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The Interest Deduction: Several New Installments in a Continuing Saga

Leon Gabinet

Observers of the federal tax scene have often noted a recurring phenomenon which enlivens the day-to-day work of the entire tax fraternity. I refer, of course, to those general upheavals caused by court decisions, treasury rulings, or new bits of legislation which purport to settle touchy issues. The result of these periodic upheavals is a sharp increase in the output of critics and commentators, all of which raises the commentative cauldron to the boiling point. By the time the boil has quieted to a simmer, a new issue and a new pronouncement (or perhaps a new pronouncement about an old issue) will appear upon the scene and the process will begin again.

The deduction for interest is no exception to the boil-simmer-boil cycle. Although Code section 163 contains brief and seemingly straightforward provisions, the variety of transactions which lend themselves to the use of the interest deduction has provided the impetus for a loving exploration of its possibilities. By definition, such taxpayer exploration focuses on the outer limits of the statutory provisions. The administrative and judicial reaction to this probing has again produced a shock wave, this time emanating from two distinct centers. The first such center is Revenue Ruling 68-643, dealing with the issue of prepayment of interest by cash basis taxpayers. The second, and perhaps more important, center encompasses three sections of the Tax Reform Act of 1969: (1) Section 221, which limits the deductibility of "excess investment interest" over "net investment income" (as those terms are defined in that section); (2) section 421, which authorizes the Commissioner

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1 See the introductory remarks of Professor Sneed in Sneed, A Defense of the Tax Court's Result in Prunier and Casale, 43 CORNELL L.Q. 339 (1958).
2 INT. REV. CODE OF 1954, § 163 [hereinafter cited as CODE].
3 1968-2 CUM. BULL. 76.
4 83 Stat. 487 [hereinafter cited as REFORM ACT].
to issue regulations regarding the classification of corporate interests as either stock or indebtedness; and (3) section 411, which limits the deductibility of interest on certain corporate indebtedness issued to acquire the stock or assets of another corporation.

These developments constitute new pronouncements relating to old problems. Inevitably, they will give rise to analysis, speculation and rethinking of taxpayer activity, for they embody some radically new approaches. It is the purpose of this paper to examine and evaluate these new substantive ground rules and to consider the manner in which they redefine the deductibility of interest.

I. REVENUE RULING 68-643 AND PREPAID INTEREST

The developments which led to the promulgation of Revenue Ruling 68-643 are not difficult to trace. Section 163(a) permits a deduction for "all interest paid or accrued within the taxable year on indebtedness." Since there is no limitation upon the nature of the underlying indebtedness which gives rise to the interest obligation, it is clear that it applies both to business and nonbusiness indebtedness. The important phrase "paid or accrued within the taxable year" sets the stage for the entire prepayment of interest problem. The words "paid or accrued" are required to be construed in accordance with the taxpayer's method of accounting. Thus, a cash basis taxpayer should be able to deduct interest when it is actually paid. This being the case, a cash basis taxpayer is in a position to exercise a considerable degree of control over the timing of his interest deduction. Assuming an appropriate arrangement with the lender, the taxpayer could prepay interest for several years and deduct the entire amount as paid in the taxable year in which he makes the prepayment. If the interest item is deductible when "paid or accrued" as that term relates to the taxpayer's accounting method, then clearly the interest has been "paid" and deductibility appears to be the natural consequence.

It was readily apparent to the Commissioner that the degree of taxpayer control over the timing of the interest deduction afforded by such a literal reading of the statute was undesirable. It would be altogether too easy for a cash basis borrower to prepay a large interest item in a year in which he had substantial income from other sources, thereby sheltering that income by an inflated interest de-

5 Code § 163(a).
6 Id. § 7701(a)(25).
duction. The Commissioner therefore resisted deduction of prepaid interest on the ground that in order to clearly reflect income, a prepayment of interest should not be deductible currently, but should be amortized over the period to which it relates — the entire life of the loan or the portion thereof supported by the prepayment. This argument was based upon section 41 of the Revenue Act of 1939,8 which, like its present counterpart, section 446(b),9 precludes the use of an accounting method which does not clearly reflect income. The argument was presented in John D. Fackler10 and was rejected by the Tax Court which concluded that, in effect, the Commissioner was attempting to place the cash basis taxpayer on the accrual basis with respect to interest prepayment. It reasoned that a postpayment of the interest would clearly be deductible in the year of payment and would result in no greater distortion of the taxpayer’s income than the prepayment. As long as cash basis accounting is permitted, there is bound to be some mismatching of income and deduction items, and, therefore, the Tax Court felt that it would be improper to place the taxpayer on an accrual basis as to only one item, the interest deduction. The Fackler case was followed by the decision in Court Holding Co.11 which again upheld a cash basis taxpayer’s right to deduct a prepayment of interest in the year of disbursement. In 1945, the Commissioner, in what appears to have been a concession of defeat, issued Income Tax Ruling 3740,12 wherein he ruled that a cash basis taxpayer could properly deduct a 5-year interest prepayment in the year of disbursement. Thereafter, a number of cases were decided in the Tax Court which firmly established the right to a current deduction for prepaid interest.13

It should be noted that the cases which allowed the current de-

7 Taxpayers have used somewhat more sophisticated arrangements to achieve similar results, with respect to both acceleration and deferral of the interest deduction. For example, because a mere increase in the principal of the loan does not constitute interest “paid” in the tax year, a deferral can be achieved by having a lending bank increase the principal of an existing debt obligation by the amount of accrued but unpaid interest. Similarly, acceleration of the deduction can be achieved by having the lending bank credit the borrower’s account by the amount of the increase in the loan and then having the borrower issue a check to meet the interest liability, thus insuring payment and current deductibility. See Kanter, Interest Deduction: Use, Ruse, Refuse, 46 TAXES 794, 798 (1968).
9 Code § 446(b).
10 39 B.T.A. 395 (1939), acquiesced in, 1939-1 CUM. BULL. 11.
11 2 T.C. 531 (1943), acquiesced in, 1943 CUM. BULL. 5.
12 1945 CUM. BULL. 109.
duction for an interest prepayment were all cases in which a bona
fide indebtedness was present. The importance of the taxpayer’s
good faith was unmistakably underscored in 1966, when the Court
of Appeals for the Second Circuit denied a deduction for prepaid
interest in three cases. In each of them the bona fides of the in-
terest transaction was the crucial issue. Two of the cases, Ippolito
v. Commissioner, \(^{14}\) and Barnett v. Commissioner, \(^{15}\) involved cash
basis, calendar year taxpayers who had won very substantial prizes
taxable as ordinary income in the year of receipt. In both cases, to-
ward the end of the tax year in which the prize was received, the
taxpayers borrowed large sums—with which they purchased govern-
ment obligations, prepaying interest on the loans (in Ippolito in-
terest was prepaid for 11 months and in Barnett for 9 months). In
January of the following year, the government obligations were sold,
the loans repaid, and the unearned interest refunded to the taxpay-
ers. The court held that the prepayment of interest was not de-
ductible because the transactions were “devoid of commercial rea-
ity,” a “sham,” and that their only purpose was to secure an interest
deduction under section 163 (a).

The third case, Goldstein v. Commissioner, \(^{16}\) while arriving at
the same ultimate result, differs markedly from its companions.
Goldstein was a prizewinner who also incurred a large indebtedness,
prepaid the interest thereon, and used the proceeds to purchase gov-
ernment obligations. The government obligations were not sold
until 18 months later, at which time the debt was repaid and the
unearned interest refunded. In this case, the Second Circuit found
that the transaction was not a sham, but notwithstanding the reality
of the transaction, it found further that there was no “purposive
activity” in the entire series of events except for the securing of a
deduction for the prepaid interest. The court stated that the deduc-
tion was proper when “there is some substance to the loan arrange-
ment beyond the taxpayer’s desire to secure the deduction.” \(^{17}\)

The Ippolito, Barnett, and Goldstein triumvirate can easily qual-
ify as pronouncements which fed the fires under the commentative
cauldron, raising it to a boil. The Goldstein case has been particu-
larly favored with a great deal of comment and analysis because the
requirement that there be “purposive activity” in a transaction which

\(^{14}\) 364 F.2d 744 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).
\(^{15}\) 364 F.2d 742 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).
\(^{16}\) 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).
\(^{17}\) Id. at 741.
otherwise creates a bona fide debt leaves something to be desired by way of clarity.\textsuperscript{18} It is not, however, appropriate at this point to embark upon a critique of Goldstein: What is important for the present discussion is to note that, in the series of decisions from Fackler to Goldstein and its companion cases, the courts had established the proposition that a prepayment of interest in the normal, routine loan transaction is deductible in the year of payment, except where the loan transaction has no substance and is a "sham," or where the transaction indicates no "purposive activity" other than the desire to secure a tax deduction. In none of the three opinions which established this exception was it suggested that the disallowance rests upon the distortion in income resulting from the deduction of prepaid interest.

Perhaps if taxpayers had remained content with this state of affairs and had limited their use of the prepaid interest deductions to those routine transactions where, for example, some prepaid interest is a condition of the loan, the Commissioner might also have been content to let the matter rest. However, this is not the way of the world. Success in shaping a loan transaction to fit the permissible mold carries a substantial tax reward. To explore the possibilities of success means to travel the outer limits of the permissible, poking at the thin membrane which separates it from the forbidden.

Representative of this taxpayer probing are the so-called "Livingstone cases" which involved prepaid interest on \textit{elaborate} loan transactions that had little, if any, economic reality.\textsuperscript{19} The courts

\textsuperscript{18} See, e.g., Webster, \textit{Prepaid Interest — Tax and Local Law Considerations for the Payor and Payee}, U. So. CAL. 1967 TAX INST. 381. It is difficult to define precisely the exact meaning of the phrase "purposive activity," since the court seems to have used it as part of a comprehensive theory of tax avoidance intended to have broad general application beyond the immediate issue of prepaid interest. The more recent cases have not refined the definition to any extent. An example is Lifschultz v. Commissioner, 393 F.2d 232 (2d Cir. 1968), where, in disallowing a deduction for prepaid interest, the court held it unnecessary to determine if the transactions were a sham because it was persuaded that they were entered into without expectation of profit. However, the loan transactions in Lifschultz were clearly subject to attack as sham. Thus, the case does establish the Goldstein approach as a general tax avoidance principle, but it does not indicate a sufficient level of expectation of economic profit to negate the exclusiveness of tax avoidance. The courts will have to give meaning to the phrase as the cases arise. Until such decisions become available, we are left with a somewhat vague notion which is short of the familiar "business purpose" rule and which requires an expectation of profit beyond mere tax avoidance. \textit{See Kanter, supra note 7, at 828-29.}

\textsuperscript{19} See, e.g., Eli Goodstein, 30 T.C. 1178 (1958), \textit{aff'd}, 267 F.2d 127 (1st Cir. 1959). The "Livingstone" cases (which have immortalized Eli Livingstone, a Boston securities broker who developed the basic format of the transaction) generally involved purchases of government obligations with borrowed funds, with interest paid in advance. The obligations were sold in a later tax year at a gain, thus utilizing the prior deduction for prepaid interest to allow the taxpayer to achieve a capital gain position as the obligations
had little difficulty in finding that these transactions were shams. Not all such probing, however, results in transactions so patently objectionable. In recent years, for example, it has become common practice to market land in southern California in a transaction substantially in this form: The buyer makes no down payment, but agrees to prepay interest on the purchase price for 5 years. In the sixth year, he commences to make payments of both principal and interest, amortized over a 5-year period (but based on a 10-year amortization with a balloon payment in the 10th year). Conceivably, this sort of transaction could run afoul of the Goldstein criterion, particularly where the sale is followed by a default resulting in return of unearned interest in a subsequent year. But even where the transaction is allowed to run its normal course, the taxpayer is stretching the prepaid interest deduction to unmerciful lengths, though he may well have avoided the pitfall of the Goldstein case. In these circumstances, the Commissioner can only attack the transaction on other grounds. He might, for example, argue that the interest prepayment is really a down payment on the purchase price, or that the transaction is really an option. Such arguments, however, are highly conceptualistic and would be difficult to sustain.

It is not surprising, then, that in Revenue Ruling 68-643,20 the Commissioner departed from his acquiescence in Fackler and Court Holding Co., and withdrew Income Tax Ruling 3740. In essence, the new ruling takes the position that any prepayment of interest by a cash basis taxpayer for a period of more than 12 months following the close of the tax year of the prepayment shall constitute a material distortion of the taxpayer's income. In such cases, pursuant to the authority granted the Commissioner by section 446(b),21 which provides for the use of a method of accounting which clearly reflects income, he will require the taxpayer to accrue the prepaid item ratably over the life of the loan. In cases of prepayment of interest for less than a 12-month period following the close of the year of prepayment, the issue of material distortion will be considered on a case-by-case basis. In short, the ruling places a cash basis taxpayer on the accrual basis with respect to prepaid interest.

However, the borrowing and purchase of the obligations were in many instances spurious and the obligations were often never delivered to the customers. In substance, the transactions amounted to no more than a great deal of paper shuffling calculated to produce an interest deduction and capital gain. These transactions were generally classified as shams by the courts and their relation to Ippolito, Barnett, and Goldstein is readily apparent.

20 1968-2 CUM. BULL. 76.
21 CODE § 446(b).
and reverses a judicial and administrative policy of 23 years standing. Moreover, it does so irrespective of whether the transaction is "clean" in terms of the Ippolito, Barnett, and Goldstein criteria, or whether it is somewhat questionable, as in the example of the California land sale. The conceptual problems are swept away in favor of an approach based on the right to insist upon a method of accounting which clearly reflects income. We have thus come full circle back to the situation which confronted the Fackler court.

