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Interest Elements in Tax Planning

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INTEREST ELEMENTS IN TAX PLANNING

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The views expressed in this article are those of the author and not necessarily those of the Internal Revenue Service.

CHAPTER 8 SYNOPSIS

- 800 Introduction
- 810 Definition and Nature of Interest
- 820 Tax Characteristics of Interest
- 830 Propositions
- 831 The Tax Law as a General Rule Has Either Ignored the Time Value of Money or Has Dealt With It Inadequately
 - 831.1 Increasing Basis
 - 831.1(1) Section 483
 - 831.1(2) Tax Planning Techniques
 - 831.1(3) Safe Harbor's Deficiencies
 - 831.1(4) Contrary Arguments
 - 831.2 Face Amount Accruals
 - 831.2(1) General Principles of Accrual Accounting
 - 831.2(2) Tax Planning Technique
 - 831.2(3) Support for Face Amount Accrual Rules
 - 831.2(4) Contrary Arguments
- 832 The Parties to a Loan Agreement Can Determine How Interest on the Loan Is to be Earned
 - 832.1 Statutory Rules
 - 832.2 Nonstatutory Rules Prior to Revenue Ruling 83-84
 - 832.2(1) Tax Planning Techniques
 - 832.2(2) Rule of 78's
 - 832.2(3) Step or Variable Interest
 - 832.2(4) Analysis
 - 832.2(5) Revenue Ruling 83-84
- 833 The Parties to a Loan Arrangement Have Been Free to Allocate Payments Between Interest and Principal Even If the Interest Has Not Yet Been Earned
 - 833.1 Present Law

833.2	Tax Planning Techniques
833.3	Words of Caution
840	Conclusion

¶ 800. INTRODUCTION

This article discusses how interest has been and is being used in tax planning. The tax planning techniques using interest include charging too little interest or none at all, reclassifying interest as principal and allocating interest among time periods to optimize the tax consequences to the parties. The issues raised by these tax planning techniques go to the heart of the tax system. They suggest inadequacies in the development of the case law and in conventional tax thinking. The unifying principal is the divergence between the possible tax consequences and the clear economic consequences of each of the transactions. The overriding policy question is whether the tax system can deal adequately with issues involving the "time value of money."

The article discusses tax planning techniques through a series of propositions and a few hypothetical illustrating application of those propositions and raising questions about them. The article begins, however, with a review of some economic and tax fundamentals which provide the groundwork for the analysis.

¶ 810. Definition and Nature of Interest

Interest has been defined as the amount charged for the use or forbearance of money.¹ The rate of interest generally mirrors the rate of inflation. During times of high inflation, the prevailing rate of interest tends to be high, generally a few points above the rate of inflation. The real or economic rate of interest is the excess of the stated or nominal rate of interest over the rate of inflation. The tax law, however, has not drawn any distinction between the real and nominal rates of interest. Thus, the nominal rate of interest has been and continues to be the focus of tax analysis and planning.

In general, when a loan is made and an agreement is entered into for repayment on a fixed schedule, the total amount of interest payable over the term of the loan is computed by subtracting from the total amount of payments to be made, the amount originally borrowed. The rate of interest, however, is an annual concept. It is a means of comparing loans and is a reflection of the yield on investment. It is determined by looking to the amount of money paid out and the timing of the payments, and is computed on the assumption that interest is earned at a uniform rate throughout the term of a loan.²

That uniform rate, sometimes referred to as "the yield to maturity" or "the effective rate of interest", when applied to the "unpaid balance" of the loan for any year, will result in interest attributable to that year. The unpaid

¹ *Dupont v. Dupont*, 308 U.S. 488, 498 (1940); *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552, 560 (1932).

² See Conf. Rep. No. 97-760, 97th Cong., 2d Sess. 553 (1982), 1982-39 I.R.B. 4, 41; S. Rep. No. 97-494 (Vol. 1), 97th Cong., 2d Sess. 209 (1982); Supplement I to Regulation Z issued by the Federal Reserve System, 12 CFR Sections 226.5 and 226.40 (1979).

balance of a loan is the amount borrowed plus interest earned minus amounts paid. Thus, the effective rate of interest is a measure of the cost of credit, expressed as a yearly rate.

Labelling of payments as interest or principal will not change the economic substance. The amount of interest and the effective rate of interest are economic concepts and are determinable without regard to the labels, interest or principal, put on the payments. Labels do have consequences, however, for both nontax and tax purposes.

¶ 820. Tax Characteristics of Interest

From an economic point of view, as discussed above, the rate of interest is simply a way of keeping score and a common denominator for comparing transactions. Labels, however, have great significance for tax purposes. Interest is includible as ordinary income,³ unless specifically excluded,⁴ whereas principal payments received by a lender are regarded as return of capital.⁵ Likewise, interest expense is deductible (regardless of whether it is incurred in a profit-seeking endeavor or is purely personal)⁶ whereas principal payments are not.

In addition, interest income and expense are includible or deductible, as the case may be, in accordance with the taxpayer's method of accounting.⁷ The cash method taxpayer realizes interest income when the interest is actually or constructively received, regardless of when it is earned.⁸ An accrual method lender, however, may realize interest income even though no actual payments have been received.⁹

Similarly, the cash method taxpayer deducts interest only when paid and only in the amount representing the current or past cost of the use of the money.¹⁰ An accrual method debtor, however, has been permitted to accrue interest deductions even though he has not actually paid the interest.¹¹

What has made interest unique are three basic characteristics, set forth below as propositions. All of these propositions have at least some supporting authority.

(1) The tax law as a general rule has either ignored the time value of money or has dealt with it inadequately;

(2) The parties to a loan agreement can determine how interest on the loan is to be earned; and,

(3) The parties to a loan arrangement have been free to allocate payments between interest and principal even if the interest has not yet been earned.

³ I.R.C. § 61(a)(4).

⁴ See I.R.C. § 103, which provides an exclusion for interest on State, municipal and certain other governmental obligations.

⁵ I.R.C. § 61 taxes only income, not return of capital.

⁶ I.R.C. § 163.

⁷ See I.R.C. §§446, 451 and 461.

⁸ Reg. § 1.451-1(a).

⁹ *Id.*

¹⁰ Reg. § 1.461-1; I.R.C. §461(a) and (g).

¹¹ Reg. § 1.461-1.

By studying these tax characteristics of interest income and expense as analyzed by some courts, the Internal Revenue Service, and in some instances, Congress, and contrasting them with the economic characteristics of interest, tax practitioners have been able to take advantage of the divergence in abusive manners. A number of tax planning devices have been created around this divergence. I will analyze and discuss each of the three propositions and set forth tax planning techniques that have been suggested to take advantage of them.

¶ 830. Propositions

¶ 831. The tax law as a general rule has either ignored the time value of money or dealt with it inadequately.

¶ 831.1. Increasing Basis

An application of this proposition for tax planning involves using interest to magnify the cost of property by purchasing through a low-interest loan. The cost of property is used for determining its basis for depreciation purposes, and when applicable, for computing investment tax credit.

