The Prepaid Interest Deduction Viewed from the Perspective of Real Estate Transactions

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COMMENTS

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Real estate transactions have played a significant role in shaping the existing law regarding the deductibility of prepaid interest. The flourishing real estate market of the middle to late sixties was enhanced by the tax benefits of prepaid interest, and the tax avoidance use of the prepaid interest deduction became notorious through its connection with real estate tax shelters. In 1968 the Internal Revenue Service responded to this form of tax avoidance by issuing Revenue Ruling 68-64 which reversed its longstanding position that prepaid interest is deductible by a cash basis taxpayer in the year of payment. The ruling provides that a deduction will not be allowed for interest prepaid for more than twelve months beyond the taxable year in question as it constitutes a material distortion of income. While the abuses which existed prior to the issuance of the ruling mandated some change in the law, serious questions have arisen as to the validity of the Service's automatic disallowance approach.

The purpose of this Comment is to analyze the trends of the law of prepaid interest from the perspective of the real estate tax shelter and to suggest the direction in which the law should develop in this area. Part I illustrates the use and advantages of prepaid interest in real estate transactions. A presentation of the general development of the law of prepaid interest is provided in part II, including an indication of the abuses which led to the issuance of Revenue Ruling 68-64 and a discussion of the specific provisions of that ruling. Part III deals with the law affecting prepaid interest subsequent to 1968 and particularly with the judicial cognizance of the 1968 revenue ruling. An analysis of the various theories on which a prepaid

1. Prepaid interest refers to the payment of interest on an indebtedness before that interest accrues. The tax advantage of such a technique depends upon the ability of the taxpayer to take a deduction for the amount paid. A prepaid interest acquisition has been defined as one involving (1) an acquisition in which the buyer's promissory note represents most of the purchase price and (2) the buyer's prepayment of several years' interest on the purchase money note. See Kaster, Prepaid Interest Purchase Method Still Useful Despite IRS Attack, 30 J. Tax. 16 (1969).

2. A tax shelter transaction is one designed to reduce tax liability by generating deductions in excess of income, thereby “sheltering” high bracket income which has accrued from other sources. Real estate investments have traditionally been regarded as attractive tax shelters because of the potential deductions such as accelerated depreciation and prepaid interest. For a discussion of several limitations on the use of tax shelters enacted in the Tax Reform Act of 1969, 83 Stat. 487, see Cunnane, Tax Shelter Investments After the 1969 Tax Reform Act, 49 Taxes 450 (1971). The proposed Tax Equity Act of 1975 limits tax shelter aspects of rental property by requiring the capitalization of interest and taxes incurred during periods of construction of rental property rather than allowing the current deduction of such expenses. See H.R. 1040, 94th Cong., 1st Sess. (1975).

interest deduction may be disallowed in the context of real estate transactions is included in part IV. In part V some conclusions are drawn regarding the validity of the Internal Revenue Service's approach to the ruling in light of the abuses which precipitated its issuance and the disparate approaches of the courts and the Service in applying the material distortion of income theory. Finally, the trends and impact of future decisions on the prepaid interest deduction are considered.

I. THE PREPAID INTEREST DEDUCTION

The statutory foundation for the interest deduction consists of a clear and simple statement in section 163 of the Internal Revenue Code: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." The Code does not provide a definition of the word "interest" but the term is regarded by the courts and by the Internal Revenue Service as meaning "the amount which one has contracted to pay for the use, forbearance, or detention of money." The basic statutory provision is broad, allowing a deduction for interest in the year paid or accrued, provided that the interest arises from a genuine indebtedness and that the payment is actually interest rather than a disguised payment of principal.

Assuming that these fundamental requirements are met, the cash basis taxpayer may have a useful tax-planning device through his control over the timing of an interest deduction. The timing decision essentially involves choosing the tax year in which the interest payment is to be made. For example, a taxpayer expecting to have a greater need for a deduction in

6. There is no statutory requirement that the interest deduction be reasonable in amount. See, e.g., Dorzbach v. Collison, 195 F.2d 69 (3d Cir. 1952) (payment of 25% of profits as interest held to be deductible under § 163). Furthermore, the deduction may be taken regardless of whether the indebtedness is incurred for a business purpose. INT. REV. CODE OF 1954, § 163(a). But see notes 55-58 infra and accompanying text for a discussion of the purposive activity doctrine.
7. See notes 47-50 infra and accompanying text.
8. See notes 84-88 infra and accompanying text. The courts will look through form to the true nature of the payment to determine whether the amount paid is interest. See, e.g., Autenreith v. Commissioner, 115 F.2d 856, 858 (3d Cir. 1940), aff'g 41 B.T.A. 319 (1940); Norman Titcher, 57 T.C. 315 (1971); L-R Heat Treating Co., 28 T.C. 894 (1957).
9. For accrual basis taxpayers the timing of an interest deduction provides no tax advantages since interest accrues ratably over time and is deductible when accrued. Furthermore, interest must be accrued pro rata over the life of the loan. See, e.g., James Bros. Coal Co., 41 T.C. 917 (1964). However, if the interest calculation is subject to the "Rule of 78's" then it may be accrued on that basis. Rev. Rul. 74-395, 1974 INT. REV. BULL. NO. 33, at 9. The rule of 78's is an interest computation method by which interest accrual is greater during the first part of the loan than in the latter. See Rev. Rul. 72-100, 1972-1 CUM. BULL. 122.
year following the one in which the interest accrues may simply delay the payment until the following year. Similarly, a taxpayer may wish to obtain a deduction by prepaying interest before it accrues on an indebtedness. The tax consequences of creating a current deduction through the prepayment of interest are amplified if the payment is made for interest which will accrue over a number of years. The prepayment of interest is especially attractive if the taxpayer is in a high income bracket in the year of payment but expects his income to drop in subsequent years. The effect in such a situation is to reduce the overall amount of taxes ultimately paid since the deduction is used to set off high-bracket income. Thus, while the prepayment of interest may generally be thought of as a technique to delay the payment of taxes, the result in some situations may be to actually reduce the total amount of taxes paid over a period of years.