Revenue Ruling 68-643 has received its first thoroughgoing analysis at the hands of Professor Michael Asimow, who concludes that the ruling was long overdue, that it should be given judicial support, and that it is correct in principle. If the ruling is correct in principle, then it was perhaps overdue and it should without a doubt be upheld in the courts. But Professor Asimow's defense of the ruling on "principle" raises some serious issues. Before giving the ruling unqualified endorsement, it seems proper to examine its own express rationale as well as two extrinsic arguments which have been marshalled in its defense. The ruling itself is expressly based upon the proposition that a prepayment of interest causes a distortion of the income of a cash basis taxpayer. In addition, the two most important extrinsic arguments raised to support the ruling are (1) that prepayment of interest is a capital expenditure and, therefore, should be capitalized, and (2) that prepayment, where refundable, is really only a deposit which is not deductible until consumed. Each of these arguments will be separately considered.

A. The Distortion of Income Principle

The Commissioner adopted Revenue Ruling 68-643, pursuant to the authority granted him by section 446(b), to require taxpayers to use an accounting method which clearly reflects income. In effect, the ruling places the cash basis taxpayer on the accrual basis with respect to all interest which is prepaid for a period in excess of 12 months after the close of the year of prepayment. It conclusively presumes that any such prepayment constitutes a material distortion of income. Professor Asimow approves of this position and cites in support of it two related propositions: (1) Sections 446(b) and

23 1968-2 CUM. BULL. at 77.
24 CODE § 446(b) provides: "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 or his delegate, does clearly reflect income."
25 Asimow, supra note 22, at 51.
when read in the light of the legislative history of the latter section, strongly support the Commissioner's broad discretion to require the use of a method of accounting which clearly reflects income, and (2) there is a significant body of case law which supports the Commissioner's broad discretion in these matters.

The historical argument offered in support of the first proposition does not, however, appear to be quite as conclusive as Asimow suggests. The argument begins with section 200(d) of the Revenue Act of 1924 (the forerunner of present section 461) which provided:

The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid and incurred," dependent upon the method of accounting upon the basis of which net income is computed under section 212 or 232, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.\(^{27}\)

The argument then moves to the House Ways and Means Committee Report wherein section 200(d) was proposed. The report stated that authority is granted the Commissioner to "allow or require" deductions and credits to be taken as of the year other than that in which 'paid' or 'accrued' when, in his opinion, it is necessary in order to clearly reflect the income."\(^{28}\) The report, however, delimited the Commissioner's power by noting:

The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which it is paid, it may result in distortion of his income which will cause him to pay either more or less taxes than he properly should.\(^{29}\)

From this language Professor Asimow deduces the Commissioner's unlimited power to deny the deduction of prepaid interest. He concludes the argument by noting that the enactment of section 461 without the clause "unless in order to clearly reflect the income, the deductions or credits should be taken as of a different period," did not result in any substantive change, and that there is general agreement among the commentators to that effect.

It may well be that no substantive change was intended by dele-
tion of the "unless" clause in present section 461. However, from the explanation of that clause contained in the House Ways and Means Committee Report it seems very clear that blanket authority was not given the Commissioner to automatically require a change of accounting with respect to prepaid rent or interest. On the contrary, the report contemplates that the Commissioner is to examine a taxpayer’s situation to determine whether, in fact, income has been distorted. While this process could properly lead to the conclusion that certain prepayments distort income, it could not support the disallowance of all prepayments. The report countenances the exercise of discretion, not the abdication thereof through the vehicle of a conclusive presumption. Revenue Ruling 68-643, however, conclusively presumes that a prepayment for a period of more than 12 months following the year of prepayment is a material distortion of income pure and simple. Granted, the taxpayer has a difficult burden of proof in such cases, but it is highly unlikely that Congress intended to elevate the presumption of official rectitude to the dignity of an irrebuttable presumption.

If legislative history is to be relied upon in support of the ruling, it would be most appropriate to consider also the language in the House Ways and Means Committee Report accompanying section 221 of the Tax Reform Act of 1969. In that report, the Committee stated that it made no provision in section 221 for prepaid interest in view of Revenue Ruling 68-643, which comports with its concept of the law. The Senate Finance Committee, however, completely deleted section 221 in its version of the Reform Act, and it was only in the final version of the bill as rewritten by the House-Senate Conference Committee that the section reappeared in its present form. Neither the Senate Finance Committee Report, nor the Report of the Joint Committee on Internal Revenue Taxation, nor the Statement of the Managers of the House-Senate Conference Committee make any further reference to Revenue Ruling 68-643. Thus, while the short statement in the House report is a strong indication of approval of the ruling, the later legislative silence
leaves its conclusiveness on the issue open to question. Even if the House statement is taken at face value, it is doubtful as to how persuasive it would be in a judicial test of the ruling. In effect, the statement is almost a parenthetical sentence appearing in a report dealing with another matter, offering no enlightenment as to why it approved a ruling so manifestly unfair to many taxpayers.

As for Professor Asimow's second proposition, cases such as Fackler and Court Holding Co. certainly do not construe sections 446(b) and 461 to mean that the Commissioner has unbridled discretion to require a change of accounting method. Instead, they indicate that the provision for cash basis accounting serves an important function for the nonbusiness taxpayer in supplying a simple and easily understood accounting method. Therefore, before denying a taxpayer the right to use the method, either as to all items of income and deduction or as to specific items, the Commissioner should be required to show an abuse which does not result in a clear reflection of income. In concert with this article's interpretation of the House Ways and Means Committee Report which proposed original section 200(d), the case law indicates that sections 446(b) and 461 require the Commissioner to employ his discretion; they do not authorize him to abdicate that discretion by adopting a blanket policy of forcing pro rata accrual of prepaid interest. Since the legislative history of these sections is at best inconclusive as to the propriety of Revenue Ruling 68-643, what Professor Asimow is really telling us is that he disagrees with the decisions in Fackler and Court Holding Co.

The fact that accountants sometimes will not approve a cash basis financial statement which differs too sharply from accrual method accounting does not alter the foregoing conclusion. As Professor Asimow points out, the proper treatment of prepaid expenses by cash basis taxpayers is a matter of accounting judgment about which many accountants differ. This being the case, it seems that the Commissioner ought not to make a conclusive and binding accounting judgment in an area in which there is considerable disagreement. As long as the tax law specifically authorizes cash basis accounting, and as long as interest is deductible under section 163(a) when paid or accrued — as those terms are used in the context of the taxpayer's accounting method — the taxpayer should at least have the opportunity of rebutting the assertion of distortion.

The Commissioner has apparently sensed the disturbing element

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35 See Asimow, supra note 22, at 58.
of unfairness in the ruling. This is indicated by two recent rulings dealing with the subject of loan processing fees (points) paid by a mortgagor-borrower to a lender as additional compensation for the loan. In Revenue Ruling 69-188, the Commissioner ruled that such a loan processing fee was a sum paid for the use or forebearance of money and was therefore interest within the meaning of section 163. Yet in Revenue Ruling 69-582, he ruled that a loan processing fee of $1200 paid by a cash basis mortgagor in full in the year the loan originated was fully deductible in that year. In a cryptic statement, the ruling referred to a sentence in Revenue Ruling 68-643 preceding the sentence in which the Commissioner creates the conclusive presumption of distortion. That sentence reads: "The Service now concludes that the deduction of prepaid interest in the year of payment . . . may not result in a clear reflection of income for the taxable year of payment." Without any further reference to the succeeding statements in which the presumption of distortion for long term prepayments is set forth, Revenue Ruling 69-582 concludes that the deduction of $1200 in points (which clearly is interest extending over the life of the loan) does not constitute a material distortion of income. What are we to conclude from this ruling? One possibility is that a $1200 prepayment is de minimis and does not warrant the application of Revenue Ruling 68-643 — even if it applies to a period of more than 12 months following the year of prepayment. If so, what amount will be considered sufficient? Another, and perhaps more significant, possibility is that Revenue Ruling 69-582 was intended to modify Revenue Ruling 68-643 so as to permit deduction of points generally; perhaps any amount payable as points will be deemed to be deductible in the year of payment under this modification. In any event, while the rationale of the later ruling is obviously unclear, its existence demonstrates that something is vitally wrong with the flat statement that all long term interest prepayments constitute material distortions of income. We may, perhaps, see a variety of similar "modifications" in the future.

In summary, sections 446(b) and 461 and their legislative histories do not justify an extension of the Commissioner's authority in accounting matters which would give him unbridled authority to require pro rata accrual of prepaid interest. The House report

statement accompanying section 221 of the Reform Act is a more recent legislative pronouncement, but is also inconclusive. Given the Code's approval of cash basis accounting, the Fackler and Court Holding Co. cases are indications of judicial support for the deduction of prepaid interest in a "clean" transaction. In the questionable transactions, the Goldstein approach of disallowance when tax avoidance is the only discernible motive is superior to the pro rata accrual contained in Revenue Ruling 68-643.

B. "Capitalization" of Prepaid Interest

As an alternative to the distortion rationale, it has been suggested that the prepayment of interest results in the acquisition by the borrower of an intangible asset, the right to the use of money extending over a period of time substantially beyond the taxable year in which the interest is prepaid.\footnote{See L. Lee Stanton, 34 T.C. 1 (1960) (dissenting opinion); Webster, supra note 18, at 390.} In such cases, it is arguable that the prepayment should not be currently expensed, but should be deducted ratably over the life of the loan. In essence, the rationale for capitalizing the prepaid interest is that section 263(a)\footnote{CODE § 263(a) provides in part: "No deduction shall be allowed for — (1) Any amount paid out for new buildings or for permanent improvements on betterments made to increase the value of any property or estate."} does not allow a current deduction for capital expenditures, and since the intangible asset created by the prepayment of interest is an asset extending beyond the taxable year, it should be treated as a nondeductible capital expenditure.\footnote{See Asimow, supra note 22, at 59, wherein the author notes that because the prepayment will not be reflected during the period of the loan if it is currently deducted, the general policy of section 263(a) "cuts across" section 163(a) — which allows a deduction for all interest paid or accrued during a taxable year — and precludes the immediate deduction of the interest payment.} Unlike the distortion argument, the proposition that prepaid interest creates an asset whose life extends beyond the year of payment and which is recoverable only through amortization has considerable merit. If we consider it only within the context of section 263(a), then it appears to be internally consistent and a far more reasonable basis for disallowance of prepayment than the position actually adopted by the Commissioner in Revenue Ruling 68-643. Refinement of the capitalization argument, however, points up some fatal weaknesses based upon its relation to other specific Code provisions and to existing case law.

To begin with, there is great variety in the transactions which involve interest prepayments. At one end of the spectrum is the
ordinary loan transaction entered into by a nonbusiness borrower for a bona fide nonbusiness purpose. At the other end are the sham transactions exemplified by the "Livingstone" cases,\footnote{See note 19 \textit{supra}.} \text{Ippolito, Barnett,} and (with modification) \text{Goldstein.}\footnote{See text accompanying notes 14-17 \textit{supra}.} The theory that prepaid interest is in the nature of a capital expense is really not apposite in these extreme situations. In the case of the routine nonbusiness loan, we are generally dealing with minimal prepayments for short periods. In the sham and nonpurposive transactions, the amount paid is not really interest, and, therefore, under the existing case law deduction of the "interest" prepayment would be completely disallowed. Where the theory may be helpful then is in those intermediate situations where neither the labels ordinary nor sham nor nonpurposive activity can be easily affixed. Two kinds of cases are illustrative. First, there is the common case in which the prepayment of interest is an integral part of a transaction wherein the taxpayer acquires or is enabled to carry an investment asset. An example of such a transaction is a loan for the purpose of purchasing securities in the hope that the gain on the securities will exceed the cost of borrowing the funds. Second, there is the more sophisticated use of interest wherein the interest deduction itself is immediately converted into capital value.\footnote{See Kanter, \textit{supra} note 7, at 813.} An example of the latter is the previously described purchase of southern California land with no down payment, but requiring a prepayment of interest for several years during which no principal payments are required.

Particularly in this second category of cases, the issue is not really whether the interest should be capitalized and deducted pro rata over the period of the loan; on the contrary, it is whether the payment is interest at all or merely a down payment. As pointed out by several commentators,\footnote{See, e.g., \textit{id.} at 814; \text{Webster, supra} note 18, at 390.} the effect of the transaction is to permit the purchasing taxpayer to carry an asset in which the down payment (if that is what the interest prepayment really is) is fully deductible in the initial years during which the property may be increasing in value. Later, the property may be sold and the increase in value taxed at capital gain rates, thus permitting the creation of a capital value based, in part, on a deductible investment. This is the kind of transaction which concerns the commentators, who conclude that it may present an appropriate situation for capitalization of prepaid prepa...
interest. But on the other hand, does it not present a stronger case for disallowance of the interest deduction altogether based on the fact that the prepayment of interest is really a down payment of the purchase price and not interest at all? This appears to be precisely the reasoning which underlies Code sections 264(a)(1) and 264(a)(2), which prohibit the deduction of any amounts paid or accrued on indebtedness incurred to purchase or carry single premium annuity and insurance contracts and amounts paid or accrued to purchase or carry any life insurance or annuity contract which contemplates systematic borrowing of annual increases in cash surrender values. Like the California land transaction, a deduction allowed for borrowing of cash surrender values to finance premium payments would result in a partially deductible investment which ultimately produces a tax-free insurance fund, thereby permitting the transmutation of interest into capital value. In such cases, disallowance of the deduction is the proper solution, for the interest really represents a part of the purchase price of the asset.