When a taxpayer purchases property for cash, his basis in the property is the amount of cash paid.¹² Thus, a taxpayer who purchases property worth \$100,000 for \$100,000 obtains a basis in that property of \$100,000 whether he pays his own cash or borrows the \$100,000 purchase price from a bank and uses the property as security for the loan.

Likewise, the result would be the same if the taxpayer instead, in effect, borrows the \$100,000 from the seller by giving the seller a purchase money mortgage in the amount of \$100,000, bearing interest at the market rate for comparable loans. Suppose, however, the taxpayer arranges his purchase money mortgage to pay the same total amount (interest plus principal) but specifies a high principal amount with a below market interest rate?

¶ 831.1(1) Section 483.

In general, section 483 applies to deferred payment sales in which some or all of the payments are due more than a year after the date of the sale. When applicable, because the contract has not provided for interest on the deferred payments, or has provided for inadequate interest, the section, in effect, converts a portion of each deferred payment to which it applies to interest. In that sense, it "imputes" interest to the transaction. Historically, the taxpayer's characterization generally was respected prior to the enactment of section 483.¹³ For example, the court in *Commissioner v. Brown*,¹⁴ permitted a contract

¹² I.R.C. § 1012.

¹³ For legislative history of section 483, enacted under Revenue Act of 1964, Pub.L.No. 88-272, 78 Stat. 19 (1964), see House Committee on Ways and Means, Revenue Act of 1964, H.R. Rep. No. 749, 88th Cong., 2d Sess., reprinted in 1964 U.S. Code Cong. & Ad. News 1313, 1380, 1509, and Senate Committee on Finance, Revenue Act of 1964, S.Rep.No. 830, 88th Cong., 2d Sess., reprinted in 1964 U.S. Code Cong. & Ad. News 1673, 1774. See also *Elliott Paint & Varnish Co. v. Comm'r*, 44 B.T.A. 241, 247 (1941), and *Anderson & Co. v. Comm'r*, 6 B.T.A. 713, 717 (1927), where the courts held that interest will not be imputed merely where the deferred payment sales price is greater than the cash sales price. Compare *Estate of Berry v. Comm'r*, 43 T.C. 723

of sale to omit provision for interest. Similarly, the court in *Kingsford Co. v. Commissioner*,¹⁵ held that the entire purchase price in a deferred payment sale was principal, not interest, and any excess of the sum of the deferred payments over what a cash purchase price would have been was not necessarily interest.

Section 483 will not be applicable as long as the deferred payment note bears interest at least at the safe harbor rate of 9% per annum simple interest.¹⁶ If the note bears no stated interest, interest will be imputed under section 483 at the rate of 10% per annum compounded semiannually.¹⁷ The principal amount of the note can then be determined by subtracting the imputed interest from the face of the note, and, presumably, will be the purchaser's basis in the property.¹⁸

¶ 831.1(2). Tax Planning Technique

With this background in mind, one can envision a plan whose objective is to combine general basis rules with section 483 to magnify the apparent cost and, therefore, the basis of purchased property. When property is purchased for a promise of future payment, either contractual or a note, bearing interest of at least 9% simple, the cost of the property under the general principles discussed above would be measured by the principal amount of the note.¹⁹ If the purchase money note bears a less than market interest rate but nevertheless fits within the safe harbor of section 483, however, the face of the note may be substantially greater than what the cash purchase price would have been.

In general, the value of a promissory note is a function of the principal amount of the note, the term of the note, the interest rate of the note relative to the prevailing market interest rate and the credit worthiness of the borrower. By placing a below market interest rate on a note, an issuer can issue a note with a principal amount in excess of the value of the note. In the absence of any requirement to charge a market rate of interest, issuers could have great flexibility to choose among ranges of rates and principal amounts. When a note is given in a purchase of property, therefore, purchasers could affect their basis in the property and, therefore, depreciation and interest deductions by adjusting the terms of the purchase money note.

A variation on the original example will illustrate how the high basis objective might be achieved. Suppose the taxpayer purchases the property worth \$100,000 with a long-term note worth \$100,000. Assume the note, however, does not bear interest at the market rate but instead contains the following terms. It has a face amount of \$809,727, bears interest at the

(1965), *afTd per curiam*, 327 F.2d 476 (6th Cir. 1967), *cert. denied*, 389 U.S. 834 (1967), *reh. denied*, 389 U.S. 998 (1967) (where the court imputed interest where, although the sales contract provided that the note was to be without interest, the contract contained a prepayment discount schedule which closely paralleled the interest which would have accrued under the buyer's earlier offer which contained a provision for interest payments.).

¹⁴ 37 T.C. 461, 488 (1961), *afTd*, 325 F.2d 313 (9th Cir. 1963), *afTd*, 380 U.S. 563 (1965). The issue in the text was discussed in the Tax Court's opinion only, and not in the opinion of the Court of Appeals or the Supreme Court.

¹⁵ 41 T.C. 646 (1964).

¹⁶ Reg. § 1.483-1(d)(1)(ii)(C).

¹⁷ Reg. § 1.483-1(c)(2)(ii)(C).

¹⁸ Rev. Rul. 82-224, 1982-2 C.B. 5.

¹⁹ *Crane v. Comm'r*, 331 U.S. 1 (1947).

annual rate of 9% simple (when the market rate of interest is 12 percent compounded annually), and is payable in full, both interest and principal, in 30 years.²⁰ The purchaser who structures his purchase in this manner expects to increase his basis for depreciation purposes from \$100,000 to \$809,727. Depreciation for the first year under ACRS, if the property were real property and were depreciated using straight line depreciation, would be \$53,982 instead of \$6,667.

The trade-off for the purchaser's high basis is that all of the payments of the purchase price (the principal of the note) will be nondeductible principal rather than deductible interest. Any such trade-off would be generally advantageous, however, as long as the extra depreciation deductions in the early years exceeded the amount of the "lost" interest. As a result of the Economic Recovery Tax Act of 1981 ("ERTA"), depreciation of "recovery property" (tangible property used in a trade or business or held for the production of income (section 168(c)), is now computed under the accelerated cost recovery system (ARCS) without regard to the actual economic useful life of the property.²¹ Thus, the period of depreciation for most types of property has been shortened, making it more likely that the term of the loan could be longer than the ACRS useful life of the purchased property. This phenomenon is particularly true with regard to real property, which is depreciable under ACRS over 15 years.

The potential benefits of this aspect of interest tax planning are even more dramatic if the investment tax credit is available on the purchase, as could be the case in the purchase of personal property. Assume, in the foregoing example, that the purchased property is 5 year ACRS property (personal property) for which an investment tax credit is available. In that example the investment tax credit would be approximately \$81,000, because it is computed on the purchase price of the property. Moreover, the increase in depreciation deductions would be even more dramatic than in the previous example, even though, as a result of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), basis in property for which an investment tax credit is taken is reduced by one-half of the amount of the credit.²² Thus, the purchaser's basis in the second example would be approximately \$769,000. Depreciation deductions in the first two years would nevertheless be increased to \$115,350 and \$169,180 respectively, from \$15,000 and \$22,000.

