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Distinguishing Interest from Damages: A Proposal for a New Perspective

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Distinguishing Interest from Damages: A Proposal For a New Perspective

ALICE G. ABREU*

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I. INTRODUCTION

INTEREST and damages can look alike.¹ Both are paid by one party to compensate another and both can be measured by the time value of money. Nevertheless, the Internal Revenue Code² treats interest and damages in very different ways.³ While much interest is deductible, the deductibility of damages depends on the origin of the claim to which the damages relate. The classification of an amount as either interest or damages can therefore determine its deductibility.⁴

Notwithstanding the importance of distinguishing between interest and damages, courts,⁵ commentators⁶ and legislators⁷ may have mis-

1. In his 1977 article on the interest deduction Professor Michael Asimow noted the potential similarity between interest and damages, and collected some of the cases in which courts grappled with the distinction. Michael Asimow, *The Interest Deduction*, 24 UCLA L. REV. 749, 770-72 (1979). The Supreme Court has also considered the similarity between interest and damages. *Kieselbach v. Commissioner*, 317 U.S. 399 (1943); *Phelps v. United States*, 274 U.S. 341 (1927); *Liggett & Myers Tobacco Co. v. United States*, 274 U.S. 215 (1927); *Brooks-Scanlon Corp. v. United States*, 265 U.S. 106 (1924); *Seaboard Air Line Ry. v. United States*, 261 U.S. 299 (1923). See *infra* notes 20-53 and accompanying text.

2. Unless otherwise stated, all references are to the Internal Revenue Code of 1986, as amended.

3. This difference in treatment has led the courts to grapple with the question of whether particular amounts are interest or something else, including damages. See, e.g., *Commissioner v. Raphael*, 133 F.2d 442 (9th Cir.), cert. denied, 320 U.S. 745 (1943); *N.V. Koninklijke Hollandische Lloyd v. Commissioner*, 34 B.T.A. 830 (1936); *Consorzio Veneziano di Armamento e Navigazione v. Commissioner*, 21 B.T.A. 984 (1930), nonacq., 10-1 C.B. 77 (1931); and the text accompanying notes 38-42, *infra*. See also *Aames v. Commissioner*, 94 T.C. 189 (1990); *West v. Commissioner*, 61 T.C.M. (CCH) 1694 (1991), discussed in Part II.B., *infra*.

4. The characterization of an amount as either interest or damages can also determine the extent to which it is included in income when received and the rate at which it is taxed. Whereas interest is ordinary income in full, the taxation of damages depends on the nature of the item for which they substitute. See *Hort v. Commissioner*, 313 U.S. 28, 30 (1941); *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir.), cert. denied, 323 U.S. 779 (1944); *Wheeler v. Commissioner*, 58 T.C. 459, 461-62 (1972); cf. Rev. Proc. 67-33, 1967-2 C.B. 659 (like the taxation of damages, the taxation of settlements depends on the taxation of the amounts for which the settlement substitutes). Damages for lost property are treated by reference to the property and are therefore included in income only to the extent that they exceed the taxpayer's basis. See *Gilbertz v. United States*, 808 F.2d 1374 (10th Cir. 1987); *Keller St. Dev. Co. v. Commissioner*, 688 F.2d 675 (9th Cir. 1982). By contrast, damages for lost wages are treated like the wages themselves and are ordinary income in full, unless they compensate the taxpayer for personal injury. See *infra* note 162. Compensatory damages on account of personal injury or sickness are excluded from the taxpayer's income in their entirety as provided by I.R.C. § 104(a). Punitive damages received on account of nonphysical personal injury are now included in the taxpayers income. I.R.C. § 104(a). The status of punitive damages received on account of personal injury is subject to debate. See Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143 (1992); Mark W. Cochran, *1989 Act Compounds Confusion Over Tax Status of Personal Injury Damages*, 49 TAX NOTES 1565 (1990). See also *infra* notes 162-70.

5. See, e.g., *Kieselbach v. Commissioner*, 317 U.S. 399 (1943); *Filipini v. United States*, 318 F.2d 841 (9th Cir.), cert. denied, 375 U.S. 922 (1963); *Johnson & Co. v. United States*, 149 F.2d 851 (2d Cir. 1945); *320 East 47th St. Corp. v. Commissioner*, 26 T.C. 545 (1956), *rev'd on other grounds*,

characterized certain types of damages by calling them interest. In its zeal to identify and tax any amounts which compensate for the time value of money,⁸ Congress may have gone too far. It may have swept

243 F.2d 894 (2d Cir. 1957); *Tiefenbrunn v. Commissioner*, 74 T.C. 1566 (1980); *Seltzer v. Commissioner*, 54 T.C.M. (CCH) 1082 (1987); *Walter v. Commissioner*, 30 T.C.M. (CCH) 1051 (1971); *A.S. Norby v. Commissioner*, 20 T.C.M. (CCH) 1077 (1961); *Pioneer Real Estate Co. v. Commissioner*, 1 T.C.M. (CCH) 527 (1943).

6. For example, in *The Interest Deduction*, Professor Asimov discusses *In re Bettendorf*, 3 B.T.A. 378 (1926), where the court denied a deduction for an amount which it found to be nondeductible damages rather than deductible interest, as well as other cases in which courts faced the issue of the characterization of a particular amount as interest. Professor Asimov concluded that "the *Bettendorf* line of authority now seems discredited." Asimov, *supra* note 1, at 771. Professor Asimov noted that *Jordan v. Commissioner*, 60 T.C. 872 (1973), *aff'd per curiam*, 514 F.2d 1209 (8th Cir. 1975), where the court found that a taxpayer who was forced to rescind a public offering of stock by offering to pay the original price of the stock plus five percent interest from the date of purchase could not deduct the five percent as interest, did not represent a revival of the *Bettendorf* theory but resulted from a failure of proof on the part of the taxpayer. He concluded that:

Although not forthrightly disapproved, the *Bettendorf* line of cases seems erroneous. In each case, the plaintiff suffered from a particular wrong on a particular date. If the plaintiff had sued immediately, he would have recovered compensation for that loss. Since suit was brought later, the court awarded an additional sum as compensation for the additional loss resulting from that delay, during which time the defendant had the plaintiff's money. This compensation is interest, whether the test utilized is that of the common man or the economist.

