Prepaid Interest–A Tax Shelter Collapses: G. Douglas Burck

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PREPAID INTEREST—A TAX SHELTER COLLAPSES: *G. DOUGLAS BURCK*

In *G. Douglas Burck*[1] the United States Tax Court may have effectively put an end to an era of tax planning through the use of prepaid interest. The *Burck* decision is the culmination of a series of attempts by the Internal Revenue Service to restrict the use of the prepaid interest tax avoidance device.

Taxpayer Burck kept his records and filed his income tax return on the cash receipts and disbursements basis for 1969. On December 29, 1969 he executed a secured promissory term note for $3,000,000 bearing interest at a rate of 7 percent per annum payable monthy. Of this amount $2,000,000 was loaned to his partnership and $1,000,000 was transferred to his personal account at First National City Bank. The taxpayer then executed a second note for $2,388,600 with the same lending institution at the same interest rate and deposited the proceeds in a non-interest bearing time deposit account at this bank. The following day Burck withdrew $377,202[2] from his personal account at First National City Bank, an amount representing one year's interest on the two promissory notes, and delivered it to the lending bank in prepayment on the two notes. On his income tax return for 1969, Burck deducted this amount as an interest expense. The Commissioner of Internal Revenue disallowed the deduction. The Tax Court sustained the Commissioner's determination, holding that a material distortion of income would result and that the Commissioner had not abused his discretion under section 446(b) of the Internal Revenue Code of 1954[3]

1. 63 T.C. 556 (1975).

2. The remainder of the $3,000,000 was used as follows: $2,350,000 loaned to the partnership, $100,000 to purchase an interest in another partnership, $150,000 as part payment on the purchase of a personal residence and $22,798 retained by the taxpayer. These facts are relevant to the extent that they possibly show a valid business purpose for the loans.

3. This section concerns methods of accounting:

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used in changing the taxpayer's method of accounting to clearly reflect income.[4]

The unfortunate aspect of the *Burck* decision is that the Tax Court did not go to any length in explaining its rationale for upholding the Commissioner's determination. Without discussing the taxpayer's arguments, the court relied on two propositions set forth by the Internal Revenue Service: First, section 446(b) of the Internal Revenue Code grants the Service the authority to determine whether a taxpayer's method of accounting clearly reflects income. Secondly, Revenue Ruling 68-643[5] is a proper guide for determining whether prepaid interest deductions materially distort income.

The scope of authority exercised by the Service under section 446(b) is identified in section 1.446-1(a) of the Treasury Regulations which states that "[t]he term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item."[6] Relying on this, the court concluded that the taxpayer had failed to prove that the Commissioner had abused his discretion in determining that there was a material distortion of income. In addition, the court regarded several of the factors mentioned in Revenue Ruling 68-643 as being determinative of a material distortion:

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by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary . . . does clearly reflect income.

(c) *Permissible methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the followin methods of accounting—

(1) the cash receipts and disbursements method;
(2) an accrual method;
(3) any other method permitted by this chapter; or
(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary . . . .

4. There was a second issue in *Burck* which is not discussed in this note for the reason that it is well settled. INT. REV. CODE OF 1954, § 163(a) allows a deduction for interest only if it is actually paid in cash during the year. Clinton H. Mitchell, 42 T.C. 953 (1964). A taxpayer giving his own note in payment of interest is not entitled to a deduction for the interest covered by the note, since the note is not considered payment by a cash basis taxpayer. Helvering v. Price, 309 U.S. 409 (1940); Nat Harrison Associates, Inc., 42 T.C. 601 (1964). The rule is the same even if the note is secured by collateral sufficient to cover it. Jenkins v. Bitgood, 101 F.2d 17 (2d Cir. 1939); Frank Kuhn, 34 B.T.A. 274 (1936). The same is true where the taxpayer receives a discounted note. John C. Cleaver, 6 T.C. 452 (1946); S.E. Thomason, 33 B.T.A. 576 (1935). However, the deduction is allowed if the interest is paid in cash, even if the cash used comes from the loan and is deposited in a separate, preexisting account. Newton A. Burgess, 8 T.C. 47 (1947). This was the case in *Burck* and the Tax Court so held.