Interest is often prepaid in connection with real estate transactions, frequently involving the purchase of raw land with little or no downpayment.10 For example, a cash basis taxpayer in a high income bracket might purchase real estate under a contract of sale calling for interest only for several years, payable at closing. Thus, the purchaser would attempt to furnish consideration in the form of interest since the actual cost of acquisition to him will be lessened by the amount of taxes saved in consequence of the interest deduction.11 Of course, there are tax consequences for the seller as well as the buyer in such a transaction. The receipt of interest payments will constitute ordinary income to the seller. In contrast, if the purchaser's available funds were used as a downpayment on principal, the payment might constitute a tax-free return of capital depending on the seller's basis, or a capital gain if the amount received exceeded the seller's basis and the property qualified as a section 122112 or section 123113 asset. A number of factors may operate to make a prepaid interest transaction economically sound for the seller. For example, the seller's income in the year of receipt may have been unusually low, or he may have current or carryover operating losses which offset the receipt of income. Furthermore, the purchase price may be inflated with a decreased interest rate to alleviate the unfavorable impact of receiving ordinary income. The frequent use of the prepaid interest technique in real estate tax shelters indicates that these and other factors have operated to make such transactions beneficial to both buyers and sellers.

II. Development of the Law of Prepaid Interest

Because of the general nature of section 16314 and the brevity of the

10. Such transactions may involve particular facts which would bring into operation certain limitations on the deductibility of the interest paid. For example, if the property purchased is classified as investment property the restrictions of section 163(d) may operate to limit the deduction. See Int. Rev. Code of 1954, § 163(b).
11. The tax advantages of the prepaid interest deduction may be amplified by certain property acquisition and financing techniques, such as the wrap-around mortgage. See Barnett, Use of the Wrap-around Mortgage in Realty Sales: The Tax Advantages and Problems, 40 J. Tax. 274 (1974).
13. Id. § 1231 (property held for use in a trade or business).
14. Id. § 163.
applicable Treasury Regulations,\textsuperscript{15} the law of prepaid interest depends primarily upon the interaction of judicial decisions with the position of the Internal Revenue Service on certain matters. In this section the specific authority for the deduction of prepaid interest is considered and contrasted with the treatment of other prepaid items; the judicial interpretation of section 163 which acts to prevent misuse of the interest deduction is discussed; and finally, Revenue Ruling 68-643\textsuperscript{16} is examined.

A. Authority for the Prepaid Interest Deduction

Judicial sanction of the deductibility of interest prepaid on a bona fide indebtedness began with the Board of Tax Appeals decision in John D. Wackler.\textsuperscript{17} The cash basis taxpayer in Fackler secured a reduced interest rate on an indebtedness by paying two years of interest in advance. The Commissioner contended that the deduction should be disallowed because it would create a material distortion of income. The basic conflict in Fackler was one of reconciling the statutory allowance of an interest deduction in the year in which payment was made with the statutory preclusion of the use of an accounting method which did not clearly reflect income.\textsuperscript{18} The Commissioner would have required the taxpayer to change his method of accounting with respect to the prepaid interest item in order to properly reflect income. This would mean that the interest would be amortized and deducted as it accrued. However, the Board of Tax Appeals rejected the Commissioner's position, holding that the prepayments did not distort income.\textsuperscript{19} The court viewed some mismatching of income as inherent in the cash method of accounting and considered it improper to place the taxpayer on an accrual method for only the prepaid interest item. In reaching its conclusion, the court analogized to the treatment of postpaid interest and stated that the deduction of prepaid interest would distort income no more than would the deduction of a current payment of interest which had accrued in previous years.\textsuperscript{20}

Fackler was followed in 1943 by the Tax Court opinion in Court Holding Co.,\textsuperscript{21} in which the cash basis taxpayer's right to deduct a prepayment of

\textsuperscript{15} See generally Treas. Reg. § 1.163-1 (1966).
\textsuperscript{17} 39 B.T.A. 395 (1939), acquiesced in, 1939 Cum. Bull. 12. Two years prior to Fackler the question of deductibility of prepaid interest arose in a Board of Tax Appeals decision which was contrary to the holding in Fackler. R.L. Blaffer, 6 P-H Tax Ct. Mem. 297 (1937). Although Blaffer was not expressly overruled in Fackler, it subsequently was regarded as obsolete.
\textsuperscript{18} Int. Rev. Code of 1939, ch. 1, § 41, 53 Stat. 24. The corresponding section in the 1954 Code is nearly identical to the 1939 version, providing that "if the method [of accounting] 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." Int. Rev. Code of 1954, § 446(b).
\textsuperscript{19} 39 B.T.A. at 395.
\textsuperscript{20} Id. at 398.
\textsuperscript{21} 2 T.C. 531 (1943), acquiesced in, 1943 Cum. Bull. 5. Although the issue regarding the interest deduction was not appealed, the Supreme Court affirmed the Tax Court's holding that the sale of assets formally accomplished by the shareholders would be attributed to the corporation. Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Court Holding Co. is regarded as a leading case for the proposition that tax consequences will be attached to the substance of a transaction rather than the form.
interest was again upheld. In 1945 the Commissioner apparently capitulated on the prepaid interest issue by publishing Income Tax Ruling 3740, which provided that a cash basis taxpayer could properly deduct a five-year prepayment of interest. It is unclear why the five-year period was chosen in light of the shorter periods involved in Fackler and Court Holding Co. However, what is significant is that taxpayers were given the assurance that prepaid interest was deductible without the risk of challenge by the Commissioner. Several cases were decided after the issuance of Income Tax Ruling 3740 which further secured the deductibility of prepaid interest. This strong judicial precedent, along with Income Tax Ruling 3740, firmly established the right of the taxpayer to deduct prepaid interest, creating a significant tax saving opportunity which was perhaps too attractive, and the interest deduction suffered serious abuse.

B. Treatment of Other Prepaid Expenses

The allowance of a current deduction for prepaid interest is unique in contrast to the treatment of several other prepaid expenses. Prepaid rent has been held to be an investment in an asset with a life extending into future years. Therefore the rental prepayments were required to be amortized over the period for which the rental was paid rather than being currently expensed. The Tax Court in University Properties, Inc. concluded: "Rentals may be deducted as such only for the year or years to which they are applied. If they are paid for the continued use of the property beyond the years in which paid they are not deductible in full in the year paid but must be deducted ratably over the years during which the property is so used."

22. 1945 Cum. Bull. 109. The position taken by the Service in the ruling was stated: "[I]t is held that where a taxpayer keeps his books of account and files Federal income tax returns on the cash receipts and disbursements basis, interest paid in advance for a period of five years constitutes an allowable deduction for Federal income tax purposes for the year in which paid. . . ." Id.