Asimov, *supra* note 1, at 772 (footnote omitted). Professor Asimov does not explain why the compensation is interest. *See id.* at 770-72. As this Article will demonstrate, the conclusion that the compensatory amount must be interest does not follow as clearly as Professor Asimov believes. That compensation is measured by an annual percentage rate does not make it interest. The need to establish the existence of indebtedness, which the court found important in *Jordan*, but which Professor Asimov is willing to minimize (*see id.* at 771), should be essential to a finding of interest.

7. *See infra* notes 10-12 and accompanying text.

8. *See, e.g.*, I.R.C. § 467 (requiring the accrual of interest on certain rental agreements); I.R.C. § 483 (requiring that certain amounts paid in connection with the sale or exchange of property be treated as interest); I.R.C. § 1272 (requiring the current inclusion in income of original issue discount); I.R.C. § 7872 (imputing interest in certain transactions which provide for inadequate stated interest). *See Daniel J. Halperin, Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986). In his dissent from the tax court's decision in *Albertson's, Inc. v. Commissioner*, 95 T.C. 415 (1990), which held that certain amounts accrued by an employer on deferred compensation arrangements were not interest for tax purposes, Judge Fay observed: "In recent years Congress has been attempting to identify hidden interest. *See* §§ 163, 467, 483, 1272, and 7872. To deny an interest element in this transaction would be to stand history on its head." 95 T.C. 415, 433 n.4 (1990) (Fay, J., dissenting). *See infra* note 105. It is precisely such reluctance to conclude that amounts are not interest that has led to the present confusion in the law.

The desire to ensure that all measurable items of economic benefit become a part of the tax base does not require a divorce between the characterization of an amount as interest and the rationale behind the interest deduction. In many cases, it will follow from the identification of an economic benefit that the benefit will be taxed. Whether the benefit is labeled interest or something else is often nearly irrelevant. Only in rare cases would a newly identified economic benefit be taxed as something other than ordinary income. *But cf.* *Aames v. Commissioner*, 94 T.C. 189 (1990) (an amount found to constitute interest was held to be separate from the personal injury judgment in connection

into the definition of the term "interest" amounts which should not be treated as interest at all.

This Article questions the current state of the law and proposes an alternative analysis. It suggests that some amounts which the law has traditionally called interest may more accurately be characterized as damages. The Article attempts to provoke further discussion by urging that the distinction between interest and damages be clearly identified and made a prominent part of the legal landscape. Doing so could provide courts and legislators with a valuable analytical tool, and bring accuracy both to the federal income tax treatment of these amounts and to the way in which they are perceived under the law as a whole.⁹

The Article uses the controversy over the deductibility of corporate deficiency interest to provide a focus for the broader discussion. The

with which it was awarded, and therefore not subject to the exclusion provided by § 104 and taxable as ordinary income). Making the term interest synonymous with 'economic benefit which the tax system should take into account' on the income side has fewer deleterious consequences than doing so on the deduction side. While making that distinction may lead to a lack of symmetry, symmetry, like consistency, is not always desirable. Classification, like form, should follow function.

9. The similarity between interest and damages, and the reason to distinguish between them, has been noted in other areas of the law. Thus, the distinction is sometimes relevant to the resolution of choice of law questions. See *Polglase v. Greyhound Lines*, 401 F. Supp. 335 (D. Md. 1975) (choice of law depended on the determination of whether prejudgment interest was interest or damages because if it was interest it was procedural and the law of one jurisdiction would apply, but if it was damages it was substantive and the law of a different jurisdiction would apply; the court concluded that prejudgment interest was in the nature of damages and was therefore a substantive matter). See also *Sylvania Elec. Prods., Inc. v. Barker*, 228 F.2d 842 (1st Cir. 1955), cert. denied, 350 U.S. 988 (1956).

Determining whether interest on a judgment is properly viewed as part of the judgment itself or as a separate element necessary to make a plaintiff whole is also important in determining whether any amounts should be added to a judgment to compensate a plaintiff for the delay in being awarded the judgment and, if so, how the additional amounts should be measured. See *Love v. New York*, 583 N.E.2d 359 (N.Y. 1991), which provides a recent illustration. In *Love*, the court reasoned that in a bifurcated personal injury trial, interest runs from the date on which the defendant's liability is established, even though the amount of damages is not yet fixed. The court held that prejudgment interest is intended "to indemnify [successful] plaintiffs for the nonpayment of what is due them." *Id.* (quoting *Trimboli v. Scarpaci Funeral Home*, 37 A.D.2d 386, 389 (1971), aff'd, 283 N.E.2d 614 (N.Y. 1972)). Indeed, in describing the court's holding in *Love*, one commentator employed an analysis which appears to foreshadow that advocated here. See *In Bifurcated Personal Injury Trial, Court of Appeals Holds Interest on Damages Runs From Earlier Verdict of Liability*, N.Y. ST. L. DIG., Dec. 1991, at 1.

In *Jones & Laughlin Steel Corp. v. Pfeifer*, 462 U.S. 523, 547-49 (1983), the Supreme Court struggled with the question of how to take the time value of money into account in determining the total amount of a damage award, and tried to identify the factors that courts should take into account in establishing the appropriate discount rate. Although other courts and legislatures have doubtless faced the same struggle, further exploration of the role of amounts commonly labeled prejudgment interest in the law of remedies is beyond the scope of this Article. See *infra* notes 13 and 120.

