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TAX SHELTERS: PREPAID INTEREST

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BY THE STAFF OF THE

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GENERAL

Since many investors in tax shelters acquire partnership interests toward the end of the calendar year, the investors will have not participated in the partnership long enough to generate a large amount of ordinary and necessary expenses in that year. Therefore, deductions for a variety of prepaid expenses have been central to the creation of tax losses.

One of the prepaid expense items widely used by tax shelters generally is prepaid interest. This item normally consists of interest on the financing which the investors incur when they initially purchase the land, apartment building, orchard, cattle, etc.

Normally, the investors (or the limited partnership or other entity which a group of investors has joined) purchase the shelter property toward the end of the calendar year. They finance a large portion of the purchase price either by borrowing funds from a bank, insurance company, or other outside lender, or by executing a purchase money mortgage note to the person who is selling the property to them. In a purchase money mortgage, the seller himself in effect extends financing to the parties who are buying the property.[1]

Prepaying interest on a debt obligation enables the investors to claim tax deductions even though the property acquired with the debt has not yet begun to produce income. Thus, if the investors have income from other sources, these deductions can be used to offset this other income rather than offsetting the income from the property to be realized in a later year. Consequently, prepaid interest gives a taxpayer the advantage of tax deferral. In some cases, the prepayment has the effect of reducing the taxpayer's cash flow (net of tax savings). In such circumstances, as long as the deduction lowers the taxpayer's effective tax rate by more than the market rate of interest, the taxpayer will find it to his advantage to shelter his income by prepaying interest. The earlier this deduction can be obtained, the longer the investor has use of the funds and thus can earn additional interest on them.

However, in many tax shelters a deduction for prepaid interest can be generated without adverse cash flow consequences by borrowing more money than is needed and promptly repaying the excess as prepaid interest. Thus, for example, a tax shelter operation needing $900,000 in borrowings for 5 years at 11 percent interest could borrow $1,000,000 at 10 percent interest in December of its first year, and pre-

[1] Often, where the investors desire to prepay interest, the seller will accept a lower "purchase price" and a larger amount of interest. Although most sellers would ordinarily desire to receive a larger purchase price (capital gain) and less interest (ordinary income), many sellers are not adversely affected by receiving interest income. For example, some sellers have expiring loss carryovers to absorb the interest income. Other sellers are dealers who would realize short-term capital gain on the sale in any event; still other sellers are pension funds, charities or other tax-exempt organizations.

pay one year's interest immediately. The economic effect of the arrangement is exactly the same as borrowing $900,000 at 11 percent. However, the net effect of structuring the transaction as a borrowing of $1,000,000 with a $100,000 interest prepayment is the acceleration of a $100,000 deduction for 5 years.

Another advantage of prepaying interest is available to individuals who receive a large amount of income in a particular year. For such individuals, the prepaid interest deduction can be used to shelter the income in excess of what would ordinarily be received by the taxpayer. In such cases, the prepaid interest deduction operates in effect as an income averaging device. These individuals also receive the deferral benefit indicated above.

Such a taxpayer will find it to his advantage to shelter his income by means of a prepaid interest deduction so long as the deduction lowers the taxpayer's effective tax rate by more than the market rate of interest on the amount of cash (net of tax savings) he must put up.

In general, reductions in the effective rate will accrue principally to taxpayers who are in the higher effective tax brackets because the percentage tax reduction in those higher marginal tax brackets makes the manipulation of income and deductions between taxable years a rewarding financial activity. Taxable income and marginal tax rates at the lower end of the progressive tax structure do not yield significant enough financial returns to warrant this type of tax manipulation.

Cash method of accounting. The cash method of accounting is especially important to investors who want to prepay interest (and other expenses). As is the case with certain other expenses suited to producing accelerated tax losses, under the cash method interest expense can generally be deducted when it is paid (regardless of the period to which the liability relates). Under the accrual method of accounting, by contrast, interest is deductible as it accrues, regardless of when the interest expense is paid. The accrual method generally achieves a better matching of income and expense than does the cash method.