5. 1968-2 CUM. BULL. 76.

6. Treas. Reg. § 1.446-1(a), 1 FED. TAX REG., U.S. CODE CONG. & AD. NEWS 1380 (1976).

The taxpayer had realized a large capital gain that made his gross income in 1969 far in excess of that for each of the two prior years; the prepayment had been made at the end of the year; and one of the motives of the taxpayer had been the avoidance of income taxes. For these reasons the court disallowed the deduction and upheld the deficiency assessment.

It has long been settled that an accrual basis taxpayer cannot deduct interest for other than the year during which it was earned by the lender.[7] However, a cash basis taxpayer has not been so limited, and this loophole has given rise to its widespread use as a tax shelter. The leading case is *John D. Fackler*,[8] where the Commissioner disallowed the deductions on the theory that to permit them would distort income and that an asset had been created which should have been capitalized. The Board of Tax Appeals, however, held that no distortion would result and, without stating reasons, that the concept of capitalization did not apply. The Board further held that by disallowing the deduction the effect would be to place the taxpayer on the accrual basis as to one item and that such a hybrid method was not permissible. Nevertheless, large scale use of prepaid interest did not develop until all doubts as to its legality were dispelled in 1945 by Income Tax Unit Ruling (I.T.) 3740[9] which concluded as follows:

> [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.[10]

With this ruling the use of prepaid interest in tax avoidance schemes became widespread and reached its peak in the mid-1960s

7. Higginbotham-Bailey-Logan Co., 8 B.T.A. 566 (1927).

8. 39 B.T.A. 395 (1939), *acquiesced in*, 1939-1 CUM. BULL. 11, *acquiescence withdrawn*, 1968-2 CUM. BULL. 3. The Internal Revenue Service has the authority to acquiesce or nonacquiesce in any Tax Court decision. *See, e.g.*, 1971-1 CUM. BULL. 1. An acquiescence by the Service can generally be relied on by the taxpayer as an indication that it will adhere to the decision in all future, similar cases. Nonacquiescence, on the other hand, indicates that the Service will continue to challenge similar facts and circumstances, even though the nonacquiescence is not binding on the courts.

9. 1945 CUM. BULL. 109.

10. *Id.* The Ruling gives no indication why a five year period was chosen. It relied basically on *Fackler* which involved a much shorter period, so the time limit seems to be purely arbitrary.

when it was common to structure large purchases of real estate using prepaid interest.[11] It was not until 1968, when Revenue Ruling 68-643 was issued, that the prepaid interest device came under serious attack by the Internal Revenue Service.

Through the issuance of Revenue Ruling 68-643, the Internal Revenue Service undertook a reconsideration of I.T. 3740. Recognizing the abuses that proliferated under it, the Service concluded that it should be revoked. In addition, the Service withdrew its acquiescence in *Fackler*.[12] The newly stated policy embodied in Revenue Ruling 68-643 disallows any deduction for prepaid interest which is not due within twelve months after the end of the taxable year during which the payment is made. The deduction of up to one year's prepaid interest is to be considered on a case by case basis and, if it appears to materially distort income, will be disallowed. If the deduction is found to distort income, the Service will change the taxpayer's method of accounting as to this item and require the taxpayer to allocate the interest over the term of the loan.[13]

The effect of this ruling is to require the taxpayer to adopt a hybrid method of accounting by placing him on the accrual basis for the interest item and leaving him on the cash basis for his other accounts. Under the 1939 Code, there was sufficient authority for the proposition that hybrid methods were not permitted[14] and the Commissioner made no attempts to force their usage. However, section 446(c)(4)[15] of the 1954 Code appears to permit them if, in the discretion of the Commissioner, they more clearly reflect income.[16] The burden is on the taxpayer, as the court noted in *Burck*, to show that the Commissioner abused his discretion in changing the taxpayer's method of accounting, because in tax cases the determination of the Internal Revenue Service is presumptively correct. This is usually a very difficult task because the scope

11. *See* Asimow, *Principle and Prepaid Interest*, 16 U.C.L.A.L. REV. 36, 46 (1968).