Another example of a transaction where capitalization of interest prepayments is not regarded as a proper solution is represented by a taxpayer who borrows funds to purchase or continue to carry securities which produce tax exempt income. Section 265(2) simply disallows the interest paid or accrued on indebtedness incurred for this purpose. The policy, of course, is to discourage borrowing which leads to the acquisition of an asset that produces tax-free income while the borrower enjoys an interest deduction on the funds borrowed.

It appears, then, that the statutory response to two important categories of interest cases is not capitalization of interest either normal or prepaid, but disallowance pure and simple. This pattern is continued in new Code subsection 163(d), which deals specifically with the deductibility of interest on borrowed funds used to purchase "investment property" producing little or no income. This provision will be discussed in detail in the second part of this article, but for the present, it is sufficient to point out that the statutory response to the mismatching of investment income and interest ex-

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46 CODE §§ 264(a)(1)-(2).
47 Id. § 265(2).
48 The only exception to the disallowance of interest under section 265(2) is where the taxpayer shows a valid business purpose to justify his incurring the obligation. See Rev. Rul. 389, 1955-1 CUM. BULL. 276.
49 CODE § 163(d). See note 30 supra.
pense (especially where it is prepaid) is simply to disallow that portion of the interest expense which exceeds a specified base amount.

Because our real concern is with those taxpayers who use prepayment of interest to establish immediate capital values or to acquire an asset which produces no immediate taxable income (but a later capital gain), it would appear that disallowance of the interest deduction is the appropriate answer in such cases. This seems to be the congressional policy expressed in sections 264 and 265, and it appears that this policy is being carried forward into new Code subsection 163(d), which covers most of the objectionable uses of interest, prepaid or normal, of which Professor Asimow complains. Similarly, disallowance is the result — and properly so — in the cases where interest is merely one component of a transaction involving sham or nonpurposive activity designed to obtain a tax advantage by artfully fashioning an interest deduction.

It seems, then, that if Revenue Ruling 68-643 were to be rationalized under the capitalization of interest theory, it would properly be restricted to a relatively narrow range of taxpayer activity. It would cover those business taxpayers who borrow for a perfectly valid business reason in a routine transaction, as well as the non-business borrower whose loan transaction is likewise free of any sham or attempt to trade upon the interest deduction. Ironically, these are situations in which the deduction is apt to be de minimis and which are clearly not tax motivated. The ruling should not cover the cases in which prepayment of interest is used as a means of establishing capital values, such as for the purchase of investment assets which provide no immediate income or in the California land transaction, because these cases are more properly disposed of by analogy to the existing statutory pattern of total disallowance of the interest deduction.

The theoretical basis of capitalization of interest remains a problem regardless of whether the foregoing analogy to the statutory pattern of disallowance is accepted or rejected. The issue has been discussed by several writers, and, in general, there are three objections to the notion that interest should be capitalized. First, the simple statutory argument that section 163(a) means what it says — interest is deductible when “paid or accrued” within the taxable year.\(^5\) Second, court decisions requiring other prepaid items to be

\(^5\)This was the basic argument in John D. Fackler, 39 B.T.A. 395 (1939). Professor Asimow calls it a “simplistic” argument and then proceeds to counter it with the fact that, while section 162(a)(3) allows a deduction for “rentals” which have been “paid,”
THE INTEREST DEDUCTION

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capitalized by cash basis taxpayers are based on significant differences in statutory language relating to such items. For example, prepaid rentals must be capitalized because such prepayments are not “ordinary and necessary” within the meaning of section 162(a).61

Third, some cases have stressed consistency and long standing practice as the dispositive factor, e.g., business insurance cases in which premiums have been prepaid.62 Each of these objections have been met by equally forceful defenses. Thus the argument based on the fact that interest is deductible under section 163(a) when “paid or accrued,” without regard to any requirement that it be “ordinary and necessary,” is met by the assertion that it is “simplistic” and that the statutory arrangement does not prevent a requirement that prepaid interest be capitalized.63 A corollary to this line of argument is the assertion that there is no logical distinction between prepaid interest and prepaid rentals which are deductible under section 263(a)(3) when paid, but which, according to the courts, must be prorated if prepaid.64 The other examples of deductible prepayments based on supposed differences in statutory language applicable to such items — principally the “ordinary and necessary” language of section 263(a) — do not preclude capitalization of certain expenses, since neither the words “ordinary and necessary” nor the characterization of a deduction as an “expense” necessarily precludes capital expenditure treatment of the item.65

While these thrusts and parries are intellectually stimulating, they somehow seem to be on the periphery of the real problem. It seems that virtually any prepayment by a cash basis taxpayer can produce an asset which ought to be “capitalized” because its life will by definition extend beyond the taxable year. But is this really a meaningful statement or is it merely a semantic sleight of hand?

the courts have nevertheless required capitalization of prepaid rents. See Asimow, supra note 22, at 67.

61 See Webster, supra note 18, at 395-99, wherein the author enumerates instances where the “ordinary and necessary” language of section 162(a) is deemed either to permit allowance or require disallowance of a prepaid item: (1) Intangible drilling expenses; (2) prepaid salary or other compensation; (3) prepaid business supplies; and (4) prepaid business insurance.

62 See, e.g., Waldheim Realty & Inv. Co. v. Commissioner, 245 F.2d 823 (8th Cir. 1957), wherein the court allowed the deduction of prepaid insurance premiums. Contra, Commissioner v. Boylston Market Ass’n, 131 F.2d 916 (1st Cir. 1942), aff’d 45 B.T.A. 1159 (1941). Happily, these business insurance cases are inconclusive; we-always-have-done-it-that-way arguments are not paragons of logic.

63 See Asimow, supra note 22, at 67.

64 See Olincy, Prepaid Income and Expenses — Where Are We Going?, U. So. Cal. 1967 TAX INST. 357, 376.

65 See Asimow, supra note 22, at 61-66.
When we make such a statement, are we not really saying that we object to cash basis accounting for tax purposes? To be more exact, are we not saying that when deductions are involved, whether they be “ordinary and necessary” business expenses or nonbusiness interest, the cash basis produces an undesirable result? Is it not the case that in many instances it is virtually impossible to draw a line between a business interest prepayment which is ordinary and necessary and one which creates an asset and, therefore, should be capitalized? When the Commissioner asserts that every prepayment of interest for a period of more than 12 months beyond the taxable year automatically creates a distortion of income, he is simply saying that he disapproves of the cash basis accounting method. Once we accept the central fact that it is cash basis accounting that is at issue, the whole problem of capitalizing interest becomes irrelevant. All prepayments by cash basis taxpayers are on the firing line, and denial of the interest deduction is merely the latest casualty whose longevity is attributable to its protected position in a separate section which “simplistically” appears to permit current deduction of prepayments. All that the capitalization argument amounts to is a respectable cover for the automatic distortion argument adopted in Revenue Ruling 68-643.

It is interesting to note that where a cash basis taxpayer receives prepaid income, it has not been suggested that he should defer its taxability to the year in which he will earn it by providing either goods or services; on the contrary, a taxpayer is required to include in his income any amount which is received during the taxable year unless his method of accounting calls for inclusion as of a different period.56 This principle applies to both cash basis and accrual basis taxpayers.57 As to cash basis taxpayers, it is generally interpreted to mean that actual receipt under a claim of right requires inclusion of the receipt in the taxable year in which it is paid, although it may be allocable to future tax years.58 It seems odd that in the name of

56 CODE § 451(a) provides: “The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is properly accounted for as of a different period.”


58 See, e.g., Gilken Corp. v. Commissioner, 176 F.2d 141 (6th Cir. 1949), aff'g 10 T.C. 445 (1948) (lease deposit treated as rental in year of receipt where lessee did not exercise option to purchase property and lessor was a cash basis taxpayer). Questions as to the propriety of inclusion of the receipt may arise where there are strings attached, i.e., where it is not clear that retention of the item is intended. See, e.g., John Mantell,
proper matching of items of income and expense, a cash basis taxpayer engaged in a routine business transaction should be required to report all prepaid income and to defer most prepaid expenses. With respect to interest prepayments, it seems doubly strange that the lender, if he is a cash basis taxpayer, should be required to report the entire prepayment as income in the year of receipt, whereas the borrower, also a cash basis taxpayer, should be required to prorate the payment over the life of the loan. Granted, symmetrical treatment of both taxpayers is not required and is perhaps undesirable where policy considerations cut across the dictates of accounting method and procedure, but in the limited range of transactions to which Revenue Ruling 68-643 will probably now apply, it seems that there is no important policy consideration requiring such asymmetry. A general dislike for cash basis accounting is not a sufficient reason for forcing deferral of all prepaid expenses and immediate inclusion of all prepaid income, regardless of the taxpayer's accounting method.\footnote{17 T.C. 1143 (1952). However, where retention appears definite at the time of receipt, a later event requiring restoration of the receipt does not prevent its inclusion in the year of receipt. United States v. Lewis, 340 U.S. 590 (1951).}

Some accrual basis taxpayers have convinced Congress that the policy of requiring inclusion of prepaid income in the year of receipt is contrary to sound accounting principles. In 1957, section 455\footnote{The repeal of section 452 is often cited as evidence of congressional rejection of deferral of prepaid items by accrual basis taxpayers. This section would have permitted deferral of prepaid income and its repeal appears to have been a very significant factor in the Supreme Court's decision in American Auto. Ass'n v. United States, 367 U.S. 687 (1961), in which an accrual basis taxpayer was denied the right to defer prepaid membership dues. The Court reasoned that the taxpayer could not determine when it would be required to render services for which the dues were paid, hence its system of deferring the income as well as some of its operating expenses to future periods was artificial. The decision, however, seems to be based as well upon the inference of congressional intent drawn from the repeal of section 452.} was enacted to permit accrual basis publishers to elect to defer subscription income. In 1960, section 456\footnote{Code § 455.} was enacted to permit accrual basis membership associations to elect to defer prepaid dues for a period of up to 36 months.\footnote{Id. § 456.} Even before the enactment of section 455, the Commissioner had ruled in Income Tax Ruling 3369\footnote{Code § 456, which, in effect, reverses American Auto. Ass’n v. United States, 367 U.S. 687 (1961).} that deferral of subscription income would be allowed if the costs allocable to obtaining the subscription were likewise deferred.\footnote{1940-1 CUM. BULL. 46.}
so that there was no material distortion of his income. It seems unfair, then, that a cash basis taxpayer should not be permitted the opportunity to show that his prepayment of an interest item does not materially distort income (just as it is inequitable that not all accrual basis taxpayers enjoy the benefits of sections 455 and 456 and of Income Tax Ruling 3369). Revenue Ruling 68-643 merely accentuates the existing inequities.

C. The "Deposit" Argument

It has been suggested that Revenue Ruling 68-643 could also be defended on the ground that where a cash basis taxpayer is entitled to a refund of unearned prepaid interest upon early payment of the loan, the interest has not been paid, but is really only a "deposit" subject to recovery.64 This argument is supported by analogy to the cases involving prepayments for animal feed and particularly to Tim W. Lillie,65 the most recent of these cases. There the taxpayer prepaid for enough cattle feed to support his animals for several years. The taxpayer did not contract for preferential treatment in the event of shortages, nor was he given any other advantage, and, thus, the prepayment motivation was apparently the tax advantage gained by the deduction. The Commissioner argued that the prepayment was a deposit and the Tax Court concurred in this view of the transaction because the prepayment was refundable. The approach of Revenue Ruling 68-643 is clearly analogous to the Lillie case. The Commissioner does not deny ultimate deductibility of the item, but requires its proration over the period to which it is properly applicable; refundable prepaid interest is viewed as a deposit, just as was Mr. Lillie's feed prepayment.

One commentator has already pointed out the first weakness of this position.66 He argues that in Lillie, the prepayment for feed had no particular relation to the taxpayer's business investment. In other words, there was no business purpose to be furthered or business advantage to be gained thereby, so basically the case really should be tested against the "purposive activity" rule of Goldstein.67

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64 See, e.g., Asimow, supra note 22, at 69-74; Webster, supra note 18, at 410-11.
65 45 T.C. 54 (1965), aff'd per curiam, 370 F.2d 562 (9th Cir. 1966).
66 Kanter, supra note 7, at 808-09.
67 Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967). It should be noted that in several cases prior to Lillie, the courts had permitted prepayments for feed where a valid business purpose existed for the prepayment. See, e.g., Cravens v. Commissioner, 272 F.2d 845 (10th Cir. 1959), rev'd 30 T.C. 903 (1958).
While in *Goldstein* no nontax purpose was served by either the current or the prepaid interest, in *Lillie* only the prepayment of interest was nonpurposive; the current payments were made to support a viable feed lot operation. Therefore, the *Goldstein* rationale should be applied only to the nonpurposive prepayment, with the result that accrual, not disallowance, would constitute the proper relief.

A second difficulty with the deposit treatment of interest is that in cases not involving sham or nonpurposive activity, it requires a tacit assumption that the parties intended a refund of the interest. In the previously mentioned California land transaction, for example, equity demands that the Commissioner show that the parties contemplated an early payment of the purchase price or perhaps even a default which would result in application of the prepaid interest to the purchase price. If such an intention can be shown, the deposit theory may apply, but on the other hand, this would be adequate evidence of sham or nonpurposive activity, in which case the interest should be disallowed and not merely prorated. If there is no evidence from which an intention to effect a refund can be inferred and if the prepayment had a valid business purpose, it would be improper to apply the deposit theory of the *Lillie* case. Thus in ordinary, bona fide interest transactions, where refundability is not contemplated but can occur only with reference to a later contingent event, *Lillie* is inapplicable. There is no intention that the refund will take place and the recipient of the interest would be required to include the prepayment in his income for the year of receipt. If there is no evidence from which an intention to effect a refund can be inferred and if the prepayment had a valid business purpose, it would be improper to apply the deposit theory of the *Lillie* case. Thus in ordinary, bona fide interest transactions, where refundability is not contemplated but can occur only with reference to a later contingent event, *Lillie* is inapplicable. There is no intention that the refund will take place and the recipient of the interest would be required to include the prepayment in his income for the year of receipt. If there is no evidence from which an intention to effect a refund can be inferred and if the prepayment had a valid business purpose, it would be improper to apply the deposit theory of the *Lillie* case. Thus in ordinary, bona fide interest transactions, where refundability is not contemplated but can occur only with reference to a later contingent event, *Lillie* is inapplicable. There is no intention that the refund will take place and the recipient of the interest would be required to include the prepayment in his income for the year of receipt.