Code has long provided that taxpayers who underpay their taxes must pay the amount of the deficiency plus an additional amount which is measured by a percentage rate.¹⁰ The Code has characterized this additional amount as interest ("deficiency interest")¹¹ and has treated it as interest for tax purposes.¹² But the characterization of deficiency interest as interest may be wrong; deficiency interest might more accurately be characterized as damages. Indeed, the Code may have confused the *measure* of damages, an interest rate, with the amount itself.¹³ Although deficiency interest compensates the government for the harm caused by

10. I.R.C. §§ 6601(a), 6621.

11. The term "deficiency interest" will be used herein to refer to interest paid or incurred on federal tax deficiencies, as provided by I.R.C. § 6601.

12. Section 6601 assumes that what it calls interest will be so treated for tax purposes. Both the Treasury Department and the Internal Revenue Service have accepted the characterization of deficiency interest as interest. Thus, Temp. Treas. Reg. § 1.163-9T(b)(2)(i) (1987) provides that income tax deficiency interest is personal interest, and Temp. Treas. Reg. § 1.163-9T(b)(2)(iii)(C) (1987) specifically excludes from the definition of personal interest deficiency interest on certain nonindividual income tax deficiencies; if deficiency interest were not interest under the Code, it would not need to be specifically excluded from the definition of personal interest in the temporary regulations. See Rev. Proc. 60-17, 1960-2 C.B. 942; I.R.C. § 6601(e); Treas. Reg. § 301.6601-1(f) (as amended in 1983) (providing that interest imposed by § 6601 will be assessed and collected in the same manner as the tax).

13. The use of the term interest to refer to an amount due as a result of the passage of time is widespread. It occurs in the case of amounts added to damage awards to compensate the wronged party for the delay in the payment of damages, commonly referred to as prejudgment interest. See, e.g., *Seaboard Air Line Ry. v. United States*, 261 U.S. 299 (1923); *Union Bank v. First Nat'l Bank*, 677 F.2d 1074 (5th Cir. 1982); *Hussey Metals Div. of Copper Range Co. v. Lectromelt Furnace Div.*, McGraw Edison Co., 417 F. Supp. 964 (E.D. Pa. 1976), *aff'd*, 556 F.2d 566 (3d Cir. 1977); DOUGLAS LAYCOCK, *MODERN AMERICAN REMEDIES*, 195-98 (1985); Michael J. Martin, Note, *Prejudgment Interest: Implementing Its Compensatory Purpose*, 15 *LOY. U. CHI. L.J.* 541 (1983); Anthony E. Rothschild, Comment, *Prejudgment Interest: Survey and Suggestion*, 77 *NW. U. L. REV.* 192 (1982). Indeed, persistence in treating these amounts as something in addition to and separate from the damages which compensate for the injury in question has led to much dispute about the circumstances under which they are allowed. See *State v. Phillips*, 470 P.2d 266, 272 (Alaska 1970) (prejudgment interest is part of damages paid to make the damaged party whole and is appropriate for all damages whether liquidated or unliquidated, pecuniary or nonpecuniary); *Union Bank*, 677 F.2d 1074, 1077 (prejudgment interest should be viewed as compensation for damages). See generally CHARLES T. MCCORMICK, *HANDBOOK ON THE LAW OF DAMAGES* §§ 54-56 (1935).

The confusion also occurs in the case of trade credit, where payment after the passage of some stated amount of time requires the payment of the stated amount plus an additional amount labeled interest. See, e.g., ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 548-53 (2d ed. 1991). It is also evident in the frequent requirement for the payment of an increased amount of interest upon late payment of the principal and interest due on a conventional loan. See *West v. Commissioner*, 61 T.C.M. (CCH) 1694 (1991). It is possible that none of these amounts are true interest but rather are delay damages. While an exploration of the ramifications of a recharacterization of interest as damages in all of these areas is beyond the scope of this Article, perhaps the analysis contained herein will prove useful to others undertaking such an exploration.

the delay in payment and is measured by a percentage rate, I suggest that it not be treated as interest at all. Treating deficiency interest as interest for tax purposes does not further the policies that justify the existence of the interest deduction.¹⁴

The characterization of an amount as interest should follow from the reason for the interest deduction. As this Article will suggest, amounts should be treated as interest for tax purposes *only* when they are paid to compensate for the consensual lending of money. To treat as interest amounts which do not arise from consensual lending transactions is arguably inconsistent with the rationale for the interest deduction and therefore fails to effectuate sound tax policy.

A prominent and clearly articulated distinction is obviously needed: in at least two recent cases the tax court struggled to determine whether particular amounts should be treated as interest or as something else.¹⁵ In addition to leading to a more appropriate characterization of amounts which the Code has called interest, the analysis proposed here might have made it easier for the tax court to distinguish interest from other amounts and thus to reach the correct result.

Part II of this Article reviews the case law and demonstrates that courts once understood and articulated the distinction between interest and damages. It develops a hypothesis to explain the demise of the distinction and shows how sound tax policy would be served by its reinstatement. Part III explains the recent controversy over the tax treatment of corporate deficiency interest and discusses the effects of adopting the suggested analysis.

Part IV analyzes a disparity in treatment of corporate taxpayers that could result from the application of the proposed analysis to deficiency interest. Because adoption of the suggested analysis would lead to a reclassification of deficiency interest as damages, deficiency interest would not be deductible *as interest*. Deficiency interest would probably not be deductible as damages, either.¹⁶ If current law remains otherwise unchanged and corporate interest expense remains generally deductible,¹⁷ corporations that pay the tax late, with deficiency interest, would

14. See *infra* text accompanying notes 115-23.

15. *Aames v. Commissioner*, 94 T.C. 189 (1990); *West v. Commissioner*, 61 T.C.M. (CCH) 1694 (1991). See *infra* text accompanying notes 54-72.