12. *See* note 8 *supra*.

13. The Revenue Ruling also lists several factors which should be considered in determining whether a material distortion of income would result. *See* text accompanying note 25 *infra*.

14. Case cited note 8 *supra*.

15. *See* note 3 *supra*.

16. Two cases decided under the 1954 Code bear this out. In Dorr-Oliver, Inc., 40 T.C. 50 (1963) the court refused to allow a taxpayer to switch from a hybrid method without the Commissioner's consent under section 446(e), reasoning that the hybrid method already clearly reflected income. In Loyd L. Parker, 37 T.C. 331 (1961), the taxpayer ran two related businesses, both of which were using hybrid methods. The court sustained the Commissioner's action in requiring one to change to a different method of accounting.

of the Commissioner's power under section 446(b) is quite broad. The courts have established some guidelines for determining when the Commissioner has abused his discretion in refusing to permit or requiring a taxpayer to change his method of accounting.[17] These may be helpful in evaluating the Commissioner's action in *Burck*.

Conformity to generally accepted accounting principles is often used to see if the Commissioner has abused his discretion.[18] Independent auditors do not recognize the cash basis as a generally accepted accounting principle primarily because the exclusion of such items as accounts payable and accounts receivable tend to distort income. A similar distortion appears when a cash basis taxpayer prepays rent and insurance, and deduction of these prepayments is expressly disallowed by the Service and the courts.[19] If these distortions are material and there is a possibility that misleading inferences will be drawn from them, the accountant will probably express an opinion that a statement does not present financial position and results of operation.[20] Considering the fact that an accrual basis taxpayer cannot deduct interest for other than the year during which it was earned by the lender, a large prepayment of interest would so materially distort income that generally accepted accounting principles would require an opinion that the accounts do not present financial position and results of operations.

Another established guideline is the amount of freedom that the taxpayer has in determining when income is reported or deductions are taken.[21] Undue control by the taxpayer in this area would permit him to reap the optimum benefit from tax avoidance schemes and delay payment of his fair share of taxes indefinitely. Related to this idea of control is the concept of consistency, one of the first terms learned by a student of accounting. Many taxpayers who use prepayments of interest do so on a one time basis, and this is not consistent with their usual

17. *See generally* Asimow, *Principle and Prepaid Interest*, 16 U.C.L.A.L. REV. 36, 50-57 (1968).

18. *See* Fort Howard Paper Co., 49 T.C. 275 (1967). *See also* Treas. Reg. § 1.446-1(a)(2) (1975).

19. Commissioner v. Boylston Market Ass'n, 131 F.2d 966 (1st Cir. 1942); Southwestern Hotel Co. v. United States, 115 F.2d 686 (5th Cir. 1940), *cert. denied*, 312 U.S. 703 (1941); University Properties, Inc., 45 T.C. 416 (1966), *aff'd*, 378 F.2d 83 (9th Cir. 1967); Lola Cunningham, 39 T.C. 186 (1962); Henry Cartan, 30 T.C. 308 (1958); Martha R. Peters, 4 T.C. 1236 (1945); George S. Jephson, 37 B.T.A. 1117 (1968); Julia Stow Lovejoy, 18 B.T.A. 1179 (1930).

20. 1 CCH AM. UNST. CERT. PUB. ACCTS. PROF. STDS., pt. AU, § 900.05 (1975).

21. *See, e.g.*, Fort Pitt Brewing Co. v. Commissioner, 210 F.2d 6 (3d Cir.), *cert. denied*, 347 U.S. 989 (1954).

habits. Businesses cannot change their accounting treatment of certain items to fit their tax needs and there is no reason why an individual should be able to do so. "Consistency is the key and is required regardless of the method or system of accounting used."[22]

In addition to the proceeding guidelines created by the courts, one might consider those established by the Service through the issuance of Revenue Ruling 68-643.[23] Revenue rulings are not binding on the courts.[24] Yet, in spite of their general lack of authoritativeness, revenue rulings are used by taxpayers for tax planning purposes and often by courts in support of their decisions. For these reasons one should analyze the factors recommended in the Ruling as being determinative of a material distortion under section 446.