Similar treatment should be accorded the payor; a deposit is not intended and the deduction should be allowed.

If the interest is in fact refunded, the *Code* and Regulations now provide that the restoration is included in the income of the taxpayer who receives the refund, an amount previously deducted, at least to the extent of the tax benefit derived from the deduction. This seems to be the preferred method of handling the restoration of the deposit, because it does no violence to the annual accounting concept and avoids the use of a transactional approach — awaiting the ultimate outcome of numerous transactions to determine their tax consequences. If one really wishes to await the ultimate out-

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68 See Gilken Corp. v. Commissioner, 176 F.2d 141 (6th Cir. 1949), aff'g 10 T.C. 445 (1948).

69 CODE § 111 allows an exclusion from gross income of recovered bad debts and taxes except to the extent that a previous year's deduction for such items resulted in tax benefit. Treas. Reg. § 1.111-1(a) (1956) extends this provision to "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years."
come of such a transaction, it would make more sense to treat it as a discount loan and to have the payor of the interest deduct the prepayment when he has repaid the loan. Economically, a prepayment of $80 interest on a $1000 loan is no different from having the lender credit the borrower's account in the amount of $920, though the principal indebtedness is $1000. It is clear, however, that in the latter situation the courts regard the interest as unpaid until the principal is repaid, and only then is the interest deductible.\(^\text{70}\) If the two situations are the same economically, and if we do not permit the deduction in the latter until the loan is paid, then there is no reason requiring deferral of the prepayment in the former. Why is it, then, that Revenue Ruling 68-643 makes such a distinction? Why does it not treat both payments as subject to proration over the period of the loan? Can it be that the Fackler court was right, and that since a postpayment of interest does not cause a distortion of income, neither does a prepayment? How else do we account for the Commissioner's strange silence on the subject of postpayments and discount loans in Revenue Ruling 68-643?

II. THE "INVESTMENT INTEREST" PROVISIONS OF THE REFORM ACT

The Act creates new Code section 163(d),\(^\text{71}\) which embodies a significant extension of the principle that a taxpayer ought not to be permitted to use the interest deduction either to purchase an investment asset which produces no offsetting ordinary income or to transmute it into a capital value. It has previously been noted\(^\text{72}\) that sections 264(a) and 265 represent limited applications of this principle to interest on indebtedness used to purchase insurance or carry obligations the interest from which is tax exempt. Section 163(d) simply extends this principle by restricting the amount of interest which may be deducted on an indebtedness incurred to carry or purchase other property held for investment.

The abuse which this provision is designed to correct is set forth in the House Ways and Means Committee Report on House Bill 13270,\(^\text{73}\) the original version of the Tax Reform Bill. Briefly, the report states that the restriction on deductibility of "investment in-


\(^{71}\) CODE § 163(d) was created by section 221 of the REFORM ACT.

\(^{72}\) See note 48 supra & text accompanying notes 46-48.

interest" — interest on indebtedness incurred to purchase or carry investment assets — is aimed at those taxpayers whose borrowings for investment purposes is motivated by tax considerations rather than straightforward investment considerations. The report assumes that a taxpayer who is investment motivated will generally invest in property which will produce a profit to offset the cost of borrowing. However, if the investment produces little or no current ordinary income, under existing law the effects of allowing a current interest deduction are the mismatching of the ultimate income from the investment with its related interest expense and the sheltering of current ordinary income from other sources. Because borrowing is voluntary, the act of incurring a large debt and a correspondingly substantial interest deduction indicates that the aforementioned tax considerations are the motivating factors in the borrowing. Consequently, the report concludes that it would be inappropriate to allow current interest deductions on such voluntary borrowing where the interest exceeds the income from the investment.

The mechanism for implementing the limited interest denial applies to investment interest on all indebtedness incurred in taxable years commencing with 1972. The new section 163(d), as enacted by Congress in lieu of the original provisions of section 211 of House Bill 13270, limits the amount of investment interest which may be deducted by an individual taxpayer to $25,000, plus the amount of "net investment income," plus an amount equal to the excess of net long-term capital gains over net short-term capital gains.

74 "Investment interest" is defined in subsection 163(a)(3)(D) as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." However, this definition is not very helpful because "property held for investment" is not defined.

75 "Net investment income" is defined in subsection 163(d)(3)(A) as "the excess of investment income over investment expenses." Subsection 163(d)(3)(B) defines "investment income" as:

(i) the gross income from interest, dividends, rents, and royalties,
(ii) the net short-term capital gain attributable to the disposition of property held for investment, and
(iii) any amount treated under sections 1245 and 1250 as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, but only to the extent such income, gain, and amounts are not derived from the conduct of a trade or business.

Subsection 163(a)(3)(C) defines "investment expenses" as the deductions authorized in sections 164(a)(1) (state, local, and foreign real property taxes) and, to the extent that they are "directly involved in the production of investment income, the deductions authorized in sections 166 (bad debts), 167 (depreciation — herein straight line only), 171 (amortization of bond premiums), 212 (ordinary and necessary expenses incurred in the production, conservation, and management of income producing property), and 611 (depletion — herein cost depletion only).
losses for the taxable year, plus one-half of the excess of investment interest over the sum of the three preceding items. Thus, the first $25,000 of interest remains deductible, and any excess is next applied against net investment income. Any remaining excess is then applied against the excess of net long-term capital gains over net short-term capital losses, and if any excess still remains only one-half of it may be deducted. Subject to certain limitations, the balance may be carried over indefinitely to succeeding tax years.\textsuperscript{76} To the extent that the taxpayer has net long-term capital gains which increase the amount of his deductible investment interest, such gains are treated as gains from the sale of noncapital assets. Therefore, the 50 percent deduction normally available for capital gains under section 1202\textsuperscript{77} is denied and they are treated as ordinary income.\textsuperscript{78} However, the gain is not treated as a preference item under new section 57(a)(9).\textsuperscript{79}

From a purely practical point of view, section 163(d) will affect only a very small number of taxpayers. If a taxpayer has net investment interest expense of $25,000 in 1972 and no investment income or capital gains whatsoever, the $25,000 exemption would allow him to deduct the full amount of his interest expense. But in order to pay $25,000 interest in one year, assuming an 8 percent interest rate, the taxpayer would have to have borrowed approximately $313,000! Moreover, a taxpayer with substantial capital gains will be able to borrow much larger amounts, since his investment interest in excess

\textsuperscript{76}The carryover is treated as investment interest paid or accrued in the succeeding year, but deductibility of the carryover is limited to one-half of the excess of net investment income for such year plus $25,000 over the greater of (1) investment interest paid or accrued in such year or (2) $25,000. If the entire carryover cannot be deducted in the second year, then the amount to be carried over to the third year is reduced by 50 percent capital of the taxpayer’s right to the capital gains deduction under section 1202 (whether or not that right is exercised). The following example will illustrate the operation of the carryover:

Assume T has disallowed investment interest in the amount of $37,000 in 1972. In 1973 he has net investment income of $60,000, capital gain of $8,000, and investment interest expense of $50,000:

\begin{center}
\begin{tabular}{ll}
\textbf{1973} & \\
(a) Net Investment Income (60,000) + 25,000 & 85,000 \\
(b) Greater of investment interest (50,000) or 25,000 & 50,000 \\
(c) Non-deductible (1/2 of (a) less (b)) & 17,500 \\
(d) Nondeductible (amount disallowed in 1972 less (c)) & 19,500 \\
(e) 50\% of 1973 capital gain & 4,000 \\
(f) Disallowed investment interest carried to 1974 ((d) less (e)) & 15,500 \\
\end{tabular}
\end{center}

\textsuperscript{77}\textsc{Code} § 1202 provides in part; “In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50\% of the amount of such excess shall be a deduction from gross income.”

\textsuperscript{78}\textsc{Code} § 163(d)(5).

\textsuperscript{79}Id. § 57(a)(9).
of $25,000 may be deducted to the extent of his capital gains. The number of taxpayers whose borrowing capacity exceeds $313,000 is probably fairly limited; yet it is apparently in this limited group that nonbusiness borrowing is used to obtain the significant tax advantages set forth in the House Ways and Means Committee Report.

Because of the cryptic nature of the definitional subsections, it is impossible to predict with specificity the transactions covered by section 163(d). As the statute presently stands, there is no definition of the term which provides the key to the section's scope, "property held for investment." Thus it appears that one of the first orders of business in connection with the new provision is a clarification of whether business interests are "property held for investment." The only possible analogy to existing statutory language — the definition of the term "capital asset" — is not sufficiently precise so as to define the new phraseology, for the capital asset definition is designed to separate capital gain from ordinary income, not to separate the taxable from the exempt. The investment interest provision has introduced a new phrase and a new class of property to which present statutory classifications are not applicable.

The House report's statement that interest on funds borrowed "in connection with a trade or business" is exempt from the limitation sheds some light on the aforementioned definitional problem. Presumably, the language means that all business borrowing is exempt. But with respect to the purchase of new business interests as opposed to assets purchased for use in an existing line of business, can we stretch the meaning of "in connection with a trade or business" to include interest on borrowed funds? Would it make any difference if the business interest is a partnership interest as opposed to corporate stock? A partner, of course, is in the same business as his partnership, but a stockholder is not necessarily in the same business as his corporation. Thus, an individual shareholder who guarantees his controlled corporation's obligation may not deduct his payment of the obligation as a business bad debt. Would

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80 See note 74 supra.

81 CODE § 1221 defines the term "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business)" subject to five exceptions, three of which are directly related to the use of the item in connection with the taxpayer's trade or business.


83 Putnam v. Commissioner, 352 U.S. 82 (1956). Under section 166(d), a nonbusiness bad debt is treated as a short-term capital loss. However, section 166(f) permits
the same reasoning apply to the purchase of closely held stock so as to prevent the interest incurred pursuant to the stock's acquisition from being treated as incurred "in connection with the trade or business"? These questions remain unanswered and the legislative history offers no hint as to how they will or ought to be answered.

The issue of borrowing "in connection with a trade or business" will create innumerable definitional problems quite apart from the question of the purchase of business interests. For example, will the reasoning of Corn Products Refining Co. v. Commissioner be applied to cases arising under the new section 163(d)? In that landmark case, a manufacturer of corn products purchased corn futures as a hedge against the possibility of both a short supply of corn and price increases. The taxpayer sold some of its futures at a very substantial profit and claimed that its gain was a capital gain. The Court held, however, that the gain was ordinary income. The basic issue, of course, was whether the corn futures were "capital assets" as defined in section 1221 or whether the future transactions were inseparable elements of the taxpayer's business. The Court reasoned that although the futures contracts were "property held by the taxpayer" which did not fall precisely within any of the exceptions listed in section 1221(1) — inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of business — they were nevertheless so integrally connected with the taxpayer's business that the profit from their sale should be treated as ordinary income. The general definition of "capital asset" was considered by the Court to apply to assets which are not the source of normal business income, thus the exclusions are to be interpreted broadly and the definition of a capital asset applied narrowly.

Suppose Corn Products Refining Co. had borrowed substantially to engage in its futures operations. Would the futures operations be considered so vitally important to the company's business that the borrowing would be considered "in connection with the trade or business" so as to render it free of the section 163(d) limitation? Since there is no easy answer to this question, we will, no doubt, reenact the Corn Products story with a wealth of variation in the context of section 163(d). It remains to be seen if the term "prop-

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85 The general view of the commentators is that Corn Products introduced an element of unnecessary doubt and complexity into the provisions of section 1221 without
property held for investment" will be interpreted as narrowly as the Court interpreted the term "capital asset" in *Corn Products*, or whether a different definitional principle will be applied to cases involving a denial of the interest deduction.

Before concluding the discussion of the scope of section 163(d), one more aspect of the provision should be noted: It does not apply to corporations. The reason for this remarkable exclusion is not at all clear. A corporation is as capable as an individual of borrowing for the purpose of investing in non-income-producing investment property — and generally does so for the same reasons. Not all corporate borrowing is business related. Because the corporation is as capable of trading on the interest deduction as is an individual, there appears to be no reason to exclude it from the effect of any corrective legislation. Perhaps the draftsmen felt that a 48 percent tax rate — the corporate normal tax and surtax — is not sufficiently high so as to make borrowing for tax avoidance purposes attractive to corporate taxpayers. Whatever the reason, there seems to be no justification in principle for placing corporations beyond the reach of the legislation.

One cannot help wondering if the complexities of section 163(d) were really necessary in order to curb the borrowing activities of a small group of affluent taxpayers, since it is entirely possible that the principles developed in existing case law might well have been extended to result in denial of the deduction for investment interest. Because voluntary borrowing to purchase non-income-producing assets is itself an indication of a tax avoidance motive, could not the *Goldstein* principle have been extended to cover current interest deductions where there is no "purposive activity" other than a tax advantage? In effect, this is what the investment interest limitation has accomplished, but it has done so without the selectivity embodied in the "purposive activity" rule of *Goldstein*. It may well be that by far the greatest revenue loss arises from investment interest paid on borrowings of considerably less than the $313,000 necessary to offset the $25,000 exemption. By setting up a mechanical formula to regulate the deduction of investment interest which will adversely affect only a very few — and admittedly, only very, very rich — taxpayers, Congress has effectively

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6. CODE § 163(d)(1).
7. *See text accompanying notes 14-17 supra.*
prevented the general operation of a more flexible principle such as that developed by the courts in Goldstein for all taxpayers. If section 163(d) is interpreted as providing the exclusive means of taxing investment interest, then of course there will be no way of reaching the taxpayer who invests in non-income-producing property, has no capital gain or investment income, and keeps his borrowing down to a mere $313,000 (at an assumed 8 percent interest rate). It seems clear that the statutory provision is intended to be exclusive and that the courts will probably not have an opportunity to pass upon the tax avoidance aspects of investment interest as it affects large numbers of taxpayers.