²⁰ For purposes of this example, we will assume that the note, including both interest and principal, is a recourse obligation of the purchaser. If it were nonrecourse, there is a substantial question whether the purchase money note would be considered an actual liability of the purchaser and therefore be includible in the purchaser's basis. See *Estate of Franklin v. Comm'r*, 544 F.2d 1045 (9th Cir., 1976). Resolution of that question would seem to depend upon whether the purchaser is likely to pay off the note and that, in turn, would seem to depend upon the expected value in 30 years of the property securing the note.

However, even a nonrecourse liability of \$100,000 that accrued interest at 12 percent per year compounded annually, would raise these same questions if payment of the entire amount of principal and accrued interest were deferred until the note matured.

²¹ I.R.C. § 168.

²² Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title II, §205(a)(1), 1982 U.S. Code Cong. & Ad. News (96 Stat.) 324, 427 (codified at I.R.C. § 48(q)).

The trade-off for these tax benefits would be reduced interest deductions for payments on the note. But, in both examples, payment comes at the end of the term of the note.

In the examples above if the purchaser is on the cash basis, he would get no deduction until he paid the interest. Thus, a high face amount on the note permits current depreciation deductions without any loss of current tax benefits.

Even a taxpayer on the accrual basis can benefit from the plan under the balloon note in the examples. That taxpayer must compare his extra depreciation deductions and their acceleration with his lesser interest deductions.

Thus, if the purchased property is real estate, which is 15 year property, and the loan has a term of 30 years, the tax benefits from depreciation will outweigh the loss of tax benefits from interest deductions. If the property is personal property, the extra investment tax credit provides additional incentive for choosing a high face amount. Accordingly, the Investment Tax Credit and depreciation under ACRS, which comes generally faster than the duration of the purchase money mortgage, now make it particularly advantageous to understate interest.

Interestingly, the seller of a capital asset in these transactions would convert interest, which would be taxed as ordinary income, to deferred payments of the sale price, which would be treated as received on the sale or exchange of property and therefore could be eligible for capital gain treatment. Under the installment sales rules of section 453, gain would be deferred until receipt of the installment payments. Thus, the plan would be attractive for the seller as well as the purchaser.

¶ 831.1(3). Safe Harbor's Deficiencies.

The technique that is involved in this variation is a play on the 9% simple interest safe harbor test rate of section 483. The section leaves unaffected a deferred payment purchase that provides for an annual interest of at least 9% per annum simple. The safe harbor rule leaves open these abuses because it deals inadequately with the problem on two accounts. First, during times of high inflation and therefore high market interest rates, 9% may be substantially below the prevailing interest rate. Thus, the purchase of property for a purchase money mortgage bearing 9% interest may result in a stated purchase price and face amount of the note substantially in excess of the fair market value of the property or note.

Second, even during times when 9% represents an approximation of the market rate of interest, the fact that the safe harbor is available for simple interest rather than compound interest creates great potential for abuse. Under a provision for simple interest, the lender earns no additional interest on earned but unpaid interest. For that reason, simple interest is nonsensical from a commercial point of view. Where all current interest payments are made currently, however, there is no difference between 9% simple and 9% compound interest. In situations in which current payments are not required, however, 9% simple interest payable at the end of the loan results in an effective rate of interest of substantially less. For example, on a 30-year loan providing for 9% simple interest with all interest and principal payable in year 30, the effective rate of compound interest is approximately $5\frac{1}{2}\%$. Accordingly, the cost of the property and the resultant ACRS depreciation and investment tax credit appear to be substantially in excess of those warranted by the fair market value of the property and purchaser's payment obligation.

While the example used here of a balloon payment of interest and principal may seem extreme, it does present a dramatic illustration of the problem with the section 483 test rate. More everyday situations involving at least some payments of interest differ from that case only in degree and not in kind.²³

¶ 831.1(4). Contrary Arguments.

There are contrary arguments to the effectiveness of this tax plan. First, a large discrepancy between the face amount of the purchaser's promissory note and the value of the purchased property, as measured by the value of the note or the property itself, provides a strong indication that the true cash purchase price was negotiated first, and the terms of the note with that value were then computed. In that event, even under pre section 483 case law, an unstated interest element computed without regard to section 483 could be determined by taking the "true" principal of the note as the purchase price.²⁴ Arguably, though, section 483 may preempt this analysis by providing certainty that meeting the 9 percent simple interest test rate is enough to establish both interest and principal as stated. On the other hand, the argument is one of substance over form. It takes the view that the interest rate stated in the agreement is not the actual agreement of the parties. Can a substance over form argument ever be preempted? It is a doctrine that is an override to the entire Code.²⁵ Perhaps, though, the Treasury has, in effect, conceded the argument. The Treasury has the power to change its regulations and if it chooses not to do so, perhaps it should be, and perhaps indeed is, stuck with the consequences.

Second, perhaps the accounting for the purchase in this manner and the resulting periodic depreciation deductions constitutes a method of accounting. If so, the Commissioner may have discretion to change that method under section 446(b) if it does not clearly reflect income. Clear reflection of income, for these purposes, could look to generally accepted accounting principles as the standard. Accordingly, simple interest (as under the current Regulations) would be acceptable if all earned interest were paid currently or if the payment obligation was relatively short term. When interest payments are deferred, however, clear reflection could require a denial of a portion of the deduction for any interest not paid currently.

The use of section 483 in this manner could be referred to as "everyman's tax shelter." Does it work? Many tax lawyers believe it does.

¶ 831.2. Face Amount Accruals.

¶ 831.2(1). General Principles of Accrual Accounting.

²³ For example, if a portion of the interest was payable currently and a portion was allowed to accrue unpaid, the effective rate of interest would be greater than 5-1/8 percent, but still less than 9 percent.

²⁴ See, e.g., *Estate of Starr v. Comm'r*, 274 F.2d 294 (9th Cir. 1959); *Estate of Berry v. Comm'r*, 43 T.C. 723 (1965), aff'd per curiam, 372 F.2d 476 (6th Cir. 1967), cert. denied, 389 U.S. 834 (1967), reh. denied, 389 U.S. 998 (1967).

²⁵ See I.R.C. § 368 and numerous cases decided thereunder such as *Gregory v. Helvering*, 293 U.S. 465 (1935); *Comm'r v. Court Holding Co.*, 324 U.S. 331 (1945).

In general, under the accrual method of accounting, income is realized when the right to receive payment accrues (becomes fixed and determinable), and deductions are allowed when the obligation to make payment accrues. The time of payment or receipt for an accrual method taxpayer is irrelevant, except for certain advance payments required to be included in income.²⁶

The Treasury Regulations under Section 461 set forth a test for determining when an expense is deductible for an accrual method taxpayer—the "all events test."²⁷ Under the "all events test," an expense of an accrual method taxpayer is deductible in the taxable year in which:

(a) "all the events have occurred which determine the fact of liability;" and

(b) the amount of the liability "can be determined with reasonable accuracy."

