of the magnitude of the change of I.T. 3740 or Revenue Ruling 68-643,\textsuperscript{89} is a change nevertheless from the approach and standards used since 1968 in this area. The refusal of the Lewis court to follow either the Service’s twelve-month rule or the post-Revenue Ruling 68-643 cases’ “checklist of factors” approach may indicate that a limitation has finally been placed on the MDOI doctrine.

\emph{Lewis’ “drawing of the line” becomes evident when the case is compared with the major decisions in this area since Revenue Ruling 68-643. When they are taken as a whole, the impression is left that it would be rare, if ever, that a prepaid interest deduction would be found not to constitute MDOI unless its prepayment period were less than one year in length. The cases run the gamut from a five year prepayment in Sandor\textsuperscript{90} to a forty month prepay-}

\begin{itemize}
  \item \textsuperscript{84} Id. at 632-33.
  \item \textsuperscript{85} See discussion at p. 496 infra.
  \item \textsuperscript{86} Code \textsection 446(b).
  \item \textsuperscript{87} 65 T.C. at 629.
  \item \textsuperscript{88} Id.
  \item \textsuperscript{89} See pp. 494-97 infra for discussion.
  \item \textsuperscript{90} 62 T.C. at 472.
\end{itemize}
ment in Cole but in all instances MDOI was held to exist. This case trend, coupled with the automatic twelve month MDOI presumption of Revenue Ruling 68-643, would lead to the conclusion that in order to qualify for the deduction the interest prepayment should be less than a one year time period. Even then, MDOI might still be found if the right facts were present.

Consequently, when the Lewis situation confronted the Tax Court, it should have had little problem in using post-1968 precedent to come to a decision. Not only did Lewis involve a one year prepayment, as did Burck, raising the almost irrebuttable presumption that MDOI existed, but Lewis also contained several of the elements used in the “checklist of factors” approach the court had employed in finding MDOI in earlier cases. For example, both Burck and Cole found it notable that the taxpayers had significantly “shielded” current income with the prepaid interest deduction. The Lewis situation arguably did the same thing since the deduction in Lewis reduced the taxpayer's taxable income from $22,960 to $2,710. Cole, Burck, and Sandor, using another checklist factor, found that the transaction's design to avoid taxes was significant in finding MDOI. While the Lewis court claimed that the taxpayer's prepayment gave him no advantage and that the transaction was partly planned to avoid taxes, it could just as easily have found that the transaction was partly planned to avoid taxes. The agreement with

91. 64 T.C. at 1099.
92. 63 T.C. at 558.
94. For a listing of factors, see, e.g., Rev. Rul. 68-643, 1968-2 Cum. Bull. 76; 62 T.C. at 472; 64 T.C. at 1102, n.5; 63 T.C. at 560. While the cases rather uniformly disaffirm absolute reliance on the expressed list of factors in Revenue Ruling 68-643, the relevant factors in the decisions were similar.
95. Mr. Lewis's “pre-deduction income” would have equaled his reported 1970 income plus his share of the deduction, i.e., $2,710 plus $40,500/2, which equals $22,960. This tax avoidance or shielding is shown even more dramatically in Mr. Lewis's law partner’s situation in the twin case to Lewis, Jackson B. Howard, P-H Tax Ct. Mem. ¶ 76,005 (1976). In Howard, the taxpayer’s taxable income because of the prepaid interest deduction went from $46,293 to $26,043.
96. 64 T.C. at 1105; 63 T.C. at 561; 62 T.C. at 481.
97. 65 T.C. at 631.
98. For a similar case in which the Tax Court did find that the taxpayer was aware of the tax consequences despite his claims of ignorance, see Anderson, TCM 1975-302, CCH Dec. No. 33,447 (M). Anderson involved a fact situation similar to that in Lewis. A taxpayer argued he was unaware of the tax impact of his prepaid interest deduction
Anchorage to allow HLI to deduct all of the first year’s interest charges instead of prorating them between the partners seems to point toward this inference. The payment of the interest on December 30 would also appear to indicate a tax consequence awareness.

The point that should be emphasized is that the above comparisons of Lewis to the pre-Lewis cases do not indicate the court’s lack of precedent awareness, but reflect the court’s change in treatment of the prepaid interest deduction. The move from the checklist of factors standard to a test where such factors are considered, but the major consideration is the deposit distortion and the similarity of the transaction to other commercial arm’s-length transactions, is one of significance, as it is a change from the previous rationale relied on in this area.

B. The Effect of the Change

Despite the change in approach to the prepaid interest deduction, the Lewis decision does little in clearing the controversy over the standards by which to determine if MDOI exists. It is difficult to predict with any degree of certainty that the interest expense in any situation is “normal,” is part of an arm’s-length transaction, and is structured without regard for tax consequences. This last portion of the rule is especially difficult to comply with since the basic reason for prepaying interest is to gain a tax advantage to compensate for the loss of the use of the money. Without special considerations for the payment, there is little reason to give money to the lender before the debt is due. In a case like Lewis where it was asserted that there was no non-tax advantage to be gained by the prepayment, the conclusion would be that the prepayment decision had to be influenced by tax considerations. However, there is a facet to Lewis that may clear the muddle. The facts state that a penalty which was relatively large in comparison to the amount of prepaid interest would have been imposed upon the borrower if he had paid the loan principal before the contract due date. The major cases since 1968 did not involve

transaction, but the Tax Court shrugged off this argument in quick fashion. CCH p. 1326 n.11.