The first factor mentioned is the amount of taxable income in the year of prepayment as compared with prior years. The inference to be drawn here is quite clear. If a taxpayer's income in the current year is far in excess of that in prior years, this is a good indication that the prepaid interest was for tax avoidance purposes and not for any legitimate business reason. A taxpayer, expecting his income to recede to its normal level in following years, might prepay interest this year to level out his income and tax. To ease the tax burden on persons with fluctuating incomes, Congress has provided a tax smoothing device through income averaging.[25] This is the preferred method and nonstatutory substitutes are generally not upheld.

The amount of the prepaid interest is another factor to be considered. A large dollar and percentage figure is more likely to distort income than a small amount and is more likely to be challenged by the Service. In addition, large amounts generally involve greater deficiencies, thus, the Service is more willing to do battle in court when a large figure is involved.

22. Advertisers Exchange, Inc., 25 T.C. 1086, 1092 (1956), *aff'd per curiam*, 240 F.2d 958 (2d Cir. 1957).

23. This Revenue Ruling has received legislative support. *See* H.R. REP. No. 413, 91st Cong., 1st Sess. 73 (1969).

24. The purpose of the publication of revenue rulings is to publish the official interpretation of the Revenue Service of certain laws as applied to certain circumstances in order to promote uniform application of the tax laws by Service employees and to advise taxpayers of the official Service position. They do not have the force and effect of Treasury Department Regulations but are published to provide precedents to be used in the disposition of other cases. They are not binding on the courts.

Andrew A. Sandor, 62 T.C. 469, 481-82 (1974).

25. INT. REV. CODE OF 1954, §§ 1301-05.

Other factors listed are the time of payment and the reason for payment. Obviously, the latter is important; if a tax avoidance motive is discovered, the deduction will be disallowed. Apparently, the time of payment is included because it may reflect motive. For example, a payment made late in the year suggests that the purpose of the payment was to avoid federal income taxes.

Even though the court in *Burck* recognized that Revenue Ruling 68-643 is advisory only and does not carry the force of law, it weighed the facts and circumstances of the case against the factors outlined in the Ruling in reaching its decision. The court thereby appears to have accepted these guidelines as useful indicia of a material distortion of income resultant from prepaid interest deductions. This contrasts with the approach taken in an earlier Tax Court decision involving prepaid interest, *Andrew A. Sandor*,[26] where the court refused to review the factors listed in Revenue Ruling 68-643. Although the court upheld the determination of the Commissioner that there was a material distortion of income and permitted the change to a hybrid method of accounting ordered by the Commissioner pursuant to section 446, the disallowance of the deduction was grounded upon the analogy between prepaid interest and prepaid rentals:

> We think that the parallel between prepaid rent and prepaid interest is inescapable. The fact that rental payments are deductible under section 162, whereas interest payments are deductible under section 163, is of little moment. The underlying theory which makes prepayments of rent not immediately deductible is equally applicable to prepaid interest—i.e., the likelihood that the deduction will result in a material distortion of income.[27]

Thus, *Burck* was the first case to give judicial support, even if only by implication, to Revenue Ruling 68-643 in its holding that a material distortion would result if a deduction for prepaid interest payments were allowed. The result for the taxpayer is that he must prorate the interest over the years due even though it is paid currently.

A tax avoidance scheme that began to bloom with an early Internal Revenue Service ruling and reached full maturity in the mid-1960s has now come to an end with the Tax Court's decision in *Burck*, apparently endorsing Revenue Ruling 68-643. Unless a taxpayer can show that an interest prepayment does not distort his income, he will be required

26. 62 T.C. 469 (1974).
27. *Id.* at 480.

to deduct it in the year to which it applies. Any prepayments of interest not due within twelve months after the end of the taxable year during which the prepayment is made will be disallowed. All other payments will be judged on a case by case basis.

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