16. See *infra* text accompanying notes 162-70.

17. Although Congress has, in recent years, enacted provisions which tie the deductibility of some corporate interest expense to the use of the borrowed funds, these provisions have been designed to curb perceived abuses and do not apply to corporate interest expense generally. See *infra* note 79. See also *infra* notes 209-17 and accompanying text.

be denied a deduction while those that borrow and incur an interest expense to pay the tax would be allowed a deduction for the interest expense incurred. Although a system that distinguishes between deficiency interest and interest on a third party loan used to pay a deficiency would not necessarily be unsound,¹⁸ the potential for disparate treatment of taxpayers in similar economic positions suggests that the deductibility of corporate interest expense should be re-examined.¹⁹ Part V therefore suggests a rationale and outlines a model for making the deductibility of corporate interest expense dependent upon the use of the loan proceeds.

II. THE CONFUSION BETWEEN INTEREST AND DAMAGES

A. *Where We Went Wrong: An Historical Perspective*

The law has not always treated all compensatory amounts measured by a percentage rate as interest, although the similarities between interest and damages were noted long ago in cases involving requests for prejudgment interest. In *Redfield v. Ystalfera Iron Co.*,²⁰ a case decided in 1884, the Supreme Court observed that "interest is given on money demands as damages for delay in payment, being just compensation to the plaintiff for a default on the part of his debtor."²¹ In *Redfield* the plaintiff had obtained a judgment in 1856, but had waited nearly 30 years to bring a collection action. In the collection action, the plaintiff sought payment of the original amount awarded plus interest for the 30 year period. The court denied the award of interest on the theory that the interest was being sought as damages — since the plaintiff was "guilty of laches in unreasonably delaying the prosecution of his claim, [the interest] may be properly withheld."²² The *Redfield* Court recognized that what the plaintiff was calling interest was really damages, and was subject to the equitable doctrines applicable to the collection of damages.

1. *The Condemnation Cases.* A series of cases involving the condemnation of property by the federal government provided another op-

18. The nature of the taxpayer's relationship to the government with respect to deficiency interest differs significantly from the nature of a taxpayer's relationship to a third party lender, and this distinction justifies different treatment of the charges. *See infra* Part IV.

19. The question of whether there are policy considerations that suggest that deficiency interest should be deductible even if it is not deductible as interest deserves thorough exploration. Such thorough exploration is beyond the scope of this Article, which uses deficiency interest only as a focus for discussing the broader subject of the distinction between interest and damages.

20. 110 U.S. 174 (1884).

21. *Id.* at 176.

22. *Id.*

portunity for the lower federal courts, and ultimately the Supreme Court, to explore the relationship between interest and damages.²³ A review of these cases helps to explain why the distinction that appeared so evident to the *Redfield* Court in 1884 seems to have disappeared from the legal landscape.²⁴

Almost 30 years after *Redfield*, the Supreme Court had to decide whether the federal government must compensate the owner of condemned land for the period between the government's taking of the land and the date on which the value of the land was judicially determined.²⁵ In *United States v. Rogers*, a property owner argued that compensation for that period was necessarily part of the just compensation which the Constitution guaranteed him. The government defended on the ground that a federal statute prohibited the government's payment of interest. The Court found that "it was the duty of the Government to make just compensation as of the time when the owners were deprived of their property,"²⁶ and ordered the government to pay the owner an amount measured by a state statute that provided for the payment of interest. The Court's use of a statutory interest rate to measure the compensation due the owner began to blur the distinction between interest and damages.

Two years later, in *Seaboard Air Line Railway v. United States*,²⁷ the Supreme Court extended the *Rogers* analysis to all condemnation cases. In *Seaboard Air Line* the Court reasoned that,

The rule above referred to, that in the absence of agreement to pay or statute allowing it the United States will not be held liable for interest on unpaid accounts and claims, does not apply here. The requirement that "just compensation" shall be paid is comprehensive and includes all elements and no specific command to include interest is necessary when *interest or its equivalent is a part of such compensation*. Where the United States condemns and takes possession of land before ascertaining or paying compensation, the owner is not limited to the value of the property at the time of the taking; he is entitled to such addition as will produce the full equivalent of that value paid contemporaneously with the taking. *Interest at a proper rate is a good measure by which to ascertain the amount so to be added.*²⁸

In *Seaboard Air Line* the Supreme Court saw clearly that under certain circumstances amounts commonly labeled interest were really only a

23. See *infra* notes 25-37 and accompanying text.

24. One notable exception remains. See *infra* notes 110-14 and accompanying text.

25. *United States v. Rogers*, 255 U.S. 163 (1921).

26. *Id.* at 169.

27. 261 U.S. 299 (1923).

28. *Id.* at 306 (emphasis added).

measure of damages.²⁹

The owners of the condemned property at issue in the foregoing cases probably did not care whether the amounts in question were interest or damages, as long as they got the money. But the growth of the income tax changed that.³⁰ A system that distinguishes between capital gains and ordinary income and provides special nonrecognition provisions for proceeds of condemnation makes it necessary to distinguish between the condemnation award and any additions thereto.³¹ Courts soon had to decide whether the additional compensatory amount was to be treated as interest or as part of the compensatory award for federal income tax purposes.³² Predictably, the Service generally favored characterization of the amounts as interest because that yielded immediate recognition at ordinary income rates. Just as predictably, taxpayers generally favored characterization as part of the compensatory award because that yielded either nonrecognition or recognition of gain at capital gains rates.

The lower courts generally agreed with the taxpayers,³³ but in 1941 the Supreme Court found in favor of the Service. In *Kieselbach v. Com-*

29. The Court followed *Seaboard Air Line* in *Brooks-Scanlon Corp. v. United States*, 265 U.S. 106 (1924); *Liggett & Myers Tobacco Co. v. United States*, 274 U.S. 215 (1927); and *Pelphs v. United States*, 274 U.S. 341 (1927).