Even if the all events test is satisfied, an expense may not be deductible or may be deductible only in part. Regulations § 1.461-1 (a)(2) also provides: "However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred."²⁸ Thus, deductibility of an item depends upon notions of capitalization as well as the fixed and determinable nature of the payment obligation.

If the literal requirements of deductibility are met, there is still a question of whether a deduction for all or a portion of the face amount of the liability can nevertheless be disallowed. Regulations § 1.461-1(a)(2) has generally been read by courts and commentators to allow a deduction for the full amount of the liability, although some courts have sought to disallow the deduction under certain circumstances and some commentators have suggested that the deduction should be for less than the face amount of the liability.²⁹

A series of examples will be helpful to illustrate the justification for the latter possibilities. The three examples suggest the potential tax advantage to be gained through use of money otherwise paid as taxes. The objective of the tax plans suggested by the examples is to obtain a current deduction for the amount of the liability that will not have to be paid until the future.

¶ 831.2(2). Tax Planning Technique.

Example 1. Assume a taxpayer, T, hires lawyer, S, to perform services in connection with the taxpayer's business. The services pertain to, and are performed in, the current year. T pays S \$10,000, which T has borrowed from a bank, payable in 5 years by repayment of principal plus \$10,000

²⁶ See, e.g., *Schlude v. Comm'r*, 372 U.S. 123, 136-137 (1963); *American Auto. Ass'n v. United States*, 367 U.S. 687, 692 (1961), reh. denied, 368 U.S. 870 (1961); *Auto Club of Michigan v. Comm'r*, 353 U.S. 180, 189 (1957), reh. denied, 353 U.S. 989 (1957); *RCA Corporation v. United States*, 664 F.2d 881 (2d Cir. 1981), cert. denied, 102 S.Ct. 2958 (1982) (requiring immediate realization of income from services to be performed on receipt of advance payments.).

²⁷ Reg. § 1.461-1(a)(2).

²⁸ *Id.*

²⁹ See *infra* text accompanying notes 32-39. See also Aidinoff and Lopala, Section 461 and Accrual Method Taxpayers: The Treatment of Liabilities Arising from Obligations to be Performed in the Future, 33 Tax Lawyer 789 (1980).

interest. Assume also that T is in the 50 percent tax bracket and is on the accrual method.

T would be entitled to a current deduction of \$10,000. That deduction would result in a tax benefit of \$5,000 for the year the liability arose. Interest deductions in the aggregate amount of \$10,000 would be allowed over the five year term of the loan.

Example 2: Assume the same facts as in Example 1, except T agrees to pay S \$20,000 in year 5 (the present value of which is \$10,000), rather than borrow the \$10,000 from a bank. Under the view that expenses to be paid in the future are deductible by an accrual method taxpayer at their face amount, T would be entitled to a current deduction of \$20,000. That deduction would result in a current tax benefit to T of \$10,000.

Arguably, a deduction could be disallowed to T if the transaction described in Example 2 constituted a "plan deferring the receipt of compensation" within the meaning of section 404.³⁰

Example 3: Assume the same facts as in Example 2, except S was not a lawyer but rather an individual plaintiff who sued T for personal injury damages resulting from T's business activity. The tax consequences to T of this "structured settlement" under the face amount deduction rule would be the same as suggested in Example 2—a current deduction of \$20,000.

The application of the face amount deduction rule to Examples 2 and 3 suggest a troublesome question. Could a 50% taxpayer get a \$10,000 tax benefit which he could invest to fund the entire, or at least a large portion of, the \$20,000 liability? If so, the Government would pay much of the cost of the services or liability, as the case may be.³¹

Example 3 provides a nuance to this troublesome question. If T's liability to S is for personal injury, S, the plaintiff, will have no income under section 104, even if payments are received 5 years hence.

¶ 831.2(3) Support for Face Amount Accrual Rule

The apparent abuse on the deduction side, as indicated above, would result from acceptance of a rule that provides that if a liability for a current expense item meets the all events test, the full amount of the liability is deductible.³² That rule has substantial case law support. For example, the court in *Lawyer's Title Guaranty Fund v. United State*³³ allowed a lawyers'

³⁰ See I.R.C. § 404(a)(5) and (b); Reg. § 1.404(b)-1.

³¹ See McGown, *Structured Settlements: Deduct now and Pay Later*, 60 *Taxes* 251(1982), who recognizes the benefits and concludes that they are available in structured settlement situations such as Example 3.

³² Reg. § 1.461-1(a)(2). See also *United States v. Anderson*, 269 U.S. 422(1926), where the Court held that an accrual basis taxpayer-corporation must take income tax deductions for munitions tax in the year in which the tax is accrued and not in the year the munitions tax becomes due and payable.

³³ 508 F.2d 1 (5th Cir. 1975). See Revenue Act of 1978, Pub. L. No. 95-600, § 133, 1978 U.S. Code Cong. & Ad. News (92 Stat.) 2763, 2783, which has apparently changed that result as it relates to services provided by independent contractors to be paid for in the future. See also Technical Corrections Act of 1979, Pub. L.No. 96-222, § 101(a)(5), 1980 U.S. Code Cong. & Ad. News (94 Stat.) 194, 196; Senate Comm. on Finance, Technical Corrections Act of 1979, S.Rep.No. 498, 96th Cong., 2d Sess. 16-18, reprinted in 1980 U.S. Code Cong. & Ad. News 316,

insurance fund on the accrual method of accounting to deduct the full amount of commissions for writing policies credited to individual lawyers and not normally payable for seven years. Moreover, the Service acquiesced and announced that it would follow that case.³⁴

In *Washington Post Co. v. United States*³⁵ the court also allowed deductions for accruals where future payment was not expected for several years and, indeed, the time of payment was uncertain.³⁶ On the income side, the Supreme Court, in *Commissioner v. Hanson*,³⁷ has required that automobile dealers accrue income in the full amount to be received even though payment of a portion would not be received for up to 60 months.

The Internal Revenue Service has also ruled favorably under a fact pattern similar to Example 3. Revenue Ruling 69-429,³⁸ involved an accrual method partnership that was required to pay a workman's compensation award to an injured employee for which it was liable under state law. In less than 150 words, which included a statement of the facts, the Service ruled that the full amount of the liability was deductible in the year in which the award was determined.

¶ 831.2(4). Contrary Arguments

Nevertheless, the issue is not free from doubt. In *Mooney Aircraft, Inc. v. United States*,³⁹ the court held that if payment was too far into the future, the deduction with respect to the future payment obligation would be disallowed. In *Mooney*, the court disallowed a deduction to an airplane manufacturer for the \$1,000 face amount of "Mooney Bonds" issued to airplane purchasers and payable to bearer on retirement of their airplanes. Retirement of an airplane and, therefore, payment of the bond was estimated at between 15 to 30 years in the future. The court sustained the Commissioner's use of discretion under section 446(b) (clear reflection of income) because the liability to pay the bonds was so far into the future that (1) the relationship of the obligation of future payment to current income was attenuated, and (2) it could not be certain that the amount would ever be paid. The *Mooney* court took an all or nothing approach. Because the payment date was so far in the future, no deduction was allowed. Presumably, if the payment date had not been so distant, the court would have allowed a deduction in the full amount of the bonds.