Another major difficulty of the investment interest provision is that its underlying assumption is tax avoidance. In other words, any transaction involving the acquisition of non-income-producing property with borrowed funds may be caught within a wide-ranging and entirely indiscriminate net. One cannot grieve over the predicament of the purchaser of California land whose purchase is financed solely with prepaid interest. On the other hand, what of the taxpayer who because of business exigencies is forced to borrow funds to purchase what can only be described as a non-income-producing investment asset? An example is the surviving shareholder of a closely held corporation who must buy the interest of the deceased shareholder pursuant to the terms of a mandatory buy-sell agreement. If the agreement is of the cross-purchase variety and has not been funded with insurance, it may well be that the survivor can effect the purchase only with borrowed funds. If he does so, he is buying an investment asset which probably does not produce current income. If the purchasing shareholder has no capital gain or net investment income against which to offset the interest on the loan, he may well find himself with nondeductible "excess investment interest." When borrowed funds are used to effect the purchase of the decedent's stock in these circumstances, one cannot accuse the borrower of deliberately seeking to mismatch his interest deduction and the ultimate income from the purchased asset. The application of section 163(d) to such a situation would not advance the congressional purpose and would only create unnecessary difficulties for a borrower engaged in a perfectly legitimate and desirable transaction.

If the required purchase of a decedent's business interest by a surviving shareholder or partner is within the purview of section 163(d) we may expect two results. The first is a possible windfall to the insurance industry because it will be necessary to fund cross-
purchase agreements in order to avoid the need to borrow where the purchase price is such that the interest on the loan will exceed $25,000. Many cross-purchase agreements are now funded with insurance, but it seems inappropriate to force taxpayers into insurance funding where they prefer not to do so. Indeed, they may be unable to do so in cases of uninsurability. A second result may be that shareholders of a closely held corporation will be forced to use the entity buy-out method rather than the cross-purchase agreement. This will follow from the fact that the corporation can borrow with impunity because subsection 163(d)(1) specifically excludes corporations from the investment interest limitation. An entity buy-out, however, is not always the procedure of choice, especially where borrowing to redeem stock is undesirable from the corporation’s point of view and where insurance funding is not feasible.88

A related problem is presented by the situation in which a taxpayer is required to pay the purchase price of a business interest in installments because the seller wishes to report on the installment basis89 or because the purchaser is making a shoestring purchase and expects to pay the purchase price out of the earnings of the business.

88 In the case of a partnership, borrowing by the partnership to finance the buy-out would result in a pass-through of nondeductible investment interest to the partners under subsection 163(d)(4)(B). This could, perhaps, be avoided on the theory that the partnership’s purchase of a deceased partner’s interest does not constitute the purchase of “property held for investment.” See text accompanying notes 82-83 supra.

89 CODE § 453 permits the usual seller of personal property to report his gain on the sale as he receives installment payments. The portion of the installment payment representing principal is divided into two parts, one representing a return of capital and the other representing gain. The portion representing gain is computed by determining the ratio of profit to basis on the entire purchase price and applying the same ratio to each installment of principal. However, installment purchases may not be covered by section 163(d). The House Ways and Means Committee Report accompanying its proposed new section 163(d) provided:

This limitation is to be applicable only to interest on indebtedness incurred or continued to purchase or carry property held for investment. Thus, interest incurred on funds borrowed for other purposes such as a home mortgage, installment purchases, consumer goods, and personal or student loans would not be affected by the limitation. In addition, funds borrowed in connection with a trade or business would not be affected by the limitation. H.R. REP. NO. 91-413, 91st Cong., 1st Sess., pt. 1, at 73 (1969) (emphasis added). Since the Report specifically mentions “installment purchases,” perhaps the intention is that installment purchases of a business interest will be exempt. It is hardly likely that all installment purchases of “property held for investment” were intended to be free of the limitation, since such a construction would simply defeat the legislation. The question is, what installment purchases are intended to be exempt from the limitation? Given the fact that the report framed its reference to installment purchases between home mortgages and consumer goods, it seems that what was probably intended was that interest on installment purchases of consumer goods be exempt from the limitation. If this is the case, then the legislative history does nothing to clear up the problem of whether installment purchases of business interests or of other property qualify as purchases of “property held for investment.”
Because every installment will have an interest element, the installment interest paid during the year may become nondeductible excess investment interest. This can occur in the mandatory buy-out, in which case the objection to the denial of a deduction for installment interest would be the same as the objection to denial of interest on a loan from a third party used to finance the purchase. But even where the purchase of the business interest is voluntary, the insistence of the seller or the financial position of the purchaser may dictate an installment transaction involving installment interest which may be classified as excess investment interest. Clearly this places undesirable obstacles in the path of perfectly legitimate and desirable business transactions.

The foregoing discussion points up the inevitable risk that is encountered in the establishment of an objective statutory standard for treating taxpayer activity which inherently involves subjective elements of motive and intent. The object of section 163(d) is to discourage abuse of the interest deduction. It does so by setting up a complex system of objective standards which purport to prevent such abuse without jarring the hornet's nest of taxpayer intent. The result is that its objective standard will apply to "clean" borrowing transactions which should not be discouraged and which are not entered into for the purpose of trading on the interest deduction. Again, one cannot help wondering if the attempt to objectify standards of taxpayer behavior is worth the difficulty which is created in the process and if perhaps the courts are not better able to handle such problems under a constantly growing "common law" of federal taxation.

With respect to section 163(d), it may be argued that the risk involved in creating an objective standard for denial of excess investment interest, i.e., the risk of penalizing taxpayers whose borrowing motives are legitimate, is considerably reduced by virtue of the blanket $25,000 exemption which applies to all interest on funds borrowed for investment purposes. Even a taxpayer who borrows out of business and investment need rather than tax avoidance motives will, after all, enjoy the benefit of a $25,000 exemption for his excess investment interest. Since few individual taxpayers will be borrowing sums large enough to generate annual interest deductions of $25,000 or more, the $25,000 exemption provision offers adequate protection for the "clean" investment interest transaction. But even if available statistics fully supported this contention, it does not jus-

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90 See Brown, supra note 85.
tify the fact that deliberate tax avoidance through timely borrowing is given a safe harbor. It simply does not make sense to attempt to draw a line between big tax avoiders and little tax avoiders, particularly when the line is so drawn that many taxpayers whose avoidance is very substantial are given the advantage of statutory protection. There is no magic in the $25,000 figure which is allowed as an exemption and there ought to be none. It seems that, given the present structure of the investment interest provision, no amount of tinkering with its exclusionary provisions would further its purported objectives or avoid its unintended evils. For example, while the $25,000 exemption might be eliminated, or a graduated schedule embodying an inverse relationship between the aggregate amount of interest paid and the amount of deductible "investment interest" might be substituted for the present statutory formula, the provision would still operate equally on taxpayers who borrow to purchase investment assets solely for tax avoidance purposes and those who do so out of legitimate investment need. The basic difficulty is that the statute fails to distinguish between these borrowers and simply assumes that all borrowing to purchase investment assets is "tainted" borrowing.

The discussion of alternatives and possible revisions of section 163(d) leads to another problem which must inevitably arise in its administration and which apparently was not considered by the draftsmen. If a taxpayer borrows funds to purchase investment assets and finds that a portion of his excess investment interest is disallowed as a current deduction, why can he not claim that the disallowed interest should be added to his basis in the investment property under section 1012 as part of the cost of acquisition? Under section 266 a taxpayer may, at his option, elect to treat amounts paid or accrued for "carrying charges" and taxes as allocable to the capital account rather than currently deducting such taxes and carrying charges. The regulations specify that such capitalized carrying may include interest on a loan in the case of real


92 CODE § 1012 provides that, subject to certain exceptions, the basis of property shall be its cost. Presumably, the carryover provisions are designed to ultimately permit the deduction of disallowed excess investment interest, so that treating the disallowed interest as an addition to basis would not be necessary. However, the carryover privilege may not accomplish this result due to the limitations contained in section 163(d)(2). See note 76 supra.

93 CODE § 266.
property, whether improved or unimproved. With respect to personal property, the regulations specifically allow the taxpayer to capitalize "interest on a loan to purchase such property or to pay for transporting or installing the same." The reason that the taxpayer is given the option to capitalize interest is, of course, that he has always had the privilege of currently deducting interest, taxes, and certain other carrying charges. Now, however, with the introduction of section 163(d), excess investment interest will be nondeductible. There seems to be no reason why such a nondeductible carrying charge should not be capitalized and added to basis. While the option provision of section 266 would not expressly apply because the taxpayer does not have the choice between capitalizing or deducting the expense, the principle is certainly applicable. Interest on a loan used to buy property is a carrying charge, and if it cannot be expensed currently, it should certainly be added to the cost of the property. If a taxpayer has the right to capitalize the item when he has the option of deducting it, he should certainly have the right to do so when he does not have the option of deducting it.

The Commissioner has no ground for objecting to the capitalization of disallowed excess investment on the theory that it defeats the punitive effect of section 163(d). The reason for the enactment of that provision is to discourage deliberate mismatching of investment expense and investment income. No more perfect matching of investment income and expense can be achieved under a system where the amount realized on the disposition of an asset is taxable in the tax year of realization and then only to the extent that the amount realized exceeds the basis of the asset in the hands of the taxpayer. This being the case, the addition of disallowed excess investment interest to the basis would produce the fairest tax result for both the Commissioner and the taxpayer. The taxpayer gets the benefit of his interest cost—but only when he disposes of the property and realizes gain or loss.

Perhaps a far better answer to the entire problem of abuse of the interest deduction would have been a simple provision requiring the capitalization of interest paid or accrued on debt used to purchase or carry certain carefully defined investment assets, where the sole purpose of the borrowing was to avoid tax. Such a provision would have avoided most of the problems which must now inevitably accompany the administration of section 163(d). It would also have

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95 Id. § 1.266-1(b)(iii)(b).
The interest deduction effected the object of the present legislation in a fairly simple way justifiable in principle, without the drawback of penalizing taxpayers whose borrowing is not motivated solely by tax considerations.

III. Debt Versus Equity — 1969 Style

In his novel Bleak House, Charles Dickens invented Jarndyce v. Jarndyce, a mythical case epitomizing the evils of English chancery practice, which he used as a vehicle for the development of his characters (several of whom were destroyed by their involvement in the case). The debt-equity problem is reminiscent of Jarndyce v. Jarndyce. It has occupied the time and energy of courts and litigants, often causing confusion for the former and disastrous results for the latter. Sometimes it lurks at the core of a tax controversy and at others it manifests itself on the periphery. It has a profound effect upon the expectations of taxpayers, and, therefore, it often dictates the manner in which they arrange their financial affairs.

Simply stated, the debt-equity issue involves characterizing an instrument issued by a corporation either as a true “debt” — in which case a creditor-debtor relationship is established between issuer and holder — or denominated as an “equity” interest — in which case the holder is treated as having received stock. Obviously, the interest deduction plays a major role in the tax expectations of the issuing corporation, since interest paid on an indebtedness is deductible by the corporation under section 163(a). If the relationship creates an equity interest, however, then the purported payment of “interest” becomes a nondeductible dividend. Furthermore, for the securityholder, repayment of a true debt is treated as a return of basis to the extent that the principal repayment does not exceed the taxpayer’s basis. But if the instrument creates an equity interest, the purported repayment of principal may be treated as a redemption of the equity interest, taxable either as a dividend or as capital gain. The interest deduction is not always the factor which

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96 Code § 1232(a)(2)(A) provides that if the principal payment exceeds the basis of the obligation, the excess will be treated as capital gain if the underlying claim is a capital asset in the hands of the payor.

97 Code § 302(b) governs the treatment of redemptions and provides two “safe harbors” which result in capital gain treatment for redemption proceeds — i.e., the “disproportionate redemption” rule of subsection 302(b)(2) and the “termination of interest” rule of subsection 302(b)(3). Both of these rules operate in a mechanical manner intended to minimize the uncertainty which pervaded the treatment of the redemptions prior to the enactment of section 302(b) in 1954. If a redemption will not qualify for capital gain treatment under either subsection, it may still qualify as a sale or exchange, if it is “not essentially equivalent to a dividend” under subsection 302(b)(1). The latter carries into the 1954 Code the provisions of its predecessor, section 113(g) of the
ultimately determines the division of corporate capital structure between debt and equity. A variety of other tax as well as nontax considerations may enter into the picture, but whatever other considerations may govern the decision, the characterization of the instrument will determine the deductibility of interest by the corporation as well as other tax results.

The issuance of the questionable instrument usually takes place at the time of incorporation, since this is the point at which the organizers and investors must make their decisions as to the form of their investment. Normally, a purported debt instrument will be issued to evidence a “loan.” However, the purported debt instrument also may be issued to evidence an obligation to pay the purchase price of an asset which has purportedly been “sold” to the corporation. The latter course of action is chosen where the object is to avoid a tax-free transfer and thus achieve two purposes: First, to give the corporation a stepped-up basis in the asset which it “purchases,” and second, to have the payment of the debt obligation issued in respect of the purchase price treated as taxable gain when the obligation is paid. As might be expected, taxpayers have made the characterization difficult by having the corporation issue “hybrid” instruments, i.e., instruments which do not follow the usual form of a debt or equity instrument and are thus not easily classified as one or the other. The debt-equity controversy will be examined below in both the incorporation and “sale” contexts.

