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The Effect of Revenue Ruling 68-643 on the Prepaid Interest Deduction

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right infringement. His action may be protected if he can convince the courts that his was a fair use of the copyrighted work. However, as a practical matter, a teacher has neither the time nor the financial resources necessary to successfully defend such an action. The result could be that teachers will not use the materials and creative teaching will be severely limited and restricted. The purpose of the constitutional provision empowering Congress to enact a copyright act is to "promote the Progress of Science and useful Arts."[38] When a classroom teacher is denied the right to reproduce materials that would enable him to better teach his students, this purpose is thwarted. The proposed revision of the copyright law, if enacted, would possibly improve the position of teachers, but this is not enough. What is needed is a specific exemption that would allow a teacher to reproduce materials for educational purposes without fear of civil or criminal liability in cases where such copying would not damage the potential market for the materials copied.

Frank Edward Jolliffee

The Effect of Revenue Ruling 68-643 on the Prepaid Interest Deduction

Revenue Ruling 68-643[1] substantially affects the law regarding the deduction of prepaid interest by precluding the deduction for more than two years prepaid interest. It also evidences the Commissioner's intention to challenge more strongly the deduction of two years prepaid interest by the cash basis taxpayer.

The Internal Revenue Code of 1954 provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.[2] Under the Code the taxable income is computed under the method of accounting which the taxpayer regularly uses in computing his income.[3] Thus a taxpayer who keeps books of account and files federal income tax returns on the cash receipts and disbursement method of accounting could deduct interest he prepaid several years in advance of the year when it accrued. However, the Code also provides that if the accounting

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[38] U.S. CONST., art. I, § 8.
[1] Rev. Rul. 643, 1968 INT. REV. BULL. No. 51st 9.
[2] INT. REV. CODE of 1954, § 163 (a).
[3] INT. REV. CODE of 1954, § 446 (a).

method used by the taxpayer does not clearly reflect income, the computation of the taxable income shall be made under such method as, in the opinion of the Commissioner, does clearly reflect income.[4] This is one check which the Commissioner could use to preclude the taxpayer from abusing the prepaid interest deduction.

The procedures outlined in the 1954 Code have caused many problems as to how much, when, and for what purpose the taxpayer can deduct interest paid in advance. The courts prior to Revenue Ruling 68-643 attempted to solve these problems, but the opinions were sometimes confusing and at times seemed inconsistent.

In past years, the Commissioner has been fairly liberal in allowing the prepaid interest deduction. Under I.T. 3740,[5] the Commissioner permitted taxpayers to deduct interest paid in advance for a period of five years, in the year in which the interest was paid. However, the Commissioner has litigated cases involving prepaid interest deducted both before and after the promulgation of I.T. 3740.

The case of *Fackler v. Commissioner*[6] arose prior to the I.T. 3740. Fackler, a cash basis taxpayer, paid $47,000 interest in 1934, of which $6,000 represented a prepayment of interest due in 1935 and $2,400, a partial prepayment due in 1936. Each prepayment was made for a good business reason. The Commissioner challenged these deductions, stating that they were in the nature of capital expenditures that should be amortized; and, to allow them as deduction would cause a distortion of the taxpayer's income. The court held that the deduction for prepayments did not distort the taxpayer's income. The court reasoned that these deductions would no more distort income than would payment in one of the current taxable years for interest covering an elapsed period of more than these years.[7]

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[4] INT. REV. CODE of 1954, § 446 (b).
[5] I.T. 3740, 1945 CUM. BULL. 109.
[6] 39 B.T.A. 395 (1939), acquiesced in, 1939-1 CUM. BULL. 11.
[7] [D]istortion 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 in one of the current taxable years for interest covering an elapsed period of more than these years . . . . And that does not prevent the deduction . . . . The effect of denying it here would be to place petitioner on an accrual basis as to one item on his return and leave him on a cash basis as to the remainder. Such inconsistency is not permissible . . . . *Id.* at 398, 399.

Shortly after promulgation of I.T. 3740, the Commissioner again challenged the taxpayer's deduction of five years prepaid interest in *Konigsberg v. Commissioner.*[8] In *Konigsberg,* a cash basis taxpayer deducted a prepayment of five years interest on a loan made to pay a premium on a life insurance policy of the taxpayer. The Commissioner did not contend, as he did in *Fackler,* that the prepaid interest deduction distorted the taxpayer's income; rather he argued that the taxpayer had merely discounted the note so that interest would not be paid until the principal was paid. The court permitted the deduction citing *Flackler* but not I.T. 3740. As recently as July 1968, in the case of *Schultz v. Commissioner,*[9] the Commissioner permitted a deduction of four years prepaid interest. In *Schultz,* the taxpayer prepaid interest on purchase money notes given in acquiring raw whiskey. The Commissioner permitted the prepaid interest deduction despite disallowing deduction of other prepaid charges incurred in acquiring the whiskey.[10]