23. The taxpayer in Fackler deducted only two years of prepaid interest; Court Holding Co. involved a payment of $350 denominated a "rent discount" on a three-year lease. One might speculate that the Commissioner was somewhat discouraged by the outcome of previous litigation of prepaid interest questions and was attempting to at least establish a maximum on the prepaid interest deduction that the courts would observe.

24. Clifford F. Hood, 30 P-H Tax Ct. Mem. 1245 (1961); L. Lee Stanton, 34 T.C. 1 (1960); cf. Joseph H. Konigsberg, 15 P-H Tax Ct. Mem. 49 (1946). The Konigsberg case was decided shortly after the issuance of Income Tax Ruling 3740 but did not cite the ruling as authority for the deductability of prepaid interest, citing only Fackler for the proposition. The deductibility of prepaid interest was not at issue in the case but does illustrate the court's cognizance and reaffirmance of Fackler.

25. Allowance of the prepaid interest deduction for four years' interest was recognized as late as 1968 by the Tax Court, where it noted that the Commissioner had allowed the prepaid interest deduction for the interest payment but disallowed the claimed deduction for other prepaid charges. George L. Schultz, 50 T.C. 688 (1968).

26. See, e.g., Southwestern Hotel Co. v. United States, 115 F.2d 686 (5th Cir. 1940), cert. denied, 312 U.S. 703 (1941); Main & McKinney Bldg. Co. v. Commissioner, 113 F.2d 81 (5th Cir.), cert. deniaed, 311 U.S. 688 (1940); University Properties, Inc., 45 T.C. 416 (1966), aff'd, 378 F.2d 83 (9th Cir. 1967); Lola Cunningham, 39 T.C. 186 (1962); Henry Cartan, 30 T.C. 308 (1958). Other cases have denied the deduction of prepaid rental on the grounds that the prepayment is not an ordinary and necessary business expense. Galatoire Bros. v. Lines, 23 F.2d 676 (5th Cir. 1928); Baton Coal Co., 19 B.T.A. 169 (1930), aff'd, 51 F.2d 469 (3d Cir.), cert. denied, 284 U.S. 674 (1931).

27. 45 T.C. at 421. Payments made by a lessor which relate to a lease, such as...
Prepaid insurance premiums have also been held to be amortizable over the period of time in which the insurance policy is in effect. The First Circuit, in Commissioner v. Boylston Market Ass'n,29 reached this result, stating that "the payments are prorated primarily because the life of the asset extends beyond the taxable year . . . and a full deduction in the year of payment would distort his income."30 However, in Waldheim Realty & Investment Co. v. Commissioner31 the Eighth Circuit rejected the capitalization theory advanced in Boylston. The court stated that the amortization statutes should not be stretched to include items which do not fall within the capital asset classification.32 The court observed that the insurance premiums add nothing to the taxpayer's plant or equipment or his ability to produce income, whereas prepaid items such as rent, lease bonuses, and commissions are for the purpose of providing the taxpayer a place to conduct business.33 Thus, the court concluded that the prepaid insurance premiums should not be treated as capital expenditures, and held that the payments were business expenses deductible by the cash basis taxpayer in the year of payment.34

An interesting series of cases exists regarding prepayments for animal feed. Deductions for such prepayments have been disallowed on the theory that they were not "paid" but were simply deposits made for future payments.35 A critical factor in the cases disallowing such deductions was that the payments were refundable if not earned through future delivery of feed. For example, in Mann v. Commissioner36 the Eighth Circuit allowed the deduction of the prepayments as an ordinary and necessary business expense, distinguishing its decision in Shippy v. United States37 as involving only a refundable deposit rather than an actual payment.38 In addition to the payment requirement, an underlying consideration in the decision of whether a deduction may be taken is whether income would be materially distorted. In John Ernst39 the prepayments were held to be deductible since they were not refundable and because the taxpayer's consistent practice of making such prepayments lessened the distorting effects which would result.40 The Internal Revenue Service has taken the position that prepayments for feed to be used in a later year may be currently deductible, but

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29. 131 F.2d966 (lstCir. 1942).
30. Id. at 968. The leading case on the deductibility of prepaid insurance premiums, also decided by the First Circuit, was Welsh v. DeBlois, 94 F.2d 842 (1st Cir. 1938), which sustained the taxpayer's claim for a deduction of such prepayments. Welsh v. DeBlois was expressly overruled in the Boylston Market decision. 131 F.2d at 968.
31. 245 F.2d 823 (8th Cir. 1957).
32. Id. at 825.
33. Id.
34. Id. at 828.
35. See Shippy v. United States, 308 F.2d 743 (8th Cir. 1962); Tim W. Lillie, 45 T.C. 54 (1965), aff'd per curiam, 370 F.2d 562 (9th Cir. 1966); R.D. Cravens, 30 T.C. 903 (1958), rev'd, 272 F.2d 895 (10th Cir. 1959).
36. 483 F.2d 673 (8th Cir. 1973).
37. 308 F.2d 743 (8th Cir. 1962).
40. Id. at 186-87.
only if the taxpayer can show that a bona fide payment has been made for a valid business purpose and that no material distortion of income will result.41

Certain other expenses are considered deductible upon prepayment, such as intangible drilling expenses42 and prepaid state taxes.43 Thus, there is no general consistency to the law regarding the deductibility of advanced payments and no common principle which renders the results predictable.44 The rationale of treating some prepaid expenses as amortizable capital expenditures and others as currently deductible expenses is anomalous and gives rise to a tension regarding the proper tax treatment for any prepaid expense.

C. Judicial Interpretation of Section 163

After the issuance of Income Tax Ruling 3740,45 taxpayers began to explore the limits of the interest deduction as a tax planning device. A large body of case law has developed dealing with situations in which the taxpayer exceeded reasonable limits. Although many of these cases involved transactions in which deductions were claimed for prepaid interest, they were resolved on issues dealing with the bona fides of the transaction since there was no objection to the deductibility of prepaid interest as such at that time.46

Section 163 requires that an actual indebtedness exist on which the interest arises in order for the deduction to be taken.47 Where a purported indebtedness has no economic reality a court is likely to classify the indebtedness as a sham, as illustrated by the famous “Livingstone cases,”48 which involved attempts by taxpayers to exploit the interest deduction. The basic scheme in each of these cases consisted of a complicated series of

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44. Mann v. Commissioner, 483 F.2d 673 (8th Cir. 1973).

45. 1945 CUM. BULL. 109.