1939 Code, as well as the vagaries and uncertainties associated with the judicially developed “essentially equivalent” standard.


99 Code § 351 provides that property may be transferred to a corporation without recognition of gain or loss if the transfer is solely in exchange for stock or securities of the transferee corporation, and, if immediately after the transfer, the transferor (or transferees) are in “control” of the corporation as that term is defined in section 368(c). Where such a tax-free exchange has taken place, section 362(a) provides that the corporation’s basis in the assets which it receives shall be the same as the basis in the hands of the transferor. An addition to basis is to be made in the amount of any gain recognized by the transferor, as would be the case where the latter had received “boot” in addition to stock and securities, or where liability assumption causes gain to be recognized under sections 357(b)-(c). In order to avoid the substituted basis requirement of section 362(a), the stockholders may cast the transfer in the form of a “sale” of the assets in order to preclude the application of section 351. If successful, the basis of the assets in the hands of the corporation would be its cost under section 1012. The cash basis transferees would argue that they realize no immediate gain on the sale by virtue of the receipt of a “debt,” e.g., a promissory note, in respect of the purchase price, and that their ‘gain, if any, is taxable only when and if the debt is paid. See, e.g., Burr Oaks Corp. v. Commissioner, 43 T.C. 693 (1965), aff’d, 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967).
A. The Classification Problem at the Time of Incorporation

The judicial response to taxpayer probing of the debt-equity dichotomy has been the development of a number of criteria against which a particular debt instrument can be measured to determine if it is what it purports to be or if it is really an equity interest masquerading as debt. The test is at best indefinite and unclear, and not all courts apply its component elements in the same way or accord them the same weight. The earlier cases generally emphasized the "thinness" of equity in relation to debt as the most significant element. This has given rise to the so-called "debt-equity ratio" test which looks to the proportion of debt in relation to the proportion of stock to determine whether the total equity interest is unrealistically thin: Too high a ratio of debt to stock results in the characterization of debt as stock.

The debt-equity ratio test has been joined by an imposing variety of other criteria which are used both independently and in conjunction with the ratio test. Later cases have adopted a somewhat more flexible approach in which an objective economic standard is applied to the instrument in question. For example, in its recent opinion in Fin Hay Realty Co. v. United States, the Court of Appeals for the Third Circuit reviewed the criteria normally employed to test a purported debt instrument and made the following observation:

The various factors which have been identified in the cases are only aids in answering the ultimate question whether the investment,
analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship.\textsuperscript{104}

The court then went on to define how it proposed to judge the nature of the instrument:

Under an objective test of economic reality it is useful to compare the form which a similar transaction would have taken had it been between the corporation and an outside lender, and if the shareholder’s advance is far more speculative than what an outsider would make, it is obviously a loan in name only.\textsuperscript{105}

The two equal shareholders in \textit{Fin Hay Realty Co.} had each paid $10,000 for their stock at the time of incorporation in 1934, and each shareholder had advanced an additional $15,000 to the corporation, receiving in return its unsecured 6 percent demand note. A month later, each shareholder advanced an additional $35,000 to the corporation, and again, the corporation issued to each of them its unsecured 6 percent demand note. The corporation used its funds to purchase three apartment buildings, the first having been acquired for a cash payment of $39,000 and the other two for a cash payment of $75,000 and a purchase money mortgage of $100,000. In applying its “objective test of economic reality,” the court concluded that the demand notes were in the nature of equity rather than debt. It noted that the corporation used the loan proceeds to purchase its assets (the apartment buildings) and that the repayment of the notes depended upon an increase in the value of the real estate and the concomitant ability of the corporation to sell or refinance it. From this fact, the court concluded that only because of the special stockholder-corporation relationship were the two shareholders willing to make this long-term commitment and to allow the notes to go unpaid.\textsuperscript{106} The court could not conceive of any outside creditor having risked his capital in 1934 in unsecured 6 percent demand notes of this corporation. Consequently, it held that “the form which the parties gave to their transaction did not match its economic reality.”\textsuperscript{107} The notes were treated as equity and the corporation’s interest deductions were disallowed.

\textsuperscript{104} 398 F.2d at 697 (emphasis added).

\textsuperscript{105} Id. (emphasis added).

\textsuperscript{106} It was not until 1962 that the Commissioner disallowed the corporation’s deduction for interest paid on the notes. At that time, the property had been refinanced and the loan proceeds had been used to retire the interest of a deceased shareholder. The interest of the other shareholder had passed to his daughters who continued to hold the notes to which they succeeded. \textit{Id.} at 695-96.

\textsuperscript{107} \textit{Id.} at 698.
The objective economic test appears at first blush to be a considerable improvement over the varied criteria previously used by the courts.\textsuperscript{108} The fact is, however, that an objective economic test has two serious drawbacks. First, it completely ignores the intention of the parties, who may have perfectly valid reasons for arranging their corporation's capital structure in a given way. Since the principal purpose behind the Commissioner's insistence on a "correct" classification is his desire to entrap those who would use the debt-equity dichotomy for purposes of tax avoidance, the classification criteria should definitely take taxpayer intent into account.\textsuperscript{109} Second, the objective economic test approach to the debt-equity problem really does no more than draw upon and restate the old criteria. Whether an outside investor would do what the shareholders are doing may depend upon such things as the nature of the obligation, the presence or absence of a fixed maturity date, the proposed source of repayment, subordination or nonsubordination to trade creditors, the rate of interest, and so on ad infinitum through the whole spectrum of available criteria. Because one cannot predict which of the available criteria will be included in a particular judicial construction of the objective economic reality test, \textit{Fin Hay Realty Co.} creates no greater certainty than had hitherto existed.

In view of this state of affairs, it is not at all surprising that in the Tax Reform Act of 1969 Congress undertook to bring some order to this chaotic problem area. The vehicle fashioned to accomplish this goal was new \textit{Code} section 385,\textsuperscript{110} a blanket provision designed to give the Commissioner the authority to issue such regulations "as may be necessary or appropriate" to determine for all tax purposes whether an interest in a corporation is stock or indebtedness. The regulations are to set forth criteria to be considered in making the necessary distinction, and among other factors may include:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return

\textsuperscript{108} For an enumeration of these criteria, see note 103 \textit{supra}.

\textsuperscript{109} In his well-known dissent in Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1959), \textit{cert. denied}, 359 U.S. 1002 (1957), Judge Learned Hand made the argument that a debt in all respects valid as between a corporation and its stockholder was a "bona fide debt" and ought to be treated as such except where its only effect upon the stockholder-creditor's "beneficial interest" was a tax reduction. Thus, where a valid business purpose (other than tax reduction) is furthered by ordering a transaction in a particular way, Judge Hand suggested that the taxpayer's modus operandi should not be upset by an undefined notion of "substantial economic reality" which does not make clear the facts which are considered determinative.

\textsuperscript{110} \textit{CODE} § 385 was created by \textit{REFORM ACT} § 415.
for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
(2) whether there is subordination to or preference over any indebtedness of the corporation,
(3) the ratio of debt to equity of the corporation,
(4) whether there is convertibility into the stock of the corporation, and
(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.\(^{111}\)

Congress has thus shifted from the courts to the Commissioner the responsibility for establishing the criteria which distinguish debt from equity, and it has offered him five nonexclusive factors which he may use in discharging that responsibility.

Before proceeding to a discussion of section 385, it should be noted that this is not the first time that a statutory provision has been proposed as a means of settling debt-equity controversies. The original House version of the Internal Revenue Code of 1954 contained a proposal which distinguished between "securities," "participating stock," and "nonparticipating stock."\(^{112}\) Under this proposal, an interest deduction would have been allowed only for payments made in respect of securities.\(^{113}\) Securities were defined as unconditional obligations to pay a sum certain with interest payable without regard to the level of corporate earnings. This proposal was rejected as inflexible,\(^{114}\) and, of course, did not appear in the Code. The American Law Institute also had included a somewhat more elaborate statutory definition of debt in section X-500 of its Tax Project.\(^{115}\) The ALI definition was nonexclusive and included the following factors: (1) An unconditional obligation with fixed maturity, issued for adequate consideration; (2) nonsubordination to trade creditors; (3) no power in the holder to vote for corporate directors; and (4) interest payable independently of corporate earnings and no later than at maturity of principal. If an obligation did not meet these tests, the section provided that it could still qualify as debt if it would be so regarded under current judicial decisions.\(^{116}\)

In a general comment on the ALI debt-equity proposals, Professor Surrey has noted a basic problem which must arise in any statute-

\(^{111}\) CODE § 385(b).
\(^{115}\) AMERICAN LAW INSTITUTE TAX PROJECT § X-500 (1954 Draft).
\(^{116}\) Id.
tory definition of debt: namely, that under any given set of facts, the inflexible application of particular definitional elements or factors may be either irrelevant or at least troublesome. Thus, for example, trade creditors are simply not an important factor in the activities of many corporations. What, then, is the significance of nonsubordination of debt to trade creditors in such a situation? Similarly, if reasonable expectation of repayment is to be a factor as it was in *Fin Hay Realty Co.*, does this introduce too great an element of uncertainty into the definition?

Obviously, these issues will arise only if the criteria proposed by the Commissioner are exclusive, for if they are nonexclusive, then they may be applied in accordance with present judicial practice, thereby avoiding the inflexibility which is objectionable in an exclusive definition. Professor Surrey feared that some administrators and courts, when confronted with a listing of definitional elements, might easily choose not to accept the fact that the definition is nonexclusive. In section 385, there is a list of suggested criteria which the Commissioner may consider in the regulations which he is to issue. He is free to accept or reject any of the suggested factors and he may choose to add others. However, there is no indication whatsoever in the mandate given to the Commissioner as to whether Congress intended that the regulations shall prescribe an exclusive or nonexclusive test. Should the Commissioner so elect, he may presumably provide that his regulations constitute the exclusive definition of debt; that any variation from the prescribed form is fatal; and that such variation will result in characterization of the instrument as stock. From an administrative point of view, the temptation to prescribe an exclusive definition must be great indeed. A nonexclusive listing of definitional factors would only invite further judicial tinkering with the debt-equity problem, rendering nugatory the broad regulatory authority granted by section 385. In view of the above, and given the Commissioner's understandable predilection to construe a questionable debt instrument as stock, it seems quite likely that the regulations will adopt an exclusive definition: Only careful draftsmanship can serve to avoid the problems alluded to by Professor Surrey.

If the Commissioner's regulations are to constitute an exclusive definition of debt, what will be the elements of such a definition?

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118 398 F.2d 694 (3d Cir. 1968).
119 Surrey, *supra* note 103, at 45.
Here, of course, one can only speculate, but it seems reasonable to assume that "troublesome" factors — factors which, if included in an exclusive definition, would permit either taxpayers or courts too much leeway and discretion — will be eliminated from the definition. An example of such a factor is the debt-equity ratio. Fortunately, the ratio is no longer as important as it once was in determining the debt status of an instrument. Courts in recent years have both struck down low debt-equity ratios (treating the "debt" as equity) and have sustained high ratios, depending on the circumstances of each case.120 These developments suggest that the new regulations quite possibly will not include the ratio test. If the test is dropped, no doubt the issue of thin capitalization would cease to be as important as it once was, but it may continue to be a matter of considerable interest to the courts in certain cases. For example, where the ratio of debt to equity is so overwhelming that there is virtually no equity at all, a court might determine that the alleged indebtedness should not be recognized.121 Thus, even if the Commissioner chooses to drop the ratio test altogether, it is doubtful whether the issue can be avoided in extreme cases. If, however, the ratio test is not dropped, the Commissioner may settle the matter by a regulatory provision arbitrarily fixing a given ratio as acceptable. Thus, the regulation might provide that a debt-equity ratio of up to 4:1 will be acceptable;122 a ratio in excess of 4:1 would then be regarded as automatically disqualifying the entire debt instrument, resulting in its treatment as stock. From an administrative point of

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120 In Talbot Mills v. Commissioner, 326 U.S. 521 (1946), the Supreme Court cautioned against "obviously excessive" debt-equity ratios. Id. at 526. In that case, the ratio of debt to equity was 4:1 and was not considered obviously excessive because "material amounts of capital were invested in stock." Id. Thus, a 4:1 ratio came to be regarded as safe. However, in Gooding Amusement Co. v. Commissioner, 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956), a debt-equity ratio of 1:1 was struck down on the ground that the parties did not intend to enforce payment of the obligations. Arguing from the Gooding case, taxpayers were able to convince courts that high debt-equity ratios should be ignored where other considerations justified the characterization of the purported debt as true debt and not as equity. E.g., Arthur M. Rosenthal, 34 P-H Tax Ct. Mem. 1507 (1965); Charles E. Curry, 43 T.C. 667 (1965), acquiesced in, 1965-2 CUM. BULL. 4. In some cases the ratio test has been dropped altogether. See Gloucester Ice & Cold Storage Co. v. Commissioner, 298 F.2d 183 (1st Cir. 1962).

121 See Burr Oaks Corp. v. Commissioner, 43 T.C. 635 (1965), aff'd, 365 F.2d 24 (7th Cir. 1965), cert. denied, 385 U.S. 1007 (1967), where the corporation had issued notes in the aggregate amount of $330,000 to three individuals as consideration for the transfer of certain realty to the corporation. The stock of the corporation was issued to the wives of two of the note holders and the brothers of the third for a total consideration of $4500. The "notes" were treated as stock and the transaction was therefore held to be a section 351 exchange rather than a "sale" of the realty. In this case, the $4500 worth of stock simply floated in a $330,000 sea of indebtedness.

view, this is desirable, but from a taxpayer's point of view, such rigidity is disastrous and is not justified where legitimate business interests are served by a higher debt-equity ratio.