Another argument based on section 446(b) may also be available to disallow a portion of the deduction. The argument is based upon the economic substance of a deferred payment transaction. Referring again to Examples (2) and (3), it may be argued that, in substance, what really happened in these transactions was the following: T undertook an obligation to pay \$20,000 in five years. The value of that obligation was approximately \$10,000 and that was the amount of the proper accrual. The remaining \$10,000 constituted interest on the \$10,000 and accrued over the five years rather than in the first year. Accordingly, accrual of a deduction for the entire latter amount should not be permitted in the first year, but rather

329-330.

³⁴ Rev. Rul. 77-266, 1977-2 C.B. 236.

³⁵ 405 F.2d 1279 (Ct.Cl. 1969).

³⁶ See also *Lukens Steel Co. v. Comm'r*, 442 F.2d 1131 (3rd Cir. 1971).

³⁷ 360 U.S. 446(1959).

³⁸ 1969-2 C.B. 108.

³⁹ 420 F.2d 400 (5th Cir. 1969).

should be allowed only over the five years.

The approach suggested in that argument conforms to the approach taken by the Accounting Principles Board in APB No. 21, unanimously adopted by the Board and issued in August, 1971.⁴⁰ That opinion states that a note without stated interest exchanged for property, goods or services should not be reported at its face amount even if the exchange was a bargained transaction entered into at arm's length.

"In these circumstances, the note, the sales price and the cost of the property, goods, or service exchanged for the note should be recorded at the fair value of the property, goods, or service or at an amount that reasonably approximates the market value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium should be accounted for as an element of interest over the life of the note . . ."⁴¹ Accordingly, it could be argued that the Commissioner has the authority under section 446(b) to require T to report the transaction for tax purposes in a manner that clearly reflects income as determined under generally accepted accounting principles.

The issue could then come down to whether the Commissioner's authority under section 446(b) is sufficiently broad to overturn longstanding assumptions and substantial judicial authority to accomplish an economically logical result. No court has yet taken this position, and contrary judicial precedents go back more than fifty years. On the other hand, these precedents developed when interest rates were low relative to current rates and when distortions resulting from face amount accruals were small relative to current distortions. Moreover, when they developed, they conformed to the general accounting practices of the day, and those practices have now changed.

Also troublesome in accepting the clear reflection of income argument is the enactment of section 483 to impute interest in sales transactions when no interest is stated. Arguably, the enactment of section 483 and its narrow scope indicates that Congress intended to leave face amount accruals untouched in the nonsales area. Moreover, since that section is primarily a character section, not a timing section, in that it is directed at preventing conversion of ordinary income into capital gains,⁴² its enactment perhaps indicates Congressional indifference to the timing problem, the precise problem raised by face amount accruals.

Finally, case law prior to the enactment of section 483 generally held that interest could not be imputed in a sales transaction.⁴³ The arguable implication of that case law is that absent a statutory requirement to the contrary, the parties to a deferred payment transaction are free to set a rate of interest and even to agree to no interest at all. On the other hand, in those cases the Commissioner failed to explicitly exercise authority under section 446(b).

There is one final troubling implication with regard to use of authority granted under section 446(b). There is no universally accepted standard of

⁴⁰ APB Opinion No. 21 (August, 1971).

⁴¹ APB Opinion No. 21 at U-12.

⁴² See H.R. Rep. No. 749, 88th Cong., 1st Sess. (1963), 1964-1 C.B. (part 2) 125, 196-198, 332-336; S. Rep. No. 830, 88th Cong. 2d Sess. (1964). 1964-1 C.B. (part 2) SOS, 605-608.

⁴³ See *supra* notes 13-15 and accompanying text.

clear reflection of income against which to evaluate the taxpayer's method. It is generally recognized that tax accrual accounting diverges from financial accrual accounting. The section 446(b) economic substance argument implies that the accrual method of tax accounting may not clearly reflect income. That argument has generally been reserved for the cash method, but it has been applied, at least in Technical Advice memoranda, to accrual method taxpayers.⁴⁴ If the accrual method of tax accounting is not the standard against which to measure clear reflection of income, and the cash method certainly is not, then the standard of clear reflection referred to in 446(b) is an income reporting standard that is not set forth in the Code. On the other hand, if generally accepted accounting principles, as modified by certain specific Code sections, represent the standard against which clear reflection is measured, that problem disappears. And, GAAP is the standard currently being applied by the Service in determining whether the cash method clearly reflects income in accounting method change request situations.⁴⁵

¶ 832. The parties to a loan agreement can determine how interest on the loan is to be earned.

¶ 832.1. Statutory Rules.

The Internal Revenue Code in section 163 deals with the deductibility of interest payments. The Code, in section 461 (g), deals with the timing of those deductions. Section 461 (g), enacted under the Tax Reform Act of 1976,⁴⁶ in general, disallows as an interest deduction interest paid by a cash method borrower that is properly allocable to another period. The section provides as follows:

"(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."⁴⁷

The section, however, does not set forth a rule for determining the cost of money for each period; it is silent on the question of how much of the interest paid is chargeable to the current period and how much to a future

⁴⁴ But see LTR's 8017008 and 8017009 (Dec. 31, 1979).

⁴⁵ Speech to the American Institute of Certified Public Accountants on May 17, 1983, in Washington, D.C.

⁴⁶ Tax Reform Act of 1976, Pub. L. 94-455, 1976 U.S. Code Cong. & Ad. News (90 Slat.) 1520 (effective October 4, 1976).

⁴⁷ Subparagraph 2 of section 461(g) provides as follows:

"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."

period. Further, there are presently no regulations under section 461(g) clarifying those matters.

The Code, as a result of TEFRA, does provide some guidance on this question, but in another context. Section 1232A provides for a method of determining how interest is earned on an obligation sold with original issue discount. In general, original issue discount arises when a debt obligation is sold by the issuer at a price ("issue price") less than the price at which the issuer will redeem the obligation at the end of its term ("redemption price"). The difference between the redemption price and the issue price is called original issue discount (OID). OID is considered earned by the holder over the life of the obligation, regardless of whether the holder is on the cash or accrual method. Prior to TEFRA, OID was considered earned under section 1232 on a straight line basis—in equal amounts each month.

Section 1232A, dealing with original issue discount, and section 1232B, dealing with stripped coupon bonds, were enacted under TEFRA to change that result. Under those sections, OID is considered earned at a uniform rate of compound interest throughout the term of the obligation. In other words, a uniform rate of interest is determined by looking to the issue price, redemption price and term of an obligation issued with original issue discount. In the first year, the amount of original issue discount attributed to that year is computed by applying a constant interest rate (the "yield to maturity" determined on the basis of compounding at the close of each bond period) to the issue price. For subsequent periods, the issue price is adjusted upward by adding previously included original issue discount and the yield to maturity is applied to that amount (the "adjusted issue price"). Thus, under this method, more interest will be considered earned in the latter years of the obligation than in the earlier years. Thus, TEFRA substituted economic accuracy for mechanical simplicity.