30. This is not to suggest that income taxes were irrelevant at the time those cases were decided. It is only to suggest that the growth of both the individual and corporate income tax systems and the increase in rates brought about by the need to finance World War I probably made tax consequences more salient than they had previously been.

31. See I.R.C. § 1033 (permitting nonrecognition of gain realized upon the involuntary conversion, including "seizure, or requisition or condemnation or threat or imminence thereof"); I.R.C. § 1231(a) (providing preferential treatment for gain recognized on certain types of involuntarily converted property).

32. The need to determine whether these amounts were interest for tax purposes also arose because of the need to determine whether the amounts were exempted from taxation altogether when they were paid by a state rather than by the federal government. If the amounts were interest, the predecessor of § 103 would provide an exclusion. The courts uniformly held that the amounts were not interest within the meaning of the predecessor of § 103 because they were not paid in the exercise of the states' borrowing power. See *infra* notes 110-114 and accompanying text.

33. See, e.g., *Commissioner v. Appleby's Estate*, 123 F.2d 700, 701 (2d Cir. 1941) (increment to award for condemnation treated as a capital gain rather than ordinary income, although denominated as "interest"); *Seaside Improvement Co. v. Commissioner*, 105 F.2d 990, 994 (2d Cir.) (additional sums paid to indemnify for delay not considered interest but part of compensation awarded for property taken), *cert. denied*, 328 U.S. 618 (1939); *Pioneer Real Estate Co. v. Commissioner*, 47 B.T.A. 866, 892-93 (1943) (interest given in addition to award for condemnation taxed as part of award), *acq.*, 1943 C.B. 18, *modified*, 1 T.C.M. (CCH) 527 (1943); *Brown v. Commissioner*, 47 B.T.A. 139, 142 (1942) (interest added to condemnation award treated as capital gain, not as ordinary income), *acq.*, 1943 C.B. 3.

missioner,³⁴ the Court held that the additional amounts were not part of the sale price of the condemned property.³⁵ That made them ordinary income, currently recognizable, regardless of whether they were interest.³⁶ The Court did not decide that the amounts were interest.³⁷ By avoiding a precise characterization, the Court set the stage for the current confusion in the law.

2. *The Nonresident Alien Cases.* Prior to the Court's decision in *Kieselbach*, the Board of Tax Appeals had been faced with the question of whether amounts awarded in addition to damages were interest or part of the damage award.³⁸ The issue often arose in the context of nonresident aliens not engaged in the conduct of a trade or business within the United States because such individuals are subject to United States tax only on certain types of income derived from sources within the United States.³⁹ In a series of cases that ended in 1943,⁴⁰ the Board held that amounts paid in addition to stated damages to compensate for the delay in payment were *not* interest and were not subject to U.S. tax.

In support of its conclusion in those cases, the Board cited the Supreme Court's opinion in *Seaboard Air Line*.⁴¹ Like the Court in *Sea-*

34. 317 U.S. 399 (1943).

35. *Id.* at 404.

36. *Kieselbach* can be seen as a revenue maximizing decision. Because condemnation awards are, by definition, paid by a governmental entity not subject to federal income taxes, a decision that the amounts are interest is irrelevant from the standpoint of deductibility to the payor, but assures maximum taxation of the payee.

37. 317 U.S. at 403.

38. See *In re Bettendorf*, 3 B.T.A. 378 (1926); *Conorzio Veneziano di Armamento e Navigazione v. Commissioner*, 21 B.T.A. 984 (1930), *nonacq.*, 10-1 C.B. 77 (1931); *N.V. Koninklijke Hollandische Lloyd v. Commissioner*, 34 B.T.A. 830 (1936); *Lang v. Commissioner*, 45 B.T.A. 256 (1941), *rev'd sub nom. Commissioner v. Raphael*, 133 F.2d 442 (9th Cir.), *and cert. denied*, 320 U.S. 735 (1943). See also Asimow, *supra* note 1, at 770-72.

39. Section 871 so provides currently, as did its predecessor, I.R.C. § 211(a)(1)(A) (1939).

40. See cases cited in note 38, *supra*. In *In re Bettendorf*, 3 B.T.A. 378 (1926), the issue arose in a different way. In that case, a taxpayer deducted amounts he was ordered to pay a plaintiff in a lawsuit. The Service challenged the characterization of those amounts as interest on the theory that they really represented damages on account of the conversion, and were therefore not deductible. The Board agreed with the Service, finding that because "the relation of debtor and creditor did not exist between the taxpayer and [the plaintiff] . . . the interest included in the decree of the court . . . was not interest on indebtedness . . . and hence is not deductible in computing the taxpayer's net income for the years in which it was paid." 3 B.T.A. at 384. Significantly, the Board distinguished post-judgment interest, and held that once the judgment was rendered, a debtor creditor relationship existed and the amount paid by the taxpayer for that period was interest for tax purposes and deductible as such. 3 B.T.A. at 384-85.

41. See, e.g., *Lang*, 45 B.T.A. at 263; *Conorzio*, 21 B.T.A. at 989; *Koninklijke*, 34 B.T.A. at 834.

board Air Line, the Board felt that although the additional amounts were compensatory, they were not interest. In 1943, the Court of Appeals for the Ninth Circuit disagreed.

The Ninth Circuit, in *Commissioner v. Raphael*,⁴² interpreted the Supreme Court's then-recent decision in *Kieselbach* as holding that such additional amounts are interest and should be treated as such for tax purposes. This characterization was unfortunate. A fair reading of the Ninth Circuit's opinion suggests that the court meant to say that the additional amounts compensated the taxpayer for its inability to earn interest, and were therefore a substitute for interest which should be taxed like interest. Had the court stated this analysis explicitly, the distinction between true interest and amounts which compensate for the damage caused by the inability to earn it might have remained clear. As it was, by holding that the amounts were interest (not merely substitutes therefor), the Ninth Circuit clouded future analysis.