Present law generally provides that a taxpayer may claim deductions in the year which is proper under the method of accounting which he uses in computing his taxable income (sec. 461). However, the income tax regulations provide that even under the cash method of accounting, an expense which results in creating an asset having a useful life which extends substantially beyond the close of the taxable year may be deducted only in part in the year in which payment is made. Consistent with this rule, the statute provides that if the taxpayer's method of accounting does not clearly reflect income, the Internal Revenue Service may recompute the income using the method which the Service believes does clearly reflect income.

Until the late 1960s tax-oriented investors were able to prepay as much as 5 years' interest with apparent approval by the Service. No specific statutory provision expressly permits prepaid interest to be deducted as paid by a cash method taxpayer. The authority for deducting prepaid interest rests on court cases and on administrative rulings by the Internal Revenue Service. In 1968, however, the Service issued

a revenue ruling providing that prepaid interest can be deducted in advance only for a period not in excess of 12 months following the taxable year in which the payment is made, and even then, only if the deduction does not materially distort income.

ADMINISTRATIVE RULINGS

In Rev. Rul. 68-643, 1968-2 C.B. 76, the Service took the position that a deduction of prepaid interest by a cash basis taxpayer will be disallowed as materially distorting income except in certain limited circumstances. Prepayment for a period extending for more than 12 months beyond the end of the current taxable year will be deemed to create a material distortion of income. In such a case the interest will be allocated over the taxable years involved.

Deductions for interest paid in advance for a period not in excess of 12 months after the last day of the taxable year of payment will be considered on a case-by-case basis to determine whether a material distortion of income has resulted.

The ruling sets forth several factors which (among others) may be considered in determining whether there is a material distortion of income: the amount of the taxpayer's income in the taxable year of payment; his income in previous years; the amount of prepaid interest; the time of payment; the reason for the prepayment; and the presence of a varying rate of interest over the term of the loan.[2] Two recent court decisions have upheld the Service's application of these criteria to particular interest prepayments.[3]

Items related to prepaid interest

Points.—It is important under present law to distinguish between "points," which are viewed as additional interest charges, and service charges such as those which a lender renders in the course of processing a loan application. In some situations, service charges are treated for tax purposes as nondeductible capital expenditures (rather than as deductible interest or as ordinary and necessary business expenses). In general, the determination of whether points or loan processing fees are deductible when paid depends on the facts of the particular situation, and the Service has published several rulings indicating whether particular payments of this kind are deductible in full when paid.

Loan commitment fees.—Often a bank or other commercial lender charges a fee for agreeing to make a loan in the future if and when a borrower desires to borrow the funds. Ordinarily, this fee is not interest since it does not relate to a borrower's use of money. In

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[2] The Service has not made clear whether these criteria apply, in the case of a partnership, solely at the partnership level or solely to each partner or possibly at both levels.

[3] *G. Douglas Burck*, 63 T.C. 556 (1975) (one year's interest on a 27-month loan prepaid on December 29; cash method taxpayer realized an unusually large capital gain during the year; a $377,000 prepayment reduced his taxable income from $419,000 to $41,400; the court allowed only 3/365 of interest in the year of payment); *Andrew A. Sandor*, 62 T.C. 469 (1974) (5 years' prepaid interest intended to shelter unusually high capital gains during year held not deductible at all in the year of payment by a cash method taxpayer).

some cases, however, the payment of the fee has been treated as an ordinary and necessary business expense deduction.

Prepayment penalties.—Generally, penalties for liquidating the principal amount of a mortgage or other loan before its due date are deductible by the payor as interest.

Loan discount.—In this type of arrangement the bank (or other lender) delivers to the borrower an amount which is smaller than the face amount of the loan. The difference is the charge for the debtor's use of the borrowed funds. Generally, the borrower cannot deduct the amount withheld in the year he receives the loan proceeds; instead, he can deduct the "discount" only over the term of the loan as he pays the face amount of the loan. (Rev. Rul. 75-12, 1975-2 I.R.B. 6.)