99. 65 T.C. at 627.
100. The Lewis court considered the similarity of the transaction to other non-tax commercial operations, the loan not being made for tax purposes, the short prepayment period, and the lack of advantages gained from the prepayment.
101. 65 T.C. at 627.
102. Id.
such a situation. While Sandor did have a refundable interest situation with penalty, the penalty involved was relatively insignificant when compared to the total interest charges.\textsuperscript{103} Cole did not allow interest refunds or penalty,\textsuperscript{104} and even noted that refundability had no effect on the determination of whether MDOI existed.\textsuperscript{105} In Burck the facts do not disclose whether interest refunds and early payment penalties were available. The significance of this is that in Lewis the amount that could have been refunded was held to be a deposit,\textsuperscript{106} and as such had to be deducted in allocations over the years to which it was applicable. Since the possible refund was so small (8 per cent) compared to the possible penalty (ninety-two per cent),\textsuperscript{107} therefore causing the “deposit distortion” to be correspondingly small, the court could be saying that the effect of the transaction was one of minor, if any, distortion. This comparison is borne out when Sandor is examined. In Sandor the possible refund was ninety-five per cent of the total interest charges, a figure relatively large when compared to the possible penalty of only five per cent.\textsuperscript{108} Thus it involved almost the exact opposite situation of Lewis, since its deposit distortion was much greater than that in Lewis. Thus Sandor should have had a correspondingly greater chance of having MDOI present than in Lewis, and this is borne out by the respective decisions.

The deposit distortion test for MDOI, while new to the prepaid interest field, has been used in comparable fashion in cases involving farmer’s prepaid feed expenses. In Mann v. Commissioner\textsuperscript{109} the Service argued successfully that the taxpayer could take no current deduction for prepaid feed expenses so long as the payment might be recovered, i.e., so long as there were a large deposit distortion. Similarly, Shippy v. United States\textsuperscript{110} held that a refundable deposit was not an ordinary and necessary business exp-

\begin{itemize}
  \item \textsuperscript{103} 62 T.C. at 472. In Sandor, a minimum penalty equal to 90 days’ interest at seven and one-half percent on $100,000 would have been imposed if the loan had been paid early. Thus, the penalty equalled $100,000 \times \frac{7.5\%}{2} \times 90/360, which equaled $1875. Compared to the total interest prepaid on the loan of $38,041, the penalty was five percent of the total interest.
  \item \textsuperscript{104} 64 T.C. at 1105.
  \item \textsuperscript{105} Id.
  \item \textsuperscript{106} 65 T.C. at 630.
  \item \textsuperscript{107} The penalty in Lewis was 180 days’ interest on $900,000 at nine percent. This equals $40,500, see note 94 supra. Compared to the total interest prepaid on the loan of $44,000, (excluding the points), the penalty was ninety-two percent of the total interest, and the refund eight percent.
  \item \textsuperscript{108} See note 95 supra.
  \item \textsuperscript{109} 483 F.2d 673 (8th Cir. 1973).
  \item \textsuperscript{110} 308 F.2d 743 (8th Cir. 1962).
\end{itemize}
pense and disallowed a current deduction of the prepayment in its entirety. Revenue Ruling 75-152\textsuperscript{111} agrees with the above, indicating that a refundable portion is a deposit and as such is nondeductible in the year of payment. Consequently, it appears that a comparison of deposit to non-deposit payments for discovery of MDOI has support from other tax areas.

For these reasons, it might be suggested that tax planners who intend to use a prepaid interest deduction device should require large penalty provisions upon their client's early payment of the loan so as to avoid MDOI. However, the practicalities of such an arrangement may preclude the tax planner from doing this, since the taxpayer may desire the early payment provisions for a number of reasons, the most obvious of which may be to avoid the financial loss of a large penalty in order to retain the flexibility of the right to early payment of the loan. In addition, the Service could characterize the entire arrangement as a sham and thus destroy its usefulness.

V. CONCLUSION

The \textit{Lewis} case, despite its change of approach from the major cases since 1968 in the prepaid interest deduction area, still does not particularly aid the tax planner in predicting future occurrences of MDOI. Since \textit{Lewis} is the only taxpayer's victory in a series of cases won by the Commissioner, it should not be taken as a basis for re-establishing the utility of prepaid interest deductions in tax planning until further decisions are made or until much needed legislative clarification is obtained. The final conclusion as to whether or not \textit{Lewis} is an unusual winning situation for the taxpayer may then be better decided.

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