3. *The Overpayment Case.* The Ninth Circuit drew support for its conclusion from *Helvering v. Stockholms Enskilda Bank*.⁴³ In *Stockholms Enskilda* the Supreme Court held that amounts labeled interest and paid by the United States on a refund of U.S. income taxes to a nonresident alien were interest within the meaning of the predecessor of section 871 and were thus taxable to the nonresident alien.⁴⁴ Reliance on *Stockholms Enskilda* for the proposition that what the Code labels interest should be treated as such for tax purposes is misplaced for two reasons. First, it assumes that overpayments and underpayments deserve equivalent treatment.⁴⁵ Second, and perhaps more importantly, the Court's analysis in *Stockholms Enskilda* actually supports the characterization of deficiency interest as damages. The Ninth Circuit saw neither of those elements, and thus created the confusion that remains in the law

42. *Commissioner v. Raphael*, 133 F.2d 442, 446 (9th Cir.), *cert. denied*, 320 U.S. 735 (1943).

43. 293 U.S. 84 (1935); *Raphael*, 133 F.2d at 445.

44. *Id.*

45. The Service has stated that:

Under the general rule, interest is paid on a tax overpayment for the time the government has the use of the taxpayer's money. Interest is collected, similarly, for the time the taxpayer has the use of the government's money. The underlying objective is to determine in a given situation whose money it is and for how long the other party had the use of it.

Rev. Proc. 60-17, 1960-2 C.B. 942.

That the Service treats interest in this way, and correctly describes this as the general rule does not mean that the rule is correct. While viewing the taxpayer as a lender in the overpayment situation might be correct, that neither compels nor justifies a view of the government as lender in the underpayment situation. *See infra* note 47.

today.⁴⁶

Arguably, the issue of the characterization of deficiency interest is not resolved by *Stockholms Enskilda* because that case involved interest on an overpayment. Although it is tempting to treat overpayments and underpayments as different sides of the same coin, such treatment is not necessarily correct. Overpayments and underpayments proceed from fundamentally different transactions and could reasonably be treated in different ways.⁴⁷ Most simplistically, in the overpayment case there is an actual transfer of money. In the underpayment case there is no such transfer — there is nothing more than a dispute about the existence of a debt.⁴⁸ It is much easier to say there is interest when there is a transfer of funds than where there is not.

46. For example, CCH Standard Federal Tax Reports notes that the tax court in *Consorzio Veneziano di Armamento e Navigazione v. Commissioner*, 21 B.T.A. 984 (1930), *nonacq.*, 10-1 C.B. 77 (1931), held that "interest included by the Court of Claims in a judgment against the U.S. for compensation for the taking of property for public use during the war is not taxable to a foreign corporation." *Judgment against the U.S.*, [1991] 7 Stand. Fed. Tax Rep. (CCH) ¶ 26,965.106 (1990). However, CCH restricts the current applicability of the holding by noting that the decision was rendered before the Supreme Court decision in *Stockholms Enskilda*. *Interest on Income Tax Refund*, [1991] 7 Stand. Fed. Tax Rep. (CCH) ¶ 26,965.097 (1990).

Careful analysis of *Stockholms Enskilda* does not require the demise of *Consorzio*. *Consorzio* involved an amount payable by the U.S. purely as compensation. There was no loan. By contrast, *Stockholms Enskilda*, like all overpayment cases, arguably involves a loan and therefore an amount properly characterized as interest. Thus viewed, *Stockholms Enskilda* is correctly decided, and *Consorzio* and cases like it remain good law.

47. In the case of an overpayment, the taxpayer has remitted her own money to the government in compliance with the requirements imposed by the Code. When the money is refunded, the taxpayer is receiving a return of her money, much like a lender does upon repayment of a loan. The economic substance of the transaction more closely resembles a true lending transaction. In the underpayment situation the taxpayer has remitted no funds. She has merely failed to comply with her duty to pay the amount of taxes due. The failure to comply with a legal duty constitutes a wrong which has harmed the government.

The overpayment situation is also consensual. The taxpayer voluntarily remits the amount she believes is due and the government agrees to refund it in the event of error. I.R.C. § 6402. The overpayment situation is therefore more like a true lending transaction even though the interest rate does not vary among taxpayers. *See, e.g.*, I.R.C. § 6611 (providing for the payment of interest on overpayment); I.R.C. § 6621(a)(1) (establishing the rate at one percentage point less than the underpayment rate). As in a commercial transaction, it is the government's creditworthiness that determines the rate of interest. Because the government is in the position of the borrower with respect to all overpayment cases, the existence of a set rate of interest does not detract from the characterization of the amount as interest. The amount need not vary from taxpayer to taxpayer because the putative borrower is always the same. By contrast, in the case of an underpayment, the identity of the putative borrower would vary in each case. True interest would also vary. *But see* Marvin J. Garbis & Miriam L. Fisher, *The Tilted Table: Penalties and Interest on Federal Tax Deficiencies*, 7 VA. TAX REV. 485 (1988) (taking the position that the difference between the overpayment and underpayment rates is unfair and ill-conceived).

48. *See infra* note 144 and accompanying text.