WRAPAROUND MORTGAGE

A recent technique used to justify larger amounts of prepaid interest within the Service's present guidelines than can be obtained under conventional financing is the "wraparound mortgage." A wraparound mortgage works as follows: Typically, the farm, shopping center, or other property which the shelter-minded investors are purchasing is encumbered by an existing first mortgage. The investor executes to the seller a new purchase money obligation whose face amount includes both the unpaid balance of the first mortgage and the new financing supplied by the seller (which would ordinarily take the form of a second mortgage).

The buyers agree to pay (and to prepay) interest on the face amount of the wraparound note, while the seller agrees to continue paying the interest on the first mortgage (out of the interest payments which he receives from the buyers). In some cases the additional prepaid interest which the buyer claims on the wraparound note is negotiated as a substitute for a larger down payment by the buyers, thereby increasing the deductible portion of the initial payments which they make to the seller. Since a wraparound mortgage usually bears a higher rate of interest than the first mortgage, the seller is motivated to use a wraparound mortgage because he is relending the balance of the first mortgage to the investor at a higher rate of interest than he pays his lender. Thus, the amount received as a result of the difference between the interest rates is additional profit to him.

To illustrate how a wraparound mortgage works, assume that the sale price of an existing apartment building which a group of investors desires to buy at the end of 1975 is $1,500,000, and that there is an existing 7 percent first mortgage on the property, the unpaid balance of which is $1 million.

Conventional financing.—Under conventional terms, the buyers might pay $100,000 cash down, take the property subject to the existing first mortgage, and agree to a $400,000 second mortgage at a 9 percent interest rate. The investors would agree to pay interest and principal on the existing first mortgage. However, without the permission of the lender of the first mortgage, the buyer/investors cannot prepay interest in 1975 on the first mortgage. They could, however, agree with the seller to prepay interest on the new financing extended by the seller under the second mortgage. The seller would then receive a total of $136,000 in the year of sale, as follows:

Conventional financing—Purchase price: $1,500,000

Seller	Buyers (syndicate)	
	Pay:	
Existing 1st mortgage (7 percent), unpaid balance $1 million.	Cash down payment	$100,000
	1st mortgage (taken subject to)	1,000,000
	2d mortgage (9 percent)	400,000
	Total	1,500,000
Cash flow:	Total paid by buyers:	
$136,000 received from buyers and retained.	Down payment—1975	100,000
	Prepaid interest (1 year on 2d mortgage)—1975	36,000
	Total	136,000
	Interest paid by buyers on 1st mortgage—1976	70,000
	Total	206,000

Under this type of conventional financing, the investors would probably claim prepaid interest deductions for 1975 in the amount of $36,000.

Wraparound technique.—Using the wraparound mortgage technique, the investors might make a down payment of $66,000 and execute to the seller a mortgage for $1.4 million at 7 percent. (The face amount of the new obligation executed by the investors includes, or "wraps around," the existing first mortgage on the property.) The buyers then prepay one year's interest on the face amount of the wraparound mortgage, or $98,000 (7 percent of $1.4 million). They might also pay the seller three points on the wraparound mortgage, or $42,000. The seller would agree to continue to be responsible for making payments on the first mortgage. (In the following year, the seller would therefore pay $70,000 to the lender on the first mortgage, and retain a net of $136,000.)

The wraparound mortgage can be described as follows:

Wraparound mortgage—Purchase price: $1,466,000

Seller		Buyers (syndicate)	
		Pay:	
$1,000,000 mortgage (seller will continue to discharge out of payments he receives from the buyers).		Cash down payment	$66,000
Cash flow:		Purchase money mortgage (wraparound) 7 percent	1,400,000
Received from Buyers—1975	$206,000	Total	1,466,000
Less: Interest due on 1st mortgage 1976	70,000	Three points on new mortgage	42,000
Retained by seller	136,000	Total paid by Buyers—1975:	
		Down payment	66,000
		Prepaid interest—1 year on purchase money mortgage	98,000
		Three points on new mortgage	42,000
		Total	206,000