47. INT. REV. CODE OF 1954, § 163.

48. M. Eli Livingstone was a securities dealer in Boston who developed a plan that offered high income taxpayers the prospect of reducing taxes at relatively low cost. Lynch v. Commissioner, 273 F.2d 867 (2d Cir. 1959). The courts have dealt with the transactions engineered by Livingstone in a number of cases. See, e.g., Becker v. Commissioner, 277 F.2d 146 (2d Cir. 1960); Lynch v. Commissioner, 273 F.2d 867 (2d Cir. 1959); Sonnabend v. Commissioner, 267 F.2d 319 (1st Cir. 1959); Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959); Broome v. United States, 170 F. Supp. 613 (Ct. Cl. 1959); John Fox, 17 CCH Tax Ct. Mem. 1006 (1958).
transactions engineered to provide the taxpayer with an interest deduction and capital gain. Usually the taxpayer would purchase government obligations with borrowed funds paying interest in advance on the loan. In *Eli D. Goodstein*,49 the first of the “Livingstone cases,” the taxpayer claimed a deduction for interest paid on a loan arranged to finance the purchase of treasury notes. Although the rate of interest paid on the loan was higher than that received from the treasury notes, Goodstein hoped to make up more than the difference by offsetting the interest deductions against other high-bracket income. The First Circuit affirmed the Tax Court’s holding that Goodstein was not entitled to the claimed deduction for two reasons. First, there was never in substance a purchase of the treasury notes or an actual borrowing of funds.50 Second, even if the transaction was recognized as having substance, there was no payment of interest since the taxpayer tendered only notes for the interest due.51 The Commissioner’s victory in Goodstein was significant because the holding contributed to the development of the doctrine that the courts are not bound to recognize an indebtedness incurred solely to reduce tax liability.

In *Knetsch v. United States*52 the Supreme Court added another element to the sham transaction doctrine. The taxpayer had purchased annuity contracts which would increase in cash-surrender or loan value at a fixed rate until a specified maturity date. The proceeds used to purchase the annuity contracts were loaned by the same insurance company that issued the contracts, and further, the interest payments were borrowed back by the taxpayer. The Court stated that there was nothing “of substance to be realized . . . beyond a tax deduction,” and therefore found that the transaction was a sham.53 Thus, under Knetsch, even where an indebtedness actually exists, the interest deduction may be struck down if the transaction lacks economic substance apart from the tax benefits created.54

49. 267 F.2d 127 (1st Cir. 1959).
50. Id. at 131. The Tax Court found that there was no borrowing since the lender had no funds to lend and that no obligation existed because Goodstein was not personally liable for payment of the note. Eli D. Goodstein, 30 T.C. 1178, 1188 (1958), aff’d, 267 F.2d 127 (1st Cir. 1959). The complicated fact situation in Goodstein is carefully analyzed in Harrar, *Is Interest Deductible Only if the Debt Has a Nontax Profit Purpose?*, 13 J. Tax. 258 (1960).
51. 267 F.2d at 131; cf. James W. England, Jr., 34 T.C. 617 (1960) (deduction disallowed on grounds that no “payment” was made where the interest obligation was satisfied by borrowing additional funds from the creditor); accord, Nat Harrison Associates, Inc., 42 T.C. 601 (1964) (interest deduction denied where borrower’s loan was increased and lender drew two checks, one was kept in payment of accrued interest on the previously outstanding amount and the other remitted to the borrower). But see Newton A. Burgess, 8 T.C. 47 (1947) (deduction allowed where the taxpayer received additional funds from the creditor and subsequently issued his own check in payment of interest).
52. 364 U.S. 361 (1960).
53. Id. at 366.
54. The scope of the Knetsch case was left open to question. For example, it is not clear from the opinion whether the beneficial interest apart from the tax benefits was to be measured by the taxpayer’s subjective motivation or by objective analysis of the transaction. Furthermore, questions remained as to whether a mere possibility of some before-tax profit would satisfy the beneficial interest test and, if so, how slight might that possibility be and meet the Knetsch requirement. For subsequent cases dealing with these questions see Bridges v. Commissioner, 325 F.2d 180 (4th Cir. 1963), aff’g 39 T.C. 1064 (1963) (some reasonable hope of a nontax benefit). But see Minchin v. Commissioner, 335 F.2d 30 (2d Cir. 1964), aff’g 22 CCH Tax Ct. Mem. 517.
Six years after *Knetsch*, the Second Circuit, in *Goldstein v. Commissioner*, disallowed the deduction of interest paid on an indebtedness because the loan was not incurred to engage in a "purposive activity" other than an attempt to obtain an interest deduction. The taxpayer had secured a large loan using the proceeds to purchase government obligations. Interest on the loan was prepaid with funds which had been won in a sweepstakes contest. When the government obligations were sold, the debt was repaid and the unearned interest was refunded. The court held that the transactions were not shams and found that a genuine indebtedness existed. However, since there was no purpose other than an attempt to secure an interest deduction, the deduction was disallowed. *Goodstein, Knetsch*, and *Goldstein* are representative of the major developments of judicial doctrine dealing with the abuse of the interest deduction prior to the issuance of Revenue Ruling 68-643. The Commissioner's attack in these cases was not leveled at the fact that interest was prepaid, but at the substance of the transaction giving rise to the interest deduction.

D. Tax Avoidance Through the Real Estate Transaction

The prototype transaction in which the interest deduction was exploited to the fullest extent involved a sale of land in which the buyer made no downpayment, paying interest in advance for five years. The principal payments would commence in the sixth year and then would involve a balloon payment at the end of the amortization period so that only a minimum amount of non tax-deductible dollars would be invested in the property. The deduction of large amounts of prepaid interest in real estate transactions highlighted a tax avoidance loophole in the law existing prior to the issuance of Revenue Ruling 68-643. In the first place, the hypothesized real estate