The Ninth Circuit's reliance on *Stockholms Enskilda* was misguided for another reason. The Ninth Circuit blindly applied the Court's holding but ignored its reasoning. In *Stockholms Enskilda* the Court used tax policy to provide an analysis remarkably like that advocated here. The Court looked at the purpose of the statute in question to determine whether the amounts which the Code labeled interest on an overpayment should be treated as interest for purposes of subjecting a nonresident alien to United States taxation.⁴⁹ Because the statutory purpose was to subject all income from U.S. sources to income taxation, and not to aid the government's borrowing by making interest on its obligations tax exempt, the Court construed the term "obligation" to include the government's statutorily created obligation to pay interest on overpayments.⁵⁰ The Court declined to construe the term obligation to cover only amounts paid under the exercise of the government's borrowing power because such a narrow construction would fail to effectuate the policy behind the statutory provision.⁵¹ Thus, reading *Stockholms Enskilda* as requiring that what the statute labels interest be treated as such for all tax purposes in all cases ignores the essence of the Court's analysis.

Taxation of interest, like all taxation, ought to be grounded in policy considerations.⁵² The cases decided by the Board of Tax Appeals before *Kieselbach* effected sound tax policy because they treated as interest only amounts which were the product of a lending transaction. Unlike nonresident aliens who loan money to a U.S. person or even nonresident aliens who overpay their federal income taxes, the nonresident aliens involved in the pre-*Raphael* cases decided by the Board of Tax Appeals did not intend or expect to derive interest income from sources within the U.S. They intended only to enter into the activities which resulted in the lawsuits in question, and it is good tax policy to treat the proceeds of those activities in accordance with that intent. If the proceeds of a sale for full and fair consideration would not have been subject to tax, sound

49. *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 86-90 (1935).

50. *Id.* at 89.

51. In *American Viscose Corp. v. Commissioner*, 56 F.2d 1033 (3d Cir.), *cert. denied*, 287 U.S. 615 (1932), the court held that interest on an overpayment of federal income taxes was not covered by a provision that exempted interest on "obligations of the United States" from federal income taxes. Like the courts which addressed the payment of delay damages in the state condemnation cases (discussed *infra* at note 110 and accompanying text), the court in *American Viscose* noted that the amounts in question were not paid under the exercise of the government's borrowing power, and therefore no purpose would be served by including them within the exclusionary provision. 56 F.2d at 1034.

52. See generally *Gregory v. Helvering*, 293 U.S. 465 (1935); Rev. Rul. 76-413, 1976-2 C.B. 214.

tax policy requires that amounts awarded to compensate for delay in receiving such proceeds not be subject to U.S. tax either.⁵³

B. *The Way Back*

The need to distinguish between interest and damages did not end with the decisions in *Kieselbach* and *Stockholms Enskilda*. Recent cases illustrate the need to return to a clearly articulated distinction between interest and damages. For example, in *West v. Commissioner*,⁵⁴ the taxpayers took the position that an additional amount due upon the late payment of a home mortgage was deductible interest.⁵⁵ The taxpayers argued that the amount due upon late payment was interest because the mortgage note gave them the option of either paying on a given date at one rate or paying at a later date at a higher rate. The Service took the position that the amounts were not interest, but found the position difficult to sustain because in Revenue Ruling 74-187⁵⁶ it had held that a late payment charge assessed by a public utility was interest.

In Revenue Ruling 74-187, the Service had attempted to distinguish interest from service charges. Since there was no evidence that the late payment charge bore a relationship to the costs of a specific service performed by the utility in connection with the delinquent customer's account, the Service concluded that the charge must be for the use or forbearance of money and was therefore interest.⁵⁷ In *West*, the Service attempted to distinguish Revenue Ruling 74-187 by urging that the late payment charge levied by the bank in that case "compensate[d] the bank for costs resulting from delinquent real estate loans."⁵⁸ The tax court

53. The courts continue to so hold with respect to payments made by states in condemnation cases. Both the Service and the courts agree that amounts so awarded by a state are not interest exempt from federal income tax pursuant to § 103. See *infra* notes 110-14 and accompanying text.

54. 61 T.C.M. (CCH) 1694 (1991), *appeal docketed*, No. 91-70217 (9th Cir. Apr. 8, 1991).

55. *Id.*

56. 1974-1 C.B. 48.

57. The Service reached similar conclusions in Rev. Rul. 79-349, 1979-2 C.B. 233 (service fees on mortgage loans); Rev. Rul. 77-417, 1977-2 C.B. 60 (one time charges on credit card accounts); Rev. Rul. 74-395, 1974-2 C.B. 46 (commitment fee); Rev. Rul. 74-607, 1974 C.B. 149 (points on a construction loan); Rev. Rul. 72-315, 1972-1 C.B. 49 (finance charges on a revolving charge account); Rev. Rul. 71-98, 1971-1 C.B. 57, *modified by* Rev. Rul. 72-315, 1972-1 C.B. 49 (finance charges on a revolving charge account); Rev. Rul. 69-582, 1969-2 C.B. 29, *amplifying* Rev. Rul. 69-188, 1969-1 C.B. 54 (loan processing fees). See also Rev. Rul. 72-2, 1972-1 C.B. 19 (amounts charged in connection with a tuition postponement plan charged by a university); *Kena, Inc. v. Commissioner*, 44 B.T.A. 217 (1941). In Rev. Proc. 92-12, 1992-3 I.R.B. 27, the Service announced a five-part test for establishing the deductibility of points paid in connection with the acquisition of a principal residence.

58. *West v. Commissioner*, 61 T.C.M. (CCH) 1694 (1991).

was unpersuaded by this distinction, and noted that the late payment charge was intended to: (1) compensate the bank for expenses it incurred as a result of the borrower's breach, (2) penalize the borrower for tardiness, and (3) compensate the bank for lost earnings. Nevertheless, it found for the Service, holding that the late payment charge should not be treated as interest.⁵⁹

The *West* court reached the correct conclusion — the problem is that it was so hard for it to get there. The court seemed troubled because the late payment charge included elements of compensation, deterrence, and replacement of foregone earnings and it was difficult for the court to make any one of these characteristics determinative.⁶⁰ Had the court considered the possibility that the amounts in question were damages, its task would have been considerably easier.⁶¹ Damages have all of the characteristics the court identified. Damages compensate both for the costs of breach and for the gain forgone as a result thereof, and the ability to award them induces compliance (or deters breach).⁶² The late pay-

59. *Id.* at 1696-97. The court ultimately ignored the ruling and justified doing so by noting that "a revenue ruling merely represents the Commissioner's position with respect to a particular factual situation; we are not bound to follow its conclusion, for it does not constitute substantive authority in this Court." *Id.* (citation omitted).