By using this technique, the seller nets the same $136,000 as under conventional terms, but the wraparound technique enables the investors to claim $140,000 in interest deductions in 1975 (rather than $36,000).[4]

In this example the total purchase price of the property has been reduced from $1.5 million to $1,466,000. The seller nets the same amount ($136,000) under either financing method. However, the buyers/investors have increased their claim to deduct one year's prepaid interest from $36,000 to $98,000. They have also paid points on the face of the wraparound mortgage which gives the seller the same dollar amount ($136,000) which he would have received under conventional financing and also gives the investors an additional interest deduction. The investors have in effect prepaid interest on the first mortgage without obtaining the lender's permission to do so. They have also converted $34,000 of purchase price dollars (if conventional financing had been used) into deductible interest dollars.

Recently, the Service has taken an administrative position indicating that it will measure the permissible prepaid interest deduction (under the tests of Rev. Rul. 68-643) not by reference to the face amount of the wraparound note but only by reference to the new credit which the seller extends to the buyer.[5]

PROBLEM

Several observations might be made concerning the deductibility of prepaid interest by a cash method taxpayer. The effect of denying deductions for interest which is prepaid by a cash method taxpayer is to place that taxpayer on the accrual method as to a single item of his income and expense (but not as to other items). However, critics of this treatment of prepaid interest point out that the rationale for denying the deductions goes beyond the concept that cash basis taxpayers cannot deduct payments of expenses whose benefit (use of money, in this case) will be realized beyond the current year. The cash method, it is argued, inherently departs from good accounting principles (matching of income and expenses, etc.), but has been permitted for reasons of convenience and ease of bookkeeping. In this view, a "clear reflection of income" test cannot logically be applied to only one item on a cash basis taxpayer's return since almost always he would report the expense differently if his return were prepared on the accrual method on accounting.[6] On the other hand, it is argued that prepaid interest,

[4] Typically, in lieu of having the investors pay points to the seller, the interest rate on the wraparound is higher than the existing interest rate on the first mortgage. In this example, the interest rate on the $1,400,000 wraparound mortgage would likely be higher than the presumably lower interest rate on the first mortgage. In such cases, the seller would retain (and profit from) the increased interest amounts on the first mortgage which the investors will pay to him but which he will not have to pay over to the lender on the first mortgage.

[5] In Rev. Rul. 75-99, 1975-12 I.R.B. 14, a party owning real estate encumbered by a $300x first mortgage (7 percent) executed a note to a real estate investment trust in the amount of $400x at 8 percent per year. The trust advanced $100x to the borrower. The trust also agreed to make the periodic principal and interest payments on the first mortgage. The ruling holds that the indebtedness between the trust and the borrower giving rise to an obligation to pay interest to the trust is not the face amount of the wraparound note, but only the $100x "actually" loaned by the trust. Payments by the trust on the first mortgage were considered made on behalf of the borrower.

[6] Some critics have also contended that a prepayment of interest in order to offset a nonrecurring or "one-shot" increase in income during a year should not be regarded as distorting income because the deduction, in effect, levels out his income.

like prepaid rent and prepaid insurance, is an expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year. If so, even under the cash method of accounting, prepaid interest is properly deductible no earlier than over the period to which it relates. This rationale has been applied to prepaid (or advance) rentals and prepaid insurance [7] even though requiring prepaid rent or prepaid insurance premiums to be deducted no earlier than over the period to which they relate arguably puts a cash method taxpayer on an accrual method for such items.

Critics of the Service's ruling tests for prepaid interest also object to a "case by case" approach to determine deductions. They argue that the deduction by the same taxpayer of prepaid interest should not be allowed in one year and perhaps not in another year. Nor should prepaid interest be deductible by one taxpayer who has a large amount of income in a given year after the deduction (so that the deduction does not "distort" his income) but possibly not be deductible by another taxpayer who has little or no taxable income after taking the deduction.[8]

ALTERNATIVE APPROACHES

There are a number of alternative approaches which the committee could consider to deal with problems created by deductions for prepaid interest. If the committee believes that deductions should not be determined case-by-case for different taxpayers (or for the same taxpayer in different years), and that a "clear reflection of income" test creates too much uncertainty, it could prescribe rules (such as allowing interest deductions only ratably over the period to which they relate) which apply generally to all taxpayers who prepay interest on the cash method of accounting.