¶ 832.2. Nonstatutory Rules Prior to Revenue Ruling 83-84.

In contrast to the newly-enacted statute, the case law so far has failed to provide precise guidance on how interest is earned. For example, in *James Brothers Coal Co. v. Commissioner*,⁴⁸ the court said "in the absence of proof of any contrary arrangement between the lender and borrower . . . , the interest in respect of the borrower's single promissory note is deemed to *accrue ratably* over the entire period of said note."⁴⁹ Further, in *Gunderson Bros. Engineering Corp. v. Commissioner*,⁵⁰ the court held that a finance charge on a note received in a dealer installment sale was earned ratably over the term of the note. In that case, the taxpayer used the Sum of the Years Digits method which the court held clearly reflected income. But the court specifically did not pass on the propriety of the taxpayer's method since it was not contested by the Service.⁵¹ The Service, rather, had sought to include the full amount of the finance charge in income at the time of the sale.

The Service also had failed to provide guidance prior to Revenue Ruling 83-84. For example, in Revenue Ruling 72-100⁵², the Service recognized the Rule of 78's method of computing interest on installment loans as an acceptable method in the context of short term loans. In the situations dealt with in that

⁴⁸ 41 T.C. 917 (1964).

⁴⁹ *Id.* at 920-21.

⁵⁰ 42 T.C. 419 (1964), acq., 1967-2 C.B. 2.

⁵¹ *Id.* at 427.

⁵² 1972-1 C.B. 122

ruling, the respective loans were for 12 and 60 months. Further, Revenue Ruling 74-607⁵³, in "clarifying" that ruling, erroneously viewed the Rule of 78's as a method of applying the effective rate of interest to the unpaid balance of a loan. Revenue Ruling 79-228⁵⁴ reiterated the Service's acceptance of the Rule of 78's in the context dealt with in Revenue Ruling 72-100, as "clarified" by Revenue Ruling 74-607. Finally, in Revenue Ruling 74-395⁵⁵, the Service indicated that prepaid interest could be recovered through deductions over the life of a loan under the Rule of 78's, if that method was provided for in the loan instrument.

The courts and the Service have held, however, that payments of interest at the inception of a loan in the form of points or otherwise are not deductible when paid. For example, in *Sandor v. Commissioner*,⁵⁶ the court held that prepayment of five years' interest was not deductible under section 446(b) because a deduction would distort the taxpayer's income. And in Revenue Ruling 74-607, the Service held that commitment fees or points paid at the inception of the loan are not deductible when paid, but rather are deductible ratably over the life of the loan.

¶ 832.2(1). Tax Planning Techniques:

The absence of a clearly-stated nonstatutory normative principle articulating how interest is earned has resulted in a perceived vacuum. Into that perceived vacuum have jumped the tax planners.

An important introductory comment is in order at this point. The plans to be discussed in this section of the article are popular tax shelter techniques. They are grounded on proposition 2. Though somewhat different in form, they share a common objective. They are designed to accelerate or "front load" interest deductions for accrual method debtors on loans that provide for interest payments on a different schedule than interest accruals.

¶ 832.2(2). Rule of 78's.

The Rule of 78's is a method of allocating the total amount of interest earned during the term of the loan among the periods of the loan. It operates in a manner similar to the Sum of Years Digits method for computing depreciation. Under the Rule of 78's method, the amount of interest allocable to each taxable period is determined by multiplying the total interest payable over the life of the indebtedness by a fraction (a) the numerator of which is the number of taxable periods remaining on such indebtedness at the time the calculation is made and (b) the denominator of which is the sum of the periods' digits for the term of the indebtedness.

An illustration will be helpful in explaining how this method works. Assume a five-year loan of \$100 with aggregate interest earned over the five years of \$100. Under a generalized Rule of 78's method, the amount of interest allocated to year 1 would be computed as follows:

$$\frac{5}{1 + 2 + 3 + 4 + 5} \times \$100 = \frac{5}{15} \times \$100 = 33 \frac{1}{3}$$

⁵³ 1974-2 C.B. 149

⁵⁴ 1979-2 C.B. 200

⁵⁵ 1974-2 C.B. 46

⁵⁶ 62 T.C. 469 (1974), a/Td 536 F.2d 874 (9th Cir. 1976).

In fact, the Rule of 78's derives its name from the sum of the months' digits from 1 through 12, which equals 78.

The Rule of 78's computation results in a greater proportion of interest allocated to the early periods of the loan than would otherwise be required by application of a uniform interest rate throughout the term of the loan. In the event of payment prior to the due date of the loan results in a penalty in that the borrower's cost of the loan exceeds the pro-rata interest amount computed by application of the uniform rate of interest throughout the term of the loan. A Rule of 78's computation is a common provision in short-term consumer finance loans and helps assure lenders that loans will run to term because of the detriment to borrowers of early payment.

Enter the tax shelter promoters. If the Rule of 78's method is used to compute interest earned on a long-term loan at the current, relatively high, prevailing interest rates, seemingly wonderful things happen. If an accrual method borrower, generally a partnership in tax shelter situations, deducts as interest accrued that portion of interest allocated to the early years of the loan under the Rule of 78's, the resulting interest deduction will greatly exceed the interest that would be considered earned under a uniform rate of compound interest.

For example, assume a loan in the amount of \$100,000 bearing interest at the rate of 12 percent per annum and payable in thirty equal annual installments of approximately \$12,414 each.

Economic interest in the first year would be \$12,000 (12% of \$100,000). Therefore, under the normal method for amortizing a loan with level payments, a portion of the first year's payment would satisfy the accrued interest and the remaining portion would amortize the principal. Each year the interest component of the payment would decrease as the outstanding principal balance of the loan was reduced, and there would be a corresponding increase in the principal portion. Homeowners with mortgages will be familiar with this amortization method, since this is the typical amortization method for those loans.

Interest computed under the Rule of 78's method for the first year, however, would be approximately \$17,575, an amount greater than the economic interest and, in fact, greater than the entire first year's payment.

¶832.2(3). Step or Variable Interest.

A related and similar example involves variable rates of interest that descend during the term of the loan. Assume again the \$100,000, 30 year self-amortizing loan of equal payments of \$12,414. Assume, though, that instead of a fixed 12 percent rate of interest, the loan provides for interest computed as follows: 17.575 percent per annum for the first year, 17 percent for the next year, etc. Under that formula, variable rate interest in year 1 would be \$17,575 as compared with economic interest of \$12,000.

¶832.2(4). Analysis

These two examples raise several interesting tax accounting issues. When does interest accrue? Has \$17,575 of interest accrued in year 1, since the agreement provides that amount is earned, or has only \$12,000 accrued? That depends in part on two subsidiary questions relating to the accrual tax accounting rules discussed previously. First, have all events occurred after the first year to fix liability for interest at \$17,575? That amount, after all, will have to be paid even if the loan is discharged prior to maturity. Is that

enough to satisfy the test or is the excess of \$17,575 over \$12,000 (\$5,575) an amount that is due only upon discharge of the loan, the liability for which awaits a further event—payment of the entire debt either prior to, or at, maturity?