Unfortunately, most of the definitional factors which have been used by the courts in an attempt to distinguish debt from equity are troublesome in the same sense that the ratio test is troublesome: They are all more or less applicable in given situations. While these factors cannot be excluded from a reasonable and comprehensive definition, their inclusion can only result in further uncertainty and more litigation. But since the definition to be fixed in the regulations will have to be exclusive to be effective from an administrative point of view, it will be difficult for the Commissioner to fabricate a regulatory standard which does more than minimize the evils of inflexibility and vagueness.

A possible solution to this problem is suggested by the regulations dealing with business entities which are taxable as corporations pursuant to subsection 7701(a)(3). In his regulations, the Commissioner sets forth the six major characteristics of the corporate enterprise. Because it is recognized that an association, trust, partnership, or other business entity may have some but not all of these corporate attributes, the regulations take the position that if the particular entity has more corporate than noncorporate characteristics, it will be classed as a corporation for income tax purposes. A similar test could perhaps be applied to the debt-equity situation. A regulation could be designed to list the characteristics or attributes which the Commissioner considers to be essential for a debt instrument. If a particular instrument has more debt than nondebt characteristics, it would be denominated debt; if it has fewer debt than nondebt characteristics, it would be classed as equity.

Such a regulation might be objectionable because of the ease with which taxpayers could plan around it. It is certainly true that taxpayers can and do plan around the regulations which define a corporation for tax purposes, but there is no inherent evil in such a procedure. In fact, in the case of limited partnerships, the regula-

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128 CODE § 7701(a)(3) provides that the term "corporation" includes "associations, joint stock companies and insurance companies." The term "association" is not defined in the Code.

124 Treas. Reg. § 301.7701-2(a) (1960). The characteristics are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. Id.

125 Id.
tions actually go so far as to provide specific assistance for planning around the corporate characteristics by pointing out how they can be avoided. Presumably, there are good policy reasons for permitting a taxpayer to utilize certain business entities which may have one or more corporate characteristics and yet escape corporate classification. The regulations provide guidance in this area and their thrust is simply to prevent an essentially corporate entity from escaping the tax consequences appropriate to it under the statute. Similarly, in the debt-equity area there is nothing inherently evil in the use of debt instruments, and there is often a good and sufficient business reason for using debt in the corporate capital structure. Given a set of basic attributes which are characteristic of debt, a preponderance of the debt attributes should result in debt classification. It is perhaps easier to specify and define the essential characteristics of a corporation than it is to specify and define those of a debt instrument where the creditor is a shareholder. Yet whatever the merits of this proposition, it seems that Congress in its wisdom has determined that the Commissioner shall establish and define these characteristics. It appears, then, that a listing of the major characteristics as developed in the course of litigation, with a proviso that classification shall depend on whether debt or nondebt characteristics predominate, would be a workable solution to the problem. Such a solution might not satisfy all parties, but it has proved to be acceptable in distinguishing between corporate and noncorporate business entities, and it should function at least as well in the debt-equity area.

B. The Classification Problem Upon a "Sale" to a Controlled Corporation

It has previously been noted that debt instruments are often issued not only in conjunction with the formation of a corporation, but also as consideration for a purported "sale" of assets by a shareholder to a controlled corporation. The purpose of such a transaction is to avoid the nonrecognition provisions of section 351, so that the corporation will receive a stepped-up basis for the assets.

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126 Treas. Reg. § 301.7701-3(b) (1960), deals specifically with the corporate characteristics of limited partnerships and gives specific examples of how particular corporate characteristics may be avoided.

127 See text accompanying notes 96-99 supra.

128 See note 99 supra.
"purchased" and the shareholder-seller will receive a tax-free return of capital to the extent of his basis in the debt instrument.\textsuperscript{129}

The courts have had considerable difficulty in developing criteria to distinguish between a purported sale and a tax-free section 351 exchange. Since a debt instrument is usually issued by the transferee corporation as consideration for the transfer, it is not surprising that, in general, the courts have attempted to solve the sale problem by determining whether such debt is valid debt or equity. This determination is made on the basis of the same judicial criteria which are used to distinguish debt from equity in the incorporation context.\textsuperscript{129} If the purported debt is classified as equity, then of course there can be no sale, for the shareholder has simply transferred property to the controlled corporation in exchange for additional equity — clearly a section 351 transaction.\textsuperscript{131} If, on the other hand, the debt is classified as valid debt, the transaction is viewed as a sale. The problem in these cases is that the debt-equity question which is raised is only partly relevant to the question of whether the transaction constitutes a sale as opposed to a section 351 exchange. Once it is determined that the instrument is debt rather than equity, the courts have tended not to proceed to the further inquiry of whether the debt is a "security" within the meaning of section 351\textsuperscript{132} and therefore still subject to the nonrecognition and basis provisions of that section. They simply hold that if the instrument is debt, the transaction is a sale.\textsuperscript{133}

Although the term security is not defined in either the \textit{Code} or Regulations, there is no inherent reason why a debt instrument may not constitute a security. Therefore, the inquiry should not terminate with the conclusion that


\textsuperscript{130} See note 103 supra.

\textsuperscript{131} In addition to this result, the substituted basis provisions of section 362(a) (governing basis to the corporation in a section 351 exchange) will be applicable so as to deprive the corporation of its anticipated stepped-up basis. See note 99 supra.

\textsuperscript{132} CODE \S 351 applies where the transferor receives, in exchange for the transfer of assets, "stock or securities" of the controlled corporation. Consequently, classification of the debt as stock, \textit{i.e.}, equity, does not preclude the possibility that the debt is a "security" and that the transaction is therefore still within the purview of section 351.

\textsuperscript{133} See J.I. Morgan, Inc. v. Commissioner, 30 T.C. 881 (1958), rev'd on other grounds, 272 F.2d 936 (9th Cir. 1959). The rationale for this view may be that a short-term debt instrument is so much like cash that gain should be recognized — \textit{i.e.}, a short-term note may be treated as "boot." This theory, however, does not explain why the courts have treated as sales those transactions in which the purchase price payable by the controlled corporation is evidenced by a long-term installment obligation, as in \textit{J.I. Morgan, Inc}..
the instrument is debt. The Tax Court now seems to have moved in this direction. Thus, in George A. Nye, it was held that a 10-year installment note issued to a shareholder as consideration for a purported sale of assets to his controlled corporation was a security, although properly classified as debt. In consequence of this approach, the transaction resulted in nonrecognition of gain under section 351 and a substituted basis for the assets transferred to the corporation.

Now that the possibility of classification of debt as a security has been recognized, the problem will shift to establishing the definition of a security. However, in view of the decision in Camp Wolters Enterprises, Inc., the definition may no longer depend solely upon the duration of the debt obligation, but upon an "overall evaluation of the nature of the debt." In Prentis v. United States, for example, it was held that a 6-month promissory note was a security within the meaning of subsections 112(b)(4) and (b)(5) of the 1939 Code based on an overall evaluation of the transaction. Thus the courts appear to be moving toward a logical resolution of the sale-section 351 problem.

The question now, however, is what effect section 385 will have upon this aspect of the debt-equity issue. If the factors established as definitional criteria will result in an equity characterization of many instruments which might otherwise have been denominated as debt, the result will be that the courts will have far less opportunity to refine the meaning of the term security. A broader equity classification will necessarily result in the treatment of a large number of purported sales as section 351 exchanges, thus precluding further inquiry into the possibility that the debt instruments issued in such exchanges are securities. This would be unfortunate for two reasons. First, since neither the Code nor the regulations define the term security, further refinement must necessarily come from the courts. A broader equity classification will thus severely restrict the opportunities for a much needed judicial definition of the term. Second, a shareholder who arranges his affairs so as to receive se-

135 50 T.C. 203 (1968).
136 22 T.C. 737 (1954), aff'd, 230 F.2d 555 (5th Cir. 1956).
137 Id. at 751.
curiosities in addition to stock should not be forced into a position of having received stock by virtue of an all embracing definition of the term equity. Section 351 does, after all, contemplate a tax-free exchange for stock and securities and not merely for stock. The danger of permitting a stepped-up basis to the corporation is avoided where the transferor's interest continues either as stock or security, while at the same time, the interest deduction continues to be available in respect of an instrument which is a valid debt. Thus, since the Commissioner's definition of equity under the regulations issued pursuant to the newly created statute is apt to be fairly broad, the effect upon the sale and security aspect of the problem may be undesirable.

IV. LIMITATION OF THE INTEREST DEDUCTION IN CORPORATE ACQUISITIONS

Congressional use of the tax laws to achieve nontax policy objectives has become so common a practice that it is now accepted as a fairly permanent feature of the tax scene. The Tax Reform Act of 1969 is no exception to this procedure; for it contains a number of provisions aimed primarily at achieving nontax legislative purposes. One significant example of such a policy-oriented provision stems from congressional concern over the proliferation of merger activity, particularly in the area of conglomerate acquisitions in which debt instruments — generally convertible debentures — are issued by the acquiring conglomerate in exchange for stock or assets of the acquired corporation. In order to discourage such

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140 Perhaps a better solution to the problem of defining "securities" would be to eliminate the term altogether from section 351 and to substitute therefor the word "indebtedness," which would apply to an instrument having a stated maturity of 1 year or more. See Surrey, supra note 103, at 49.

141 The practice is criticized by many able commentators who believe that the tax laws should generally be neutral in relation to various groups of taxpayers and with respect to nontax policy matters. See, e.g., Blum, "Federal Income Tax Reform — Twenty Questions," 41 Taxes 672, 679 (1963).

142 For example, sections 521(a) and (b) of the Reform Act eliminate the use of the double declining balance and sum of the years-digits depreciation methods for new real property. However, an exception is made for new residential real property so that these fast depreciation methods may be used with respect thereto. Obviously there is a nontax policy objective involved in the retention of a substantial depreciation tax shelter for new residential realty, i.e., to attract investment into the residential real property sector. The same is true of the special provisions of section 521(a) of the Reform Act which allows recovery of rehabilitation expenditures on low- and moderate-income housing on the basis of a 5-year useful life — straight line method. This, too, is obviously a policy-oriented tax provision.

143 During 1968, merger announcements increased 50 percent over 1967, and
acquisition activity, the Reform Act contains a provision which severely limits interest which an acquiring corporation may deduct in respect of debt instruments issued to acquire the stock or assets of another corporation. Such a provision clearly is not a tax reform provision in its own right; it is essentially a manipulation of the tax law designed to achieve certain objectives within the province of antitrust law, securities regulation, accounting, and basic economic policy.

The interest deduction, however, can be an effective control mechanism because of its importance in planning conglomerate acquisitions. The tax benefits for the acquiring corporation are the same as those which generally inure to a corporation with a significant amount of debt in its capital structure, i.e., the interest incurred on the debt is deductible. For example, $10 million in 8 percent 25-year debentures will result in total interest deductions of $20 million. At current corporate rates, this means a tax saving over the entire 25-year period of $9.6 million. This tax saving, plus the fact that debt requires no immediate capital outlay, causes no dilution of ownership, and the interest can be paid out of the acquired corporation's anticipated profits, all conspire to make a debt-financed acquisition attractive indeed.1

The policy of the Reform Act is implemented by the provisions of new Code section 279.145 This section establishes a category of corporate debt called "corporate acquisition indebtedness," which is defined as a bond, debenture, note, certificate, or other evidence of indebtedness issued by a corporation as consideration for the acquisition of not less than 5 percent of the combined voting power of all classes of stock, or not less than two-thirds of all the operating assets — other than cash — of another corporation. In order to be classified as corporate acquisition indebtedness, the instrument must comply with the following criteria: (1) It must be subordinated to the claims of trade creditors of the issuing corporation or expressly subordinated to the payment of any substantial amount of unsecured indebtedness of the issuing corporation; (2) it must be convertible into stock of the issuing corporation or it must be part of an investment unit which includes an option to acquire stock of the issuing corporation; and (3) the ratio of debt to equity of the issuing

merger activity during the first part of 1969 was substantially greater than for the same period in 1968. See Sax, supra note 91, at 235-36 nn.2-3.

144 Id. at 237.

145 REFORM ACT § 411.
corporation must not exceed 2:1 as of the last day of the taxable year in which any obligation is issued for the acquisition of stock or assets of the acquired corporation, or the projected earnings of the issuing corporation must not exceed three times the annual interest to be paid or incurred. Subsection 279(c)(2) provides that the term "ratio of debt to equity" shall mean the ratio of the total indebtedness of the issuing corporation to the adjusted basis of all its assets — including money — less such total indebtedness. Thus, the ratio test used in this context differs markedly from the ratio test which is applied in the usual debt-equity situation. In the latter case, the ratio of shareholder debt to shareholder equity is the critical issue.

Once it is determined under sections 279(b) and (c) that the debt meets the requirements of corporate acquisition indebtedness and is issued for the purpose of stock or asset acquisition, section 279(a) provides the legislation's major thrust by disallowing the deduction for interest incurred in respect of such indebtedness to the extent that such interest exceeds $5 million. Further, subsection 279(a)(2) requires that the $5 million floor may be reduced by the amount of interest paid or incurred on debt issued after December 31, 1967, as consideration for the proscribed stock or asset acquisition, but which does not qualify as corporate acquisition indebtedness under the tests set forth in section 279(b). These provisions operate to effectively discourage the use of subordinated convertible debentures, the favorite instrument used to effect corporate combinations.