The IRS has not been unsuccessful in all cases involving the deduction of prepaid interest. In two comparatively recent cases[11] the Commissioner was successful in precluding the prepaid interest deduction by characterizing the transaction which gave rise to the interest as a sham. In *Knetsch v. U.S.*[12] the taxpayer purchased single-premium thirty year maturity deferred annuity savings bonds with an aggregate face value of $4,000,000. The taxpayer paid only a minimal sum in cash and gave nonrecourse notes secured by the bonds for the balance. The taxpayer paid a substantial amount as interest in advance on that indebtedness. These borrowing and interest payments were then repeated in two subsequent years. The Commissioner disallowed the interest deduction, and the court affirmed characterizing the transaction as a sham since it did not appreciably affect the taxpayer's beneficial interest.[13]

In Bridges v. Commissioner[14] the Commissioner was again successful in disallowing the interest deduction on the basis that the

[8] 5 C.C.H. Tax ct. Mem. 48 (1946).
[9] 50 T.C. 688 (1968).
[10] "The fact that respondent did not disallow, in the year of payment, petitioner's deduction for prepaid interest in further evidence that respondent considered the transactions as having substance." *Id.* at 694 n.4.
[11] Knetsch v. U.S., 364 U.S. 361 (1960). Bridges v. Commissioner, 325 F.2d 180 (4th Cir. 1963).
[12] 364 U.S. 361 (1960).
[13] Knetsch's transaction with the insurance company, "did not appreciably affect his beneficial interest except to reduce his tax." *Id.* at 366.
[14] 325 F.2d 180 (4th Cir. 1963).

transaction which gave rise to the interest was a sham. In that case, the taxpayer purchased $500,000 of United States Treasury 1⅝ per cent notes on September 19, 1956. The notes were due on May 15, 1957. The First National Bank of Baltimore, Maryland loaned the taxpayer $500,000 on a promissory note dated September 24, 1956 and signed by the taxpayer. The note was due on May 15, 1957, the maturity date of the treasury notes which were pledged as collateral security for the promissory note. On September 21, 1956, the taxpayer prepaid to the bank the stipulated interest on the loan. On May 15, 1957, the Baltimore bank redeemed the treasury note at maturity for $500,000 and extinguished taxpayer's liability on the promissory note. On his 1956 return, the taxpayer claimed a deduction for the $19,687 interest payment made to the Baltimore Bank and reported a long-term capital gain of $13,125 as a result of the sale on May 15, 1957 of the United States Treasury notes. The taxpayer performed a second transaction similar to the above in 1957, deducting the prepaid interest and claiming a long-term capital gain on the sale of similar treasury notes in 1958. In affirming the tax court's disallowance of the interest deduction, the court characterized the transaction as a sham and said that the transaction did not affect the taxpayer's beneficial interest other than reducing his taxes.[15]

The issue of the deductibility of prepaid interest arose again in *Goldstein v. Commissioner.*[16] The Commissioner did not characterize the transaction which gave rise to the interest as a sham, as in the *Bridges* and *Knetsch* cases, but attacked it on the grounds that the transaction had no substance or utility apart from their anticipated tax consequences.[17] In *Goldstein,* the taxpaper won $140,218 in the Irish Sweepstakes and received the proceeds in December, 1958. The taxpayer borrowed $465,000 from the First National Bank of Jersey City and purchased $500,000 face amount of United States Treasury ½ per cent notes, due to mature on

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[15] [N]o real indebtedness was created and the Tax Court was fully justified in finding that, as payments of interest 'on indebtedness,' the transactions were shams . . . . [I]t is patent that there was nothing of substance to be realized by Bridges from either transaction beyond a tax deduction; and plainly the transactions did not in any way affect his beneficial interest except to reduce his tax. *Id.* at 185.

[16] 364 F.2d 734 (2nd Cir. 1966).

[17] We hold . . . that Section 163(a) of the 1954 Internal Revenue Code does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences. *Id.* at 740.

October 1, 1962. The taxpayer pledged these notes as collateral for her loan. The taxpayer then repeated this procedure with a $480,000 loan from the Royal State Bank of New York. The taxpayer prepaid the interest that would be due on the loans she had received if they remained outstanding for one and a half to two and a half years in late December, 1958 and then claimed the sum of the prepaid interest as a section 163(a) deduction on her 1958 income tax return. The interest deduction was disallowed by the court which concluded that the taxpayer only borrowed the money to obtain the deduction.[18] However, the court by way of dictum stated that the interest deduction will not be disallowed even though the transaction may be partially motivated by the prospect of the interest deduction, as long as there is some substance to the loan arrangement beyond the desire to secure the dedcution.[19]

Considering the holdings in these cases, one may make certain observations about the law concerning the deductibility of prepaid interest . . . . prior to Revenue Ruling 68-643. The cash basis taxpayer could deduct interest paid in advance for a period of five years from the year in which it was paid[20] as long as he had a good business reason,[21] and the interest was in fact paid, and the loan was not discounted.[22] However, it was necessary that the loan agreement contain some substance beyond the taxpaper's desire to secure the deduction, even though the interest deduction could be one of mixed motives that prompted the taxpayer to borrow funds.[23] However, the interest deduction was denied when the transaction giving rise to the interest was a sham and did not affect the beneficial interest of the taxpayer except to reduce taxes,[24] or it could not

[18] Notwithstanding Section 163(a)'s broad scope, this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of interest deduction: and a good example of such purposeless activity is borrowing of funds at 4% in order to purchase property that returns less than 2% and holds no prospect of appreciation sufficient to counter the unfavorable interest rate differential. Goldstein v. Commissioner, 364 F.2d 734, 741 (2nd Cir. 1966).