Second, even if the full \$17,575 amount labelled interest did satisfy the "all events test," would the entire amount be deductible as interest in the first year or does a portion of it relate to subsequent years? If a portion did relate to subsequent years, that portion would be deductible only in those subsequent years. Further, in that latter connection, can interest computed in these examples be distinguished from "discounted" points for which no current interest deduction is allowed?

The answers to the foregoing questions depend upon how we consider interest to be earned. Can the parties' agreement on "how interest is earned" fix the tax consequences, or is there an economic principle that determines how interest is earned? Section 1232A now prescribes a method by which interest is earned on an obligation issued with original issue discount. That section, in substance, provides that interest on such obligations is earned at a uniform rate of compound interest over the entire term of the obligation. Perhaps that normative standard, which generally conforms to economic reality, should be carried over to all debts, whether or not covered by section 1232A. If that normative rule were adopted, then accrued but unpaid interest in excess of the amount that economically accrues would not be deductible to an accrual method borrower. If the loan is paid prior to maturity, the amount of accrued but unearned interest, applying the Section 1232A standard of earned interest, may be regarded as a prepayment penalty.

¶832.2(5). Revenue Ruling 83-84

The Service has recently answered some of these questions in Revenue Ruling 83-84⁵⁷. The facts of that ruling involved a loan agreement which provided that interest was to be earned in accordance with the Rule of 78's computation and the taxpayer in that situation, who was on the accrual method, computed his interest deduction in accordance with that computation. The Service held that the Rule of 78's agreement did not define how interest actually was earned on the loan. Rather, it represented a purely mechanical formula for allocating interest among periods.

"The amount of interest attributed to the use of money for a period between payments is determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan for that period."⁵⁸

The effective rate of interest is a uniform rate over the term of the loan computed by reference to the amount borrowed and the repayment schedule. The effective rate of interest, when applied to the unpaid balance of the indebtedness for any period, produces the true cost of the indebtedness for that period, and that cost is referred to as the "economic accrual of interest" for that period. Accordingly, the Service held that only the amount of interest that economically accrues, computed by applying the effective rate of interest to the unpaid balance, will be deductible and no deduction for interest will be allowed for any year in excess of that amount.

⁵⁷ Rev. Rul. 83-84, 1983-23 I.R.B. 12, modifies and supersedes Rev. Rul. 72-100, 1972-1 C.B. 122.

⁵⁸ 1983-23 I.R.B. at 13.

Although the facts of Revenue Ruling 83-84 involve the Rule of 78's, the analysis and implications of the ruling are far broader. The ruling itself suggests that it will be extended. It provides as follows:

"Because interest is earned by application of the effective rate of interest over the term of the loan, any agreement that provides that interest is earned in another manner, such as under the Rule of 78's computation, lacks economic substance because it fails to reflect the true cost of borrowing.⁵⁹

The Service did permit a limited carve-out from the general rule enunciated in Revenue Ruling 83-84 for certain short term consumer loans which provided for interest in accordance with the Rule of 78's. Revenue Procedure 83-40⁶⁰ provided this exception but limited its application to situations when "there is a self amortizing loan that requires level payments, at regular intervals at least annually, over a period not in excess of 5 years (with no balloon payment at the end of the loan term) . . ."

Thus, the Service has taken a large step in supplying a normative standard for determining how interest is earned on a loan. Because the ruling, on its face, deals with a Rule of 78's fact pattern, practitioners have questioned its scope and implications. Proceedurally, they have requested guidance on the application of section 481 relating to the adjustments required for a taxpayer who is changing from an erroneous method of accounting such as the accounting for interest under the Rule of 78's method to a correct method. The Service is aware of the need for guidance on this matter.

Substantively, practitioners have questioned the application of the ruling to other methods of computing interest. For example, will a borrower who enters into a loan transaction that provides that interest will accrue at 9 percent simple, but will not be due until the end of the loan term, be permitted to deduct each year the stated interest or only the amount that economically accrues? The broad analysis of Revenue Ruling 83-84 suggests the latter.

Are there situations, however, in which a variable interest rate would be justified from an economic point of view? Perhaps a variable rate is only justified if the rate is tied to an independent variable such as the prime rate of interest.

The questions suggested in this part and the Service's response need to be considered in connection with planning around proposition 2 or in evaluating others' plans.

¶833. The parties to a loan arrangement have been free to allocate payments between interest and principal even if the interest has not yet been earned.

¶833.1. Present Law.

Allocation of payments on a loan can have important tax consequences to both the borrower and the lender. Payments of interest, in general, are deductible by the borrower if they relate to the current year, and are includible in the lender's income regardless of the year to which they relate.⁶¹ Payments of principal, on the other hand, are not deductible by the borrower nor includible in the lender's income. Rather, they are regarded as a

⁵⁹ 1983-23 I.R.B. at 14.

⁶⁰ Rev. Proc. 83-40, 1983-23 I.R.B. 22.

⁶¹ See *supra* text accompanying notes 6-11.

return of capital from borrower to lender. Thus, even if the absolute amount and schedule of repayments are fixed, the labelling of those repayments may be quite important for tax purposes.

In general, the case law has been quite liberal in allowing taxpayers to allocate repayment of a loan between interest and principal. For example, in *Huntington—Redondo Co. v. Commissioner*,⁶² the court held that the parties to a loan agreement have the right to agree to an allocation of payments between interest and principal and that any such allocation will be determinative for income tax purposes.⁶³ More specifically, in *E. P. Greenwood v. Commissioner*,⁶⁴ the court held that the parties can agree to have all payments allocated first to interest, and in *O'Dell v. Commissioner*,⁶⁵ the court held that the parties can agree to have all payments allocated first to principal.

The Internal Revenue Service has been quite liberal in this regard also. The Service held in Revenue Ruling 63-57,⁶⁶ for example, that if parties to a loan agree that payments on a note will be charged to principal and only after principal is repaid to interest, the lender will have no income until receipt of payments designated interest under the repayment agreement. Further, in Revenue Ruling 70-647,⁶⁷ the Service held that the parties' agreement to the designation of a payment to principal may be inferred from the circumstances of the loan.

Moreover, it appears that payments can be allocated to interest even if the interest has not yet been earned on the loan. Points paid in advance for the use of money are a prime example of this phenomenon. Several recent cases, such as, *Sandor v. Commissioner*,⁶⁸ and *Burck v. Commissioner*,⁶⁹ have treated points as interest, albeit prepaid interest. In fact, points paid for the use of money are now recognized as interest statutorily as a result of the Tax Reform Act of 1976. Section 461 (g) recognizes that "points" not paid for services may be treated as interest and, indeed, subsection (g)(2) permits a current deduction for points treated as prepaid interest under certain circumstances if connected with a mortgage on the payer's personal residence.