(1963). For a complete discussion of the sham transaction doctrine see Comment, *Tax Avoidance Use of the Interest Deduction*, 45 TEXAS L. REV. 1218 (1967). 55. 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), aff'g 44 T.C. 284 (1965). 56. 364 F.2d at 742. The court stated that an interest deduction should be allowed "when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in . . . purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way." *Id.* at 741. The court indicated what it meant by purposive activity by stating that no deduction should be allowed when the transaction "has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction . . . ." *Id.* at 741-42. 57. *Id.* In contrast the circuit court decided two companion cases on the ground that they involved sham transactions and no real indebtedness existed. *Barnett v. Commissioner*, 364 F.2d 742 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), aff'g 44 T.C. 261 (1965); *Ippolito v. Commissioner*, 364 F.2d 744 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), aff'g 24 CCH Tax Ct. Mem. 894 (1965). For a criticism of *Goldstein* as an unwarranted departure from *Knetsch* see Comment, supra note 54. 58. 364 F.2d at 742. The *Goldstein* rationale was further refined by the Second Circuit in *Lifschultz v. Commissioner*, 393 F.2d 232 (2d Cir. 1968), aff'g 25 CCH Tax Ct Mem. 1146 (1966). However, application of the principles by other courts has resulted in some confusion regarding the *Goldstein* decision. See, e.g., Herbert Enoch, 57 T.C. 781 (1972) (reading *Goldstein* as requiring a "primary purpose" other than tax motivation); *Rothschild v. United States*, 407 F.2d 404 (Ct. Cl. 1969) (referring to the "business purpose" test of *Goldstein*). 59. 1968-2 CUM. BULL. 76.
transaction did not involve the artificiality of the Goodstein variety where the transaction was a sham in the factual sense.\textsuperscript{60} Since the purchase would ordinarily give rise to a bona fide indebtedness, it would not be subject to characterization as a sham.\textsuperscript{61}

A more intriguing problem arose in the context of the tests sets forth in Knetsch\textsuperscript{62} and particularly Goldstein,\textsuperscript{63} which dealt with difficult issues regarding the motives of taxpayers for entering into tax shelter transactions.\textsuperscript{64} Real estate transactions of the variety discussed were clearly conceived for tax avoidance purposes. However, the significant factor involved in applying the "purposive activity" test of Goldstein is the existence of some economic substance apart from the tax savings to be realized.\textsuperscript{65} A purchase of real estate involved the ideal conduit for achieving the desired tax deduction because of the additional purpose of holding real estate for its appreciation in value. Since the amount of appreciation is a matter of speculation, a court generally would not be able to calculate the non-tax benefit to the taxpayer as could be done in the transactions involving investments with a fixed return such as government securities. Thus, in the real estate purchase the taxpayer was equipped with a strong argument that the transaction involved "purposive activity" other than tax avoidance and, therefore, satisfied the Goldstein requirements.\textsuperscript{66}

E. Revenue Ruling 68-643

The reaction of the Internal Revenue Service to the abuse of the interest deduction, largely through prepayment in real estate transactions, was the issuance of Revenue Ruling 68-643.\textsuperscript{67} The ruling revoked Income Tax

\textsuperscript{60} See notes 49-51 supra and accompanying text.

\textsuperscript{61} See notes 46-48 supra and accompanying text.

\textsuperscript{62} 364 U.S. 361 (1960).

\textsuperscript{63} 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), aff'd 44 T.C. 284 (1965).

\textsuperscript{64} See generally Gregory v. Helvering, 293 U.S. 465 (1935) (taxpayer has a legal right to seek to decrease his taxes, but the action taken by the taxpayer apart from the tax motive must be that which the statute intended).

\textsuperscript{65} See notes 55-58 supra and accompanying text.

\textsuperscript{66} Abuses of this nature may be curtailed to some extent by the limitations imposed by INT. REV. CODE OF 1954, § 163(d) which was added to the Code by the Tax Reform Act of 1969, 83 Stat. 487. The section places limits on the amount of interest deductible if it arises in connection with debts incurred to purchase or carry investment property. The provision was intended to preclude tax avoidance through a mismatching of income and expense items in situations where a current interest deduction was created through borrowing large amounts to acquire investment property. The property would produce capital gains when sold but would generate little current income, thus, the current interest deduction was used to offset other income. See H.R. REP. No. 91-413 (Part I), 91st Cong., 1st Sess. 72 (1969). For a discussion of the provision indicating its limited application see Bedell, The Interest Deduction: Its Current Status, 52 NYU INST. TAX. 1117 (1974).

\textsuperscript{67} 1968-2 CUM. BULL. 76. The ruling itself only refers to "certain abuses which have arisen with respect to prepayment of interest." Id. However, the use of the deduction in real estate transactions was widely used and publicized for a short period immediately preceding the ruling. It was not uncommon for national or local newspapers to carry advertisements offering land for sale detailing the terms and emphasizing the attractiveness of the prepaid interest deduction. This type of transaction became particularly prevalent in Southern California. See Asimow, Principle and Prepaid Interest, 16 U.C.L.A. REV. 36 (1968); Kanter, Interest Deduction: Use, Ruse, Refuse, 46 TAXES 794 (1968).
Ruling 3740\textsuperscript{a} and the Commissioner's acquiescence in John D. Fackler\textsuperscript{b} and Court Holding Co.\textsuperscript{c} The position taken in the ruling is that any deduction of interest prepaid for a period extending more than twelve months beyond the close of the tax year in which the payment was made constitutes a material distortion of income and will be disallowed. Furthermore, there is no assurance that a deduction will be allowed for prepayments of interest attributable to periods extending less than twelve months beyond the close of the year of payment since the ruling states that such prepayments will be considered on a case-by-case basis. For the determination of the material distortion issue in these cases the ruling provides: "[S]ome of the factors to be considered . . . include but are not limited to the amount of income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason for prepayment, and the existence of a varying rate of interest over the term of the loan."

The ruling does not include a statement of the manner in which the factors are to be applied or an indication of their relative importance. The conclusion that a material distortion of income has resulted from a prepayment of interest, either through the conclusive presumption if the payment extends to a period of more than twelve months beyond the year of payment or through the application of the listed factors for shorter periods, moves the Commissioner into a position to require that the taxpayer's method of accounting be changed so as to clearly reflect income under section 446(b).\textsuperscript{d} The result is that the prepaid interest must be accrued ratably over the life of the loan and, thus, the cash basis taxpayer is placed on the accrual method of accounting with respect to the prepaid interest, while remaining on the cash receipts and disbursements method for other items.\textsuperscript{e} However, the critical issue presented in Revenue Ruling 68-643 is whether a prepayment of interest materially distorts income. One of the questionable aspects of the ruling is its approach to resolving the material distortion issue, particularly the position that prepayments for interest accruing beyond the twelve-month period after the tax year automatically cause a distortion of the taxpayer's income.