[19] [T]he interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction.

[20] I.T. 3740, 1945 CUM. BULL. 109.

[21] Fackler v. Commissioner, 39 B.T.A. 395 (1939).

[22] 5 C.C.H. Tax ct. Mem. 48 (1946).

[23] Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir. 1966).

[24] Knetsch v. Commissioner, 364 U.S. 361 (1960); Bridges v. Commissioner, 325 F.2d 180 (4th Cir. 1963).

with reason be said to have purpose, substance and utility apart from the anticipated tax consequences, even though the transaction itself was not a sham.[25]

Revenue Ruling 68-643[26] changes the above interpretation regarding the deduction of prepaid interest. The ruling expressly revokes I.T. 3740 and also withdraws the Commissioner's acquiesence to the *Fackler* case.[27] The ruling states that a prepaid interest deduction for a period extending more than twelve months beyond the end of the current taxable year will be construed as materially distorting income and the Service will require the taxpayer to change his accounting method so that the prepaid interest is allocated over the taxable years involved.[28] Thus it seems clear that the deduction of more than two years prepaid interest in the year when it is paid will be disallowed even though the loan is obtained for a bonafide business purpose, and with no intention of obtaining the interest deduction.

However, Revenue Ruling 68-643 does not preclude the deduction of all prepaid interest. Under its terms the cash basis taxpayer may still deduct up to two years prepaid interest.[29] But, in these cases the taxpayer will have to justify his prepaid interest deduction by showing that the interest deduction does not distort his income. There are no examples in the ruling of cases in which the prepaid interest deduction distorts income although several factors[30] to be considered in making this determination are listed.

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[25] Goldstein v. Commissioner, 364 F.2d 734 (2nd St. Cir. 1966).
[26] Rev. Rul. 643, 1968 INT. REV. BULL. No. 51 at 9.
[27] *Id.* at 11.
[28] If interest is prepaid for a period extending more than 12 months beyond the end of the current tax-year, the deduction of such prepaid interest in the taxable year of payment will be considered as materially distorting income. Where a material distortion of income has been found to result from the deduction of prepaid interest, the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest in order to allocate it over the taxable years involved. Rev. Rul. 643, 1968 INT. REV. BULL. No. 51, at 10.
[29] The Service now concludes that the deduction of prepaid interest in the year of payment by a taxpayer employing the cash receipts and disbursements method of accounting may not result in a clear reflection of income for the taxable year of payment. A deduction for interest paid in advance on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made will be considered on a case by case basis to determine whether a material distortion of income has resulted. *Id.*
[30] 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

The principles set forth in *Knetsch,*[31] *Bridges,*[32] and *Goldstein*[33] should also aid the taxpayer in making his decision to go ahead with a transaction which is keyed to the prepaid interest deduction.

Although there are no examples of cases involving denial of a prepaid interest deduction because it materially distorts income, it is possible to ascertain some standards of what a material distortion of income is from cases in which the Commissioner has attempted to preclude other types of deductions on the grounds that they materially distort the taxpayers income. This issue arose in *Lucas v. Ox Fibre Brush Co.*[34] In the *Lucas* case, the directors of the corporation granted its president and treasurer extra compensation amounting to $24,000 in 1920. The corporation deducted this amount. The Commissioner disallowed the deduction, and the Board of Tax Appeals had concluded that the amount was too excessive to be considered reasonable compensation for the year and could not be deducted.[35] The Supreme Court in reversing stated that the amount could be deducted since the compensation was properly paid and incurred during the year.[36] The Commissioner again was unsuccessful in challenging a deduction of a full year's property taxes when a taxpayer, on the accrual basis, filed a short period return for eleven days in *Simon J. Murphy Co. v. Commissioner.*[37] The court said that the taxes resulted in a legal

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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. *Id.*

[31] 364 U.S. 361 (1960).

[32] 325 F.2d 180 (4th Cir. 1963).

[33] 364 F.2d 734 (2nd Cir. 1966).

[34] 281 U.S. 115 (1930).

[35] Ox Fibre Brush Co. v. Commissioner, 8 B.T.A. 422 (1927).

[36] Section 212 (b) provides: (b) the net income shall be computed upon the basis of the taxpayer's annual accounting period. (but) if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion the Commissioner does clearly reflect the income."

This section relates to the method of accounting; the Commissioner may make the computation on a basis that does clearly reflect the income, if the method employed by the taxpayer does not. But this section does not justify the Commissioner in allocating to previous years a reasonable allowance as compensation for services actually rendered, when the compensation was properly paid during the taxable year and the obligation to pay was incurred during that year and not previously." Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 120 (1930).

[37] 231 F.2d 639 (6th Cir. 1956).