The application of section 279 to debt issued in connection with a corporate acquisition does not prevent the concurrent application of section 385, which authorizes the Commissioner to issue regulations defining debt and equity "for purposes of this title." Thus, because the regulations to be issued under section 385 will be applicable for all purposes arising under the income tax law, they must necessarily cut across the provisions of section 279. It seems rather obvious that the very tests which establish the status of debt as corporate acquisition indebtedness also point to its classification as equity. Subordination to general creditors and unsecured claims, convertibility to stock, and a ratio test of 2:1 based on the ratio of

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146 These requirements are set forth in detail in new CODE § 279(b).

147 The convertibility feature enables the debenture holder to benefit from the appreciation in value of the acquired corporation's stock, since the convertible debenture will increase in value as the value of the stock approaches the conversion price. In the meantime, the holder enjoys an assured return on his investment.

148 CODE § 385(a).
all debt to the adjusted basis of all assets are all indicia of equity rather than debt.\textsuperscript{149} This point was specifically considered by the House Ways and Means Committee Report which stated:

Your committee does not believe that many corporate bonds and debentures which presently are being treated as debt are, in fact, debt rather than equity. In fact, some security exchanges have even raised questions as to listing some of these securities as "bonds" or indebtedness. The characteristics of these bonds or debentures, such as convertibility and subordination, in many cases make them more closely akin to stock than to debt. In other words, the characteristics of the obligation make the interest in the corporation which it represents more similar to a stockholder's interest than to a creditor's interest. \textit{Your committee is particularly concerned with the present situation, which involves an increasing amount of debt used for corporate acquisition purposes, in view of the fact that it normally is much easier to effect a substitution of debt for equity at the time of corporate acquisition.}\textsuperscript{150}

The Committee then concluded that even if a transaction manages to find refuge within one of the section 279 provisos — the $5 million floor or the limited application to "corporate acquisition indebtedness" — the interest paid on acquisition debt may nevertheless be fully disallowed under the general rule that interest must be incurred in respect of debt in order to be deductible.\textsuperscript{151} The foregoing clearly indicates that the special disallowance rules of section 279(a) will apply only if the corporate acquisition indebtedness has first cleared the hurdle of section 385 and qualifies generally as debt under the regulations to be prescribed thereunder. Given the fact that the criteria which define corporate acquisition indebtedness are attributes which have traditionally led to an equity classification within the context of section 385, it appears probable that section 279 will operate only on a limited number of debt instruments. Considering that all the attributes of corporate acquisition indebtedness must \textit{simultaneously} be present in order for an instrument to be covered by section 279, it should not be difficult for corporations to plan around that section by deleting one or more of those attributes. The critical question would then become whether such an instrument would possess sufficient attributes of debt to pass muster under section 385.

\textsuperscript{149} These factors are included in the suggested criteria listed in section 385, though the debt-equity ratio mentioned in that section is the conventional shareholder debt-equity ratio rather than the special ratio defined in section 279(c). 


\textsuperscript{151} Id. at 104-05.
Despite the harshness of the dual application of sections 279 and 385, there is no reason why corporate acquisition indebtedness should not be subjected to the Commissioner's scrutiny under section 385. The application of a general debt-equity test to such instruments is a perfectly reasonable procedure. What is questionable, however, is the wisdom and propriety of disallowing all or a part of the interest incurred on debt obligations issued in corporate acquisitions which manage to qualify as valid debt. It is uncertain whether, under the regulations drafted pursuant to section 385, it will be possible for subordinated convertible debentures issued by a corporation with a low debt-equity ratio to qualify as valid debt. What is beyond cavil, however, is the impropriety of a statute which would classify that potential valid debt as equity.

Section 163(a) allows a deduction for interest paid or accrued on indebtedness. Assuming a valid debt, the allowance of the deduction is mandatory. New section 163(d), however, limits an individual's deduction for interest incurred on indebtedness used to purchase or carry investment assets. This limitation is firmly grounded in sound tax policy and is not intended as an aid to nontax policy objectives. It prevents taxpayers from trading upon the interest deduction in order to establish capital values. It is intended as unadorned tax reform, though one may question whether it represents the best solution to the problem it attempts to solve. With respect to section 279 — which also may disallow interest incurred on valid debt — can it be said that there is a valid argument in its favor based on tax reform grounds and not merely on the basis of nontax policy? The question is important because the introduction of nontax policy provisions diminishes the neutrality of the tax laws and renders it difficult to construct a rational and consistent tax jurisprudence. Numerous provisions of the tax law are the result of the play of political forces rather than the application of consistent tax theory. When congressional antimerger schemes (or other nontax policy objectives) are added to the existing political pressures in the tax field, the construction of a rational tax system becomes a well nigh impossible task.

What, then, are the purely tax merits (if any) of the new section 279? Let us assume that a corporation issues its debt obligation — classified as valid debt under the future section 385 regulations — in order to acquire stock or assets of another corporation. If the corporation acquires stock or assets it will do so either for

162 See text accompanying notes 71-73 supra.
investment purposes or to gain control of the acquired corporation. If the principle purpose of the stock or asset acquisition is investment, there is absolutely no reason why the corporation should be permitted to use the interest deduction generated by the debt to establish capital values, i.e., to achieve capital gains while sheltering its ordinary business income with an interest deduction. In other words, in the investment situation, section 279 tends to act as the logical corporate counterpart of section 163(d) which disallows "excess investment interest" for individuals. It has, however, two drawbacks in this respect. First, like its counterpart, section 163(d), it has a significant ($5 million) exemption which allows much of the proscribed activity to avoid its impact. Second, it does not apply where the debt is issued to acquire an interest of not less than 5 percent of the total combined voting power of all classes of voting stock of the acquired corporation. These limitations may make sense in the antimerger policy context, but they do not make sense from a tax reform viewpoint.

Where the acquisition debt — again, valid debt under the future section 385 regulations — is issued to obtain either sufficient stock to control the acquired corporation or a substantial portion of its operating assets, the analogy of section 163(d) breaks down. Here the debt is issued to acquire a business which produces business income taxable to the acquired or acquiring corporation at ordinary corporate rates. In these circumstances, the acquiring corporation is not really trading on the interest deduction to establish capital values. It may, and probably will, use the earnings of the acquired corporation to pay the interest on the acquisition debt, but those earnings will be subject to tax. Theoretically, and from a purely tax point of view, disallowance of the interest is not justified. It can be defended only by pointing to a nontax policy objective — the discouragement of debt-financed merger activity. But even this nontax element is questionable because the congressional concern in this area is merger activity financed by debt which in reality is equity. If the debt passes muster as valid debt under the section 385 regulations, the existence of a valid nontax policy is rendered questionable. Thus, it is precisely in the noninvestment acquisition, the acquisition of control, that the case for the disallowance of the interest under section 279 is weakest. The foregoing analysis leads to the conclusion that section 279 is merely a piece of tax legislation.

153 See CODE § 163(d)(1)(A) & text accompanying note 74 supra.
154 CODE § 279(d)(5).
whose ramifications were not thoroughly explored and which should, perhaps, have been somewhat refined so as to allow for different treatment of interest on valid debt used for noninvestment purposes.

V. CONCLUSION

The Code contains two diametrically opposed provisions: Section 163(a), which authorizes cash basis accounting, and sections 446(b) and 461, which effectively authorize the Commissioner to disallow cash basis accounting when its use would distort income. With regard to interest prepayments, the courts sought to reconcile the two provisions by preserving the taxpayer’s right to account on the cash basis except where he had executed a sham or nonpurposive transaction. This solution had the effect of defining distortion subjectively, in terms of taxpayer intent. The Commissioner registered his dislike for the judicial resolution and his displeasure over taxpayer attempts to stretch its limits by issuing a ruling which, in effect, denies the taxpayer the right to utilize cash basis accounting for interest prepayments. While the Commissioner has the discretion to substitute an objective standard for the subjective judicial test, the legislative history of the sections which grant him such discretion suggest it was not intended that he abdicate his discretion by creating a standard which precludes the use of cash basis accounting. A proper objective definition of distortion would contain meaningful differentiations between large and small prepayments, not a single rule covering both dimes and dollars. Given the lack of such a discriminating objective standard, the subjective judicial resolution — complete disallowance of the deduction in cases involving sham or nonpurposive activity — is superior to the across-the-board pro rata accrual required by Revenue Ruling 68-643. The judicial rule has a much harsher impact on those whom it touches, but its selectivity insures that only the black-hearted will feel its wrath. Further, any objective standard which is similarly discriminating would probably cover almost an identical group of taxpayers, for few persons have a legitimate need to prepay large amounts of interest. The Commissioner’s power to require the use of a proper accounting method does not justify a ruling which places an entire species of cash basis transactions in an undifferentiated category requiring accrual treatment. It is submitted that the judicial approach is preferable, for it preserves the basic function of cash basis accounting: namely, to provide a simple bookkeeping method which does no violence to the ordinary taxpayer’s concept of income and expenses.
The commentators' suggestion that the ruling could be justified by rationales other than discretion is unconvincing. The capitalization and deposit theories are indeed weak reeds to support such a broad exercise of administrative discretion. Capitalization simply does not apply to the sham transaction or to the transaction having no purposive activity other than tax avoidance, because in the former the prepaid item is not really interest and in the latter it has no independent economic function. In these cases, the courts already prescribe disallowance as the logical method for dealing with prepaid interest. It would be a strange result indeed if the taxpayer were to be rewarded with accrual in such cases rather than punished with disallowance. As to other cases, it seems that the capitalization notion is again not the proper answer. Where the prepayment of interest is for the purpose of establishing capital values (the California land transaction) or for trading on the interest deduction to achieve a capital gain position (using loan proceeds to purchase securities) the Code pattern points to disallowance, not to accrual. While the question of whether prepaid interest should be capitalized and added to the basis of the asset is not easily answered, it is clear that in the situation which most concerns the Commissioner — use of prepaid interest to create capital values — the answer to such abuse is disallowance, not capitalization. This leaves for consideration only the routine loan transaction in which interest is prepaid. In these situations the taxpayer is merely utilizing the Code's express provision for cash basis accounting within the context of a bona fide transaction, and while the capitalization argument could be applied, because of both the inherent nature of the transaction and the de minimis amount involved, it seems inadvisable to do so.

The deposit theory is just as weak, for it rests on the assumption that the parties intended the prepaid interest to be refundable. Where there is no intention that a prepayment is to be refunded, or if it is to be refunded only upon the happening of some contingency beyond the control of the parties, the cases support the deductibility of the prepayment and its includibility in the income of the recipient in the year the payment is made. Thus, in the bona fide loan situation, a refund is not intended and the prepaid interest should not be treated as a deposit. If such refund is contemplated, then the transaction may well be something other than what it purports to be and can be handled under the Goldstein principle. It appears, therefore, that Revenue Ruling 68-643, though a response to a jus-
tified and genuine concern, works a great deal of mischief and has attracted a supporting structure of highly questionable rationales.

The arrival of new section 163(d) is also an unfortunate development. Its object is to discourage the use of borrowed funds to finance the purchase of non-income-producing property or of property which will ultimately result in capital gain, since such borrowing results in a large current interest deduction which shelters ordinary income. The statute, however, is drafted so that it actually offers a safe harbor for all but the most ambitious of borrowers. This is accomplished by establishing a deduction floor which insures the deductibility of large amounts of interest by persons fortunate enough to have large amounts of investment income and capital gains. Since borrowing to purchase investment assets allows a taxpayer to trade on the interest deduction and thereby establish capital values, it would have been logical to extend the total disallowance pattern of section 264 to this situation. It is difficult to see how section 163(d), in its present form, can properly be called a reform provision.

The courts have wrestled unsuccessfully with the debt-equity problem for many years. There is no assurance, however, that leaving the problem to be solved by administrative regulation as proposed in section 385 of the Code will result in a better or more acceptable solution. The grant of authority to distinguish between debt and equity by regulation is tantamount to the establishment of a statutory definition and it therefore suffers from the weaknesses inherent in a statutory definition. If the definition is to be really effective, it should be exclusive, and if it is exclusive, it may well be unbearably rigid. On the other hand, a nonexclusive definition does not necessarily solve the problem because under such a definition the debt-equity distinction will remain the judicial and administrative nightmare which it is now. Since the Commissioner now has the ball and must run with it, perhaps he would be well advised to follow the form established in his regulations dealing with associations taxable as corporations, i.e., to enumerate a broad list of debt characteristics, so that the predominant characteristics of a particular instrument will determine its classification. The taxpayer, of course, will be able to achieve his objective by some broken field running around, about, and through such regulations, but that is precisely what he must do now, and regulations such as those suggested would at least define the rules of the game and the boundaries of the field.
The provisions of new section 279 are inextricably intertwined with those of the general debt-equity provisions of new section 385. Assuming that a corporation may issue corporate acquisition indebtedness which will qualify as valid debt under the regulations to be issued pursuant to section 385, it seems that there is no real reason for an interest deduction floor of $5 million where the purpose of the acquisition is investment. There is no reason why a corporation should be able to borrow or to issue its own debt and trade upon the interest deduction so generated to obtain investment assets. On the other hand, where control is acquired in the acquisition transaction, the assets or stock obtained with the borrowing produce ordinary income and the deduction for interest should be allowed in full. While this would nullify the section's antimerger impact, from a purely tax point of view the deduction is justified.

In view of the many theoretical and administrative problems posed by Revenue Ruling 68-643 and the interest provisions of the Reform Act, it is small wonder that together they have caused another periodic shock wave that has stirred the tax world and goaded its commentators into action. No doubt this activity will subside, but only until another seismic disturbance destroys the uneasy calm that characterizes the world of federal income taxation.
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