III. PREPAID INTEREST SINCE THE 1968 RULING

The most striking aspect of the law of prepaid interest in recent years is the distinct absence of judicial reliance on Revenue Ruling 68-643. In

\textsuperscript{a} 1945 CUM. BULL. 109; see note 22 supra and accompanying text.
\textsuperscript{b} 39 B.T.A. 395 (1939), acquiesced in, 1939 CUM. BULL. 11.
\textsuperscript{c} 2 T.C. 531 (1943), acquiesced in, 1943 CUM. BULL. 5.
\textsuperscript{d} 1968-2 CUM. BULL. 76.
\textsuperscript{e} INT. REV. CODE OF 1954, \S\ 446(b).

The taxpayer is placed on a "hybrid" method of accounting which is what the Tax Court objected to in John D. Fackler, 39 B.T.A. 395 (1939), acquiesced in, 1939 CUM. BULL. 11. See notes 18-20 supra and accompanying text. However, section 446(b) appears to sanction this result, stating that permissible methods of accounting include "any combination of the foregoing methods [including both cash and accrual methods] permitted under regulations prescribed by the Secretary or his delegate." INT. REV. CODE OF 1954, \S\ 446(c)(4). See also Schlude v. Commissioner, 372 U.S. 128 (1963); American Auto. Ass'n v. United States, 367 U.S. 687 (1961); Automobile Club v. Commissioner, 355 U.S. 180 (1957).
contrast, some congressional sanction of the ruling is indicated by a statement issued by the House Ways and Means Committee:

Your committee's attention was also called to the matter of deductions for prepaid interest. On November 26, 1968, the Internal Revenue Service issued a ruling which held that any prepayment for prepaid interest which would materially distort income . . . should be allowed only on the accrual basis. This ruling is in accord with the treatment given other prepayments of expenses and is in accord with your Committee's concept of the law. Thus, it does not seem necessary to include a provision in the bill to deal with this problem.\(^\text{74}\)

However, the committee report is not a binding statement of the law and in the absence of legislation it remains for the courts to determine the validity of the revenue ruling.\(^\text{75}\) A discussion of several cases decided since the issuance of the ruling provides an indication of the judicial attitude toward the ruling and the future acceptance or rejection thereof.\(^\text{76}\)

A. Failure To Reach the Material Distortion Issue

The prepaid interest cases which have arisen since 1968 have, for the most part, neither relied upon the ruling nor dealt with the material distortion theory. However, several of these cases revealed that a material distortion of income may have resulted had the deduction been allowed. The decisions, in cases where the result was a disallowance of the deduction, turned upon a failure to meet the requirements of section 163.\(^\text{77}\) Thus, reliance was placed on the law pertaining to the allowance of an interest deduction in general, as did the pre-1968 cases,\(^\text{78}\) rather than relying on a particular theory affecting the deductibility of prepaid interest alone.

In *Norman Titcher*\(^\text{79}\) the Tax Court disallowed a claimed deduction for prepaid interest because the payment "was not in fact paid as 'interest' on 'indebtedness' . . . but rather represented in substance the major part of the down payment on the purchase price and was merely dressed up to look like 'interest.'"\(^\text{80}\) The crucial factor in *Titcher* was that the taxpayer's alleged "interest" payment was made prior to the consummation of the sale, when an indebtedness did not exist. In *Estate of Martin Melcher*\(^\text{81}\) the claimed deduction for fifteen years of prepaid interest was disallowed on the grounds that the entire transaction was a sham and, therefore, there was no bona fide indebtedness on which interest could arise.\(^\text{82}\) In that case, a corporation

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\(^{75}\) Although revenue rulings are published to be used as precedent in the disposition of cases they are not binding on the courts. See *Stubbs, Overbeck, & Assoc. v. United States*, 445 F.2d 1142 (5th Cir. 1971); *United States v. Hall*, 398 F.2d 383 (8th Cir. 1968). For proposed legislation included in the Tax Equity Act of 1975 which would allow the deduction of interest only as it accrued, thus eliminating the tax advantage of prepaying interest, see H.R. 1040, 94th Cong., 1st Sess. (1975).

\(^{76}\) See notes 77-98 infra and accompanying text.

\(^{77}\) INT. REV. CODE OF 1954, § 163; see notes 4-8 supra and accompanying text.

\(^{78}\) See notes 46-59 supra and accompanying text.

\(^{79}\) 57 T.C. 315 (1971).

\(^{80}\) Id. at 322.


\(^{82}\) Id.
which was controlled by the taxpayer acquired a residence for $85,000 which was resold to the taxpayer for $110,000. The taxpayer obtained a loan of $80,000 to pay for the house and prepaid interest for fifteen years on the loan in the amount of $76,000. The court found that the acquisition by the corporation was a sham because in reality there was only one transaction. In substance the taxpayer rather than the corporation originally acquired the residence. In both Melcher and Titcher the court ruled that the facts fitted within well-established interpretations of section 163 and, thus, did not approach the material distortion issue or Revenue Ruling 68-643.

Kenneth D. La Croix was a recent Tax Court decision in which the claimed deduction of prepaid interest was disallowed on the theory that the payment was in reality a deposit or a downpayment of principal. The taxpayer had purchased an office building for the sum of $1,300,000. A payment of $250,000 designated as "prepaid interest" was made and additional interest was to accrue at the rate of 6.6 percent per annum. The agreement provided that each year a $25,000 credit would "be given for interest paid in advance by reducing the then outstanding principal balance due." The court accepted the Commissioner's argument that $250,000 was not a payment of interest but was in substance a deposit or downpayment on the principal balance. The court stated that the payment labeled "prepaid interest" was merely "an artifact to provide the petitioners with a means of lowering their taxes." In support of the result the court observed two peculiar aspects of the transaction. First, the court found it difficult to believe that a transaction so large would have no downpayment whatsoever. Second, the market rate of interest was 8.0 percent at the time of the sale in contrast to the 6.6 percent called for in the agreement. The court noted that by treating the $250,000 payment as principal the rate would be effectively raised to approximately 8.0 percent.

In light of the particular facts of La Croix the decision adds no new theory of broad applicability to prepaid interest cases. However, in Andrew A. Sandor the Tax Court advanced a deposit theory which would in effect require the interest deduction to be taken as accrued on the ground that the payment was actually a deposit to be applied as interest when earned in the future. The Sandor rationale is somewhat broader than that in La Croix.