¶ 833.2. Tax Planning Techniques.

From a tax planning point of view, advantageous labelling of payments as interest or principal could, based upon present statements of the law, yield tax benefits to the borrower or the lender. Because the parties to a loan agreement may employ different methods of accounting, tax advantages to one may not be offset by tax detriment to the other. In other words, there may be no diversity of interest in labelling payments, and the lender and the borrower could reach an agreement detrimental to the third, unrepresented, party in the agreement—the Government.

A series of examples will be helpful to illustrate how one set of tax planning objectives can be accomplished: deferral of income to the lender and maximization of deduction for the borrower. Assume that L lends \$100,000 to B. Assume the loan bears interest at 10 percent per annum,

⁶² 36 B.T.A. 116 (1937), acq., 1937-2 C.B. 14.

⁶³ See also *Sefton v. Comm'r*, 292 F.2d 399 (9th Cir. 1961).

⁶⁴ 34 B.T.A. 1209 (1936), acq., 1937-1 C.B. 11.

⁶⁵ 26 T.C. 592 (1956), acq., 1963-1 C.B. 4.

⁶⁶ 1963-1 C.B. 103.

⁶⁷ 1970-2 C.B. 38.

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

⁶⁹ 533 F.2d 768 (2nd Cir. 1976).

compounded annually, and is to be fully amortized by level annual payments of \$15,000. Assume further that B and L are unrelated within the meaning of Section 267(b). Set forth are two examples, containing changes to certain variables, but without change to the economics of the transaction. The variables are (1) the allocation of payments between interest and principal, and (2) the methods of accounting employed by B and L.

Assume, as the first variation, that the parties agree to allocate the entire \$15,000 annual payment to interest. Under the case law and Service positions set forth above, it appears that L will have \$15,000 includible in income, regardless of whether he is on the cash or accrual method of accounting. B, however, will be entitled to a deduction of \$10,000, the amount of interest chargeable to the first year of the loan. This will be true regardless of his method of accounting. The remaining \$5,000 of the payment will constitute prepaid interest, nondeductible in the year of payment but deductible in subsequent years.

Suppose, however, that the parties had agreed to allocate the entire \$15,000 to repayment of principal. If such an allocation were respected for tax purposes, the tax consequences to L and B would appear to be as follows: If L were on the cash method, he would have no income because he has merely recovered his capital; the income element of the loan has yet to be received and a cash method taxpayer has income upon receipt. If L were on the accrual method, however, he would have \$10,000 of income because \$10,000 of interest (10% of \$100,000) accrued on the loan and an accrual method taxpayer, in general, realizes income when it is earned, even if it is not received until a later period.

B's tax consequences are also dependent upon his method of accounting. If he is on the cash method, payment of \$15,000 allocated entirely to principal would yield no interest deduction to him. A cash method taxpayer cannot deduct interest on a loan until he pays that interest. If he were on the accrual method, however, there is general case law support for the conclusion that he could be entitled to a deduction of \$10,000.⁷⁰ Because payment of an item is generally irrelevant for deduction purposes to an accrual method taxpayer, the allocation of the entire annual payment to principal does not cause B any tax detriment.

The variations on the example suggest a rule of thumb for allocating loan repayments. If allocations are respected for tax law purposes, it appears that loans between cash method lenders and accrual method borrowers should provide for allocation of payments first to principal and, only after the principal of the loan has been repaid, to interest. Such an allocation would permit maximum income deferral to L. The economic benefit resulting to L presumably could be divided between B and L through negotiation. The detriment of that negotiation would fall on the unrepresented party—the Government.

¶833.3. Words of Caution

A few words of caution may be in order. The examples assumed that B and L were unrelated. If they were related within the meaning of section 267(b), for example, if B and L were husband and wife or parent and child, section 267 would disallow the deduction to an accrual basis borrower for accrued but unpaid interest payable to a cash method creditor.

⁷⁰ But see *Mooney Aircraft Inc. v. Comm'r*, 420 F.2d 400 (5th Cir. 1969).

Second, there is a line of cases that has grown up in the context of sales of property for promises of future payment. When the note has arisen because L sold property to B and reported the transaction as a "closed transaction" including the fair market value of B's note as an amount realized under section 1001, some cases have prescribed how payments on that note should be treated.⁷¹

In general, payments received on the purchaser's promissory note will be apportioned between recovery by the taxpayer of his basis in the note, which is the fair market value of the note at the time of receipt, and collection gain. The fraction of each payment that is treated as a return of capital is equal to the ratio of the fair market value of the obligation at the time of sale to the face value of the obligation.⁷²

Under some circumstances, however, there is authority to report collection gain on a note, the value of which is less than the face amount, only after basis has been fully recovered rather than pro rata. This cost recovery treatment has been permitted in cases in which the promissory note is speculative. In *Underhill v. Commissioner*,⁷³ the Tax Court listed several factors to be used in determining whether a particular obligation is speculative, including (1) the personal liability of the debtor and his financial position; (2) marketability of the obligation; (3) substantial default of the obligation; (4) the terms of payment and the existence of security for payment and value thereof; and (5) the size of the discount.⁷⁴

The principal line of cases that has been discussed and this latter line have never crossed, even though both lines deal, in essence, with the same issue, fixed return on invested funds—interest.

¶ 840. CONCLUSION

This article has set forth three propositions, and has raised an important and fundamental issue in the tax law with each of them. First, should interest that is clearly part of the economics of a transaction be ignored for tax purposes? In that connection, should an accrual method taxpayer be able to deduct the face amount of an obligation of future payment when it arises? Second, how is the annual cost of money computed— as the parties agree or in some standardized economic way? Third, should the parties' agreement on the allocation of payments between interest and principal, when there is no diversity of interest between debtor and creditor, be effective for tax purposes?

All of these questions share a common element—have a common thread: they involve in some form the question whether parties without diversity of interest should have *carte blanche* to agree on how interest that is part of

⁷¹ Under amended section 453 dealing with installment sales, closed transaction treatment requires that the seller elect out or installment sales treatment.

⁷² See, e.g., *Darby Investment Corp. v. Comm'r*, 37 T.C. 839 (1962), *af'd*, 315 F.2d 551, 553 (6th Cir. 1963); *Tombari v. Commissioner*, 299 F.2d 889, 892-93 (9th Cir. 1962). See generally Goldberg, *Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980*, 34 *Tax Lawyer* 605 (1981).

⁷³ 45 T.C. 489, 494 (1966).

⁷⁴ See also *Liftin v. Comm'r*, 36 T.C. 909, 911 (1961), *af'd*, 317 F.2d 234 (4th Cir. 1963).

the economics of a transaction will be treated for tax purposes to the detriment of the third, unrepresented party—the Government. When the tax consequences of a transaction diverge from the economic consequences, there is the likelihood of abuse. The inadequacy in the law so far has been its inability or unwillingness to properly deal with the time value of money.

Tax planners have mixed and matched these propositions and have used them in combinations to achieve tax results too good to be true. Perhaps they are too good to be true.