The committee could consider dealing with prepaid interest by authorizing the Treasury to permit deductions for interest by reference to an overall effective rate of interest on a debt obligation. If a payment purportedly of "prepaid interest" exceeds the amount of interest computed at the effective interest rate over the term of the loan, the excess would be treated as a payment of principal by the borrower.

This approach would result in treating prepaid interest loans somewhat like discount obligations. For example, if a buyer of property (or other borrower) obtains a loan of $10,000 payable 1 year later and, at the time of obtaining the loan, also purports to prepay interest for 1 year in the amount of $900 (assuming a 9-percent interest rate), the transaction might be viewed as though the taxpayer borrowed only $9,100 and agreed to repay $10,000 1 year later (i.e., a discounted loan). Under this approach, the $900 current payment would be viewed as an

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[7] *Commissioner v. Boylston Market Ass'n*, 131 F.2d 966 (1st Cir. 1942) (prepaid insurance); *Norman Baker Smith*, 51 T.C. 429 (1968) (prepaid rent); *University Properties, Inc.*, 45 T.C. 416, 421 (1966), aff'd, 378 (F.2d 83 (9th Cir. 1967) (prepaid rent); *Martha R. Peters*, 4 T.C. 1236 (prepaid insurance); Rev. Rul. 70–413, 1970–2 C.B. 103 (prepaid insurance); contra, *Waldheim Realty & Inv. Co. v. Commissioner*, 245 F.2d 823 (8th Cir. 1957).

[8] Some commentators who have analyzed the Service's tests and the case law believe that the rule of present law is, in effect, that the Commissioner can place cash method taxpayers on the accrual method as to prepaid interest if a deduction under the cash method causes a great (rather than merely some) disparity between taxable income as computed on the cash method and as computed on the accrual method.

immediate repayment of principal (nondeductible), reducing the net amount of the loan to the borrower. The taxpayer could then deduct interest as part of each further principal payment which he makes on the loan.

A rule of this type would not deny deductions for interest on the cash method of accounting. Instead, it would treat certain kinds of interest prepayments as not true payments of interest but as repayments of principal.

An exception might be provided for relatively small amounts or certain kinds of interest (such as interest on a home mortgage). In addition, the Treasury might be authorized to exempt from the rule transactions which satisfy the Treasury that no tax avoidance is involved.

If the committee believes that prepaid interest deductions should not generally be disallowed, it could consider permitting deductions for prepayments up to the amount of income from the property to which the interests relates for the year in which paid by a cash method taxpayer. Typically, such a rule would adversely affect a tax-motivated investment made at the end of the year where a shelter property is purchased by a group of investors who make a partial down payment and finance the balance with a bank loan or a purchase money mortgage. One difficulty with this type of rule is that it appears to presuppose a loan secured by a specific property purchased with the loan proceeds. However, taxpayers may find ways to borrow investment funds secured by income-producing assets and then use the loan proceeds to purchase a shelter property.[9] In any such case, some prepaid interest might qualify as deductible even if the farm, apartment house or other shelter asset produced no income during the prepayment year.

A. 1974 committee bill

Last year the committee bill provided that a cash method taxpayer could deduct a prepayment of interest only in the period to which it relates under an accrual method of accounting. As an exception to this general rule, however, prepaid interest properly allocable to the 12-month period following the year in which it is paid could be deducted in the year in which paid to the extent of the net income for that year from the property to which the interest relates.

Points paid on a mortgage secured by the taxpayer's principal residence would not have been subject to the above general rule.

B. Mr. Ullman

His proposal is the same as that in the 1974 committee bill, except that he would not include the 12-month exception described above.

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[9] It should be noted, however, that if the investor uses other income producing property as collateral to secure the loan (even though the loan may be nonrecourse as to his personal liability), that property would be at risk should his investment fail.

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