83. Id.
84. 61 T.C. 471 (1974).
85. Id. at 475 (emphasis added by court).
86. Id. at 481. The court quoted from the decision in United States v. Consolidated Edison Co., 366 U.S. 380, 391 (1961): "Payment' is not a talismanic word. It may have many meanings depending on the sense and context in which it is used. As correctly observed by the Court of Appeals, 'a payment may constitute a capital expenditure, an exchange of assets, a prepaid expense, a deposit, or a current expense . . . ." 61 T.C. at 479 (emphasis added by the court).
88. The court stated that "[i]t would be quite plausible to consider the prepaid interest as a deposit to be applied as interest when earned in the future, rather than a payment of interest in 1968." Id. at 482. The deposit theory as applied to the prepayment of interest is drawn from an analogy to cases involving the denial of a deduction for the prepayment of cattle feed. See, e.g., Tim W. Lillie, 45 T.C. 54 (1965), aff'd per curiam, 370 F.2d 362 (9th Cir. 1966); Shippy v. United States, 199 F. Supp. 842 (D.S.D. 1961), aff'd, 308 F.2d 743 (8th Cir. 1962). But see John Ernst, 32 T.C. 181 (1959).
since there was no provision by the parties to the transaction that the payment be credited periodically to reduce the principal balance. Ultimately Sandor turned on the issue of material distortion. The deposit theory was merely offered as support for the result reached, but it indicates the development of a viable theory regarding the deduction of prepaid interest.

Although Titcher, Melcher, and La Croix never explicitly reached the material distortion issue, the possibility of a distortion of income existed had the deductions been allowed. However, the courts declined to express their affirmation or disapproval of Revenue Ruling 68-643. In contrast, the determinative issue in Andrew A. Sandor was whether a material distortion of income existed. Thus, the Tax Court’s approach to Revenue Ruling 68-643 is highly significant.

B. The Sandor Approach to Material Distortion

In Andrew A. Sandor a cash basis taxpayer had borrowed $100,000 to enable him to engage in certain securities transactions. He claimed a deduction for a payment of five years interest in advance on the loan, amounting to roughly $38,000. The Commissioner disallowed the deduction stating that under section 446 it would materially distort taxable income in the year of payment. The issues stipulated by the parties went a step further than the question of whether income was materially distorted, specifically drawing into question the validity of Revenue Ruling 68-643. The court, however, noted that the only issue to be decided was whether the taxpayer could deduct the prepaid interest, and held that the claimed deduction would in this case materially distort income and must, therefore, be disallowed.

With respect to Revenue Ruling 68-643, the court discussed at some length the authority of the Commissioner to issue the ruling and concluded that he had not overstepped this authority in dealing with the prepaid interest deduction through the mechanism of section 446(b). The court stated that Congress did not intend that a deduction for prepaid interest be allowed when such allowance would result in a distortion of income. According to the court, section 163 must be read in light of section 446 and

89. 62 T.C. 469 (1974).
90. Id.
91. The court recited the stipulated issues: “[w]hether petitioners’ deduction of 5 years’ prepaid interest should be disallowed pursuant to Rev. Rul. 68-643 . . . [and] [w]hether Rev. Rul. 68-643 was a proper exercise of the rule-making authority of the Commissioner.” Id. at 470.
92. Id. at 481. Stating that the situation in this case was not controlled by the principles of cases such as Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), aff’g 44 T.C. 284 (1965), the court in Sandor found that the transaction “had economic reality, gave rise to a true indebtedness from petitioner to the bank, and that the amounts here involved were paid as interest on that indebtedness.” 62 T.C. at 474.
93. INT. REV. CODE OF 1954, § 446(b).
461,94 thussubjecting the timing of interest deductions to the requirement that
the method of accounting clearly reflect income.95 In reaching this conclu-
sion the court quoted a statement included in both a House and a Senate
Committee report dealing with section 461: "Section 461 adopts the provi-
sion of section 43 of the 1939 Code in rearranged form. The timing of
deductions and credits otherwise allowable is determined by the taxpayer's
method of accounting. The method must clearly reflect the income of the
taxpayer."96

The significant aspect of the decision, however, is the approach taken by
the court in determining whether a material distortion of income existed. The
disallowance of the claimed deduction rested upon the court's own determi-
nation that a material distortion would result, rather than on an application
of the standards set forth in Revenue Ruling 68-643. The court refused to
adopt the conclusive presumption established in the ruling that a material
distortion automatically results where interest is prepaid for more than one
year beyond the year of payment, stating:

[W]e are not prepared to say that a deduction of any prepaid interest
extending beyond a period of 12 months following the year of payment
would distort income under all circumstances and justify changing a
taxpayer's method of accounting with respect to the prepaid interest
item. This would be ruling in advance of any knowledge of the facts
and circumstances. We believe the Revenue Service may be called
upon to support its determinations in some such cases.97

The divergence of the holding from the position taken in the revenue ruling
is found in the court's unwillingness to rule "in advance of any knowledge of
the facts and circumstances,"98 in contrast to the premise of the ruling that a
material distortion results regardless of the circumstances other than the
single fact that interest is prepaid for more than one year beyond the year of
payment.

IV. THEORIES OF DISALLOWANCE IN THE CONTEXT OF
REAL ESTATE TRANSACTIONS

A variety of situations may arise in the context of real estate purchases,
and the appropriate treatment of the prepaid interest deduction will depend
upon the circumstances of each particular transaction. The material distortion theory, upon which the 1968 revenue ruling is based, must be contrasted to other theories for the disallowance of the prepaid interest deduction. These theories are not only conceptually distinct, but they also may have important differences in result as to whether a prepayment, if disallowed as a current deduction, must be entirely disallowed or may be amortized over the period of the loan.

The interest deduction in tax-shelter real estate purchases involving large prepayments of interest may clearly be disallowed on the grounds that a material distortion of income results, whether through an application of the standards set forth in Revenue Ruling 68-643 or through an independent determination by the court as was the approach in Andrew A. Sandler. The result is that the deduction must be taken over time as the interest is earned. The same result would be reached if one of several other theories were applied. For example, the current deduction of prepaid interest might be disallowed if a capitalization theory were accepted as is applied to other prepaid expenses such as rent and insurance premiums. Amortization would be required so that the deduction would be spread over the term of the loan. Similarly, if the prepayment were refundable a current deduction might be disallowed on the theory that funds advanced were not a payment of interest but merely a deposit to be applied as interest is earned. Again, the deduction would in effect be amortized over the life of the loan.

Each of these theories has a common problem. If the prepaid interest is the economic equivalent of a downpayment of principal, and is made in lieu thereof, then the proper result would be the total disallowance of the deduction rather than a deferral of the deduction. Characterization of the payment as principal was the approach in Kenneth D. La Croix. Although that case could be limited to its peculiar fact situation, its rationale is highly appropriate for dealing with tax avoidance transactions which involve large prepayments of interest with little or no downpayment and which caused the concern of the Internal Revenue Service prior to the issuance of Revenue Ruling 68-643. However, the validity of this theory diminishes in dealing with transactions involving more than a nominal amount of downpayment and, thus, may not be left to stand alone against the variety of prepaid interest transactions which may arise.

Another hypothetical real estate transaction illustrates the deficiency of the Service's approach in Revenue Ruling 68-643. A transaction may be conceived which involves a purchase of property with a substantial downpayment of principal and a prepayment of several years of interest on an indebtedness relatively small in comparison to the total purchase price. This situation is posed not because of the frequency of its occurrence but because it highlights an irrational aspect of the 1968 ruling. It is evident that the described situation could easily result in very little actual distortion of

99. Id. at 469; see text accompanying note 97 supra.
100. See notes 26-34 supra and accompanying text.
income. However, the amount of the prepaid interest is considered irrelevant by the Service if the interest applies to a period more than one year beyond the year of payment. The fallacy of this approach is further illustrated by contrasting the Service's position regarding the deductibility of mortgage points and other loan fees to the position taken in Revenue Ruling 68-643. In 1969 the Service issued Revenue Ruling 69-188\textsuperscript{102} which stated that the payment of mortgage points would constitute interest. Since mortgage points and fees may represent interest for the term of the loan they will usually be attributable to periods extending more than twelve months beyond the end of the tax year. However, in Revenue Ruling 69-582\textsuperscript{103} the Service took the position that points paid in connection with a mortgage, provided that the interest rate and points were set through arm's-length bargaining, would not be considered to distort income materially. Thus, the points may be deducted in full in the year in which they are paid. The Service's position on the deductibility of points may be rationalized on the theory that the payments are de minimis and, therefore, would not cause a significant distortion of income. The de minimis rationale should be equally applicable to prepayments of interest in small amounts regardless of the period of time to which the interest relates.

Although the de minimis rationalization is useful to point up logical inconsistencies in the Service's positions, it is relatively insignificant from a practical standpoint, particularly with respect to real estate transactions. It is likely that the indebtedness on which an interest prepayment is made will be of substantial size in proportion to the entire purchase price. In such a transaction, assuming that a realistic downpayment of principal is made, the acceptance or rejection of the conclusive presumption approach to material distortion becomes most critical. The determination of whether or not a material distortion of income would actually result from a prepayment of interest in such a transaction logically would be reached from an examination of all the facts and circumstances. For example, if the taxpayer consistently prepaid interest on a regular basis in similar transactions, it would reduce the likelihood that his income would be materially distorted. In addition, the taxpayer's income in relation to the amount of prepayment would be highly determinative in assessing whether income would be materially distorted. Furthermore, if the income is abnormally high in the year of payment, the possibility of a material distortion would increase since the effect would be to shift current income into future years in which the income bracket would be expected to be lower. The Service demonstrates its awareness of factors such as these by listing a number of them in Revenue Ruling 68-643.\textsuperscript{104} However, they are considered relevant only to prepayments applicable to periods of less than one year beyond the year of payment. The position that the factors are totally immaterial for prepayments applicable to longer periods cannot be supported by logic or necessity.

\textsuperscript{104} See note 71 \textit{supra} and accompanying text.
The development and direction of the law in respect to the deductibility of prepaid interest is best understood when examined in conjunction with the real estate transaction involving a prepayment of interest. The widespread abuse of the interest deduction through these transactions led the Internal Revenue Service to reverse a long-standing position regarding the deductibility of prepaid interest. The issuance of Revenue Ruling 68-643 was an unfortunate reaction to these abuses. In part, however, the ruling provided some badly needed changes in the Service's position, in particular the revocation of Income Tax Ruling 3740.\footnote{105}{1945 Cum. Bull. 109.}

The use of prepaid interest in real estate transactions often created a situation which clearly involved tax avoidance through exploitation of the interest deduction. But the transactions often went unchallenged by the Commissioner because the transaction and the indebtedness were bona fide, there was an actual payment of interest, and there was economic purpose for the transaction other than tax avoidance. One objectionable feature of these transactions was that they often seriously distorted the taxpayer's income. However, the existence of Income Tax Ruling 3740 precluded the disallowance of the deduction on the grounds that a material distortion of income would result, relegating the Commissioner to arguments attacking the bona fides of the underlying transaction based on the principles of cases such as Goodstein, Knetsch, or Goldstein.\footnote{106}{See notes 47-59 supra and accompanying text.} At this point the Service should have merely revoked Income Tax Ruling 3740, thus making available the material distortion challenge to curtail abusive transactions. The additional attempt to establish a conclusive presumption that material distortion results where interest is prepaid for periods more than twelve months beyond the year of payment is an artificial solution to the complex problem of when a material distortion of income exists. Such a solution should not be followed by the courts.

For the most part, the courts have avoided passing on the validity of the 1968 ruling primarily because the cases have presented fact situations which could be resolved without reaching the material distortion question. However, several of these cases could have easily been treated within Revenue Ruling 68-643 had the courts been anxious to approve the ruling. Furthermore, the approach of the court in Andrew A. Sandor,\footnote{107}{62 T.C. 469 (1974).} where the court determined independently of Revenue Ruling 68-643 that a material distortion existed, is correct and should be followed. If the courts require the Commissioner to support his determination that a material distortion of income exists, the conclusive presumption stated in the Revenue Ruling is emasculated. The abstention of the courts from indicating their approval of the ruling in cases presenting an opportunity to do so, and particularly the well-conceived approach in Sandor, indicates that the presumption of the ruling may not be followed in future decisions.

\footnote{105}{1945 Cum. Bull. 109.}
\footnote{106}{See notes 47-59 supra and accompanying text.}
\footnote{107}{62 T.C. 469 (1974).}
Although the treatment of Revenue Ruling 68-643 by the courts indicates a failure to accept the Service's approach to the material distortion issue, the advisability of taking a prepaid interest deduction remains questionable at best. As long as the Service maintains the position taken in the ruling, prepayment of interest invites a challenge by the Commissioner. The courts should explicitly reject that aspect of the ruling establishing the conclusive presumption of material distortion and thereby cause the Service to revise the position taken in the revenue ruling. Such action would mean that prepaid interest would be deductible in certain legitimate transactions, subject to the limitation that a material distortion of income may not result.