60. In particular, the existence of the element of deterrence in many of these situations, as in the case of liquidated damages generally, has exacerbated the confusion. Some courts, and even the Service, feel compelled to decide whether particular amounts are interest or penalties. *See, e.g.,* *Wusich v. Commissioner*, 35 T.C. 279, 287-88 (1960); Rev. Rul. 61-210, 1961-1 C.B. 31; Rev. Rul. 60-127, 1960-1 C.B. 84. The option of holding that the amounts are neither interest nor penalties but represent damages would make classification easier.

61. Although the court noted the resemblance between the amounts in question and liquidated damages, it did so only to the extent that it saw the late charge as compensating the bank for the additional expenses it incurred as a result of the taxpayer's delinquency. 61 T.C.M. (CCH) 1694, 1696 (1991). The court did not consider the possibility that all of the characteristics of the amounts in question made them precisely like damages and that the amounts were not interest because they were damages.

62. Although the law distinguishes between liquidated damages and penalties, enforcing those which it finds to be the former but refusing to enforce those which it finds to be the latter (*see* MCCORMICK, *supra* note 13, at § 146), the existence of that distinction should not suggest that damages cannot serve to induce compliance or deter breach. For a consideration of the differences between liquidated damages and penalties, *see* generally Ian R. Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495 (1962); Justin Sweet, *Liquidated Damages in California*, 60 CAL. L. REV. 84 (1972); William S. Harwood, Comment, *Liquidated Damages: A Comparison of the Common Law and the Uniform Commercial Code*, 45 FORDHAM L. REV. 1349 (1977); Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351; *see also* *Southwest Eng'g Co. v. United States*, 341 F.2d 998 (8th Cir.) (considering the difference between damages and a penalty), *cert. denied*, 382 U.S. 819 (1965). Indeed, the very existence of damages as part of the law of contract serves to induce compliance. If parties to a contract knew that a breach would have no deleterious consequences (as would be the case if a breaching party did not have to pay damages in lieu of providing the benefits expected from compliance), breaches would

ment charges in question in *West* were not interest because they were damages.

The tax court faced a similar quandary in *Ames v. Commissioner*.⁶³ In *Ames* the taxpayer had obtained a judgment on a medical malpractice claim. He had also received an amount denominated interest from the date of the original injury to the date of judgment (so-called prejudgment interest). *Ames* took the position that the entire amount recovered was excluded from income by section 104.⁶⁴ The Service disagreed, on the ground that prejudgment interest is interest and not damages. After citing *Kieselbach* as well as some condemnation cases where the courts had refused to find that prejudgment interest was part of the condemnation award eligible for nonrecognition treatment under section 1033,⁶⁵ the tax court agreed with the Service.

The court's conclusion that the amounts in question did not come within the purview of the exclusion provided by section 104 was correct. Again, the problem was that it was so difficult for the court to reach that result. The *Ames* court, and others which have addressed similar issues,⁶⁶ might have had an easier task had they entertained the proposi-

probably occur more often. See Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 558 (1977). One might ask whether the notion of a contract requires the allowance of damages for breach. See E. ALLEN FARNSWORTH & WILLIAM F. YOUNG, CASES AND MATERIALS ON CONTRACTS 641 (1980) (contract law is based upon a concern directed at relieving a party after a breach).

63. 94 T.C. 189 (1990).

64. Section 104(a)(2) excludes from income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness," except to the extent that the amounts are punitive damages received "in connection with a case not involving physical injury or physical sickness."

65. *Tiefenbrunn v. Commissioner*, 74 T.C. 1566, 1572-74 (1980) (interest was compensation for delay in payment and not part of the gain on the involuntary conversion of property entitled to nonrecognition); *Smith v. Commissioner*, 59 T.C. 107, 112 (1972) (lump sum payment in condemnation settlement presumed to include interest under Pennsylvania law). Section 1033(a)(2)(A) allows a taxpayer to elect not to recognize the gain upon an involuntary conversion, to the extent the taxpayer uses the award to replace the condemned property within a given period of time. See also *Spangler v. Commissioner*, 323 F.2d 913, 916 (9th Cir. 1963) (interest awarded in lieu of ordinary income taxpayer would have earned on the sums wrongly withheld, taxable as income); *320 East 47th St. Corp. v. Commissioner*, 243 F.2d 894, 897-99 (2d Cir. 1957) (amount corporate taxpayer received as interest on condemnation award taxable as "personal holding company income"); *Commissioner v. Goldberger's Estate*, 213 F.2d 78, 83 (3d Cir. 1954) (interest on judgment treated as income and subject to tax law in effect at judgment, not when claim was entered).

66. See, e.g., *Spangler*, 323 F.2d 913; *320 East 47th St. Corp.*, 243 F.2d 894; *Tiefenbrunn*, 74 T.C. 1566; *Smith*, 59 T.C. 107; *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933) (interest found to be added to amount of award, distinct and separately calculated); *Granger v. Commissioner*, 37 T.C.M. (CCH) 1849-23 (1978) (even where taxpayer could prove judgment did not fully compensate for loss, interest specifically designated as such will be considered interest for tax purposes).

tion that the amounts in question were damages for delay in payment and ought to be taxable as such.

The damages analysis would not have changed the result in *Aames*, *West*, and similar cases. The amount included in the taxpayer's income in *Aames* would be included in his income under the damages analysis,⁶⁷ and the amounts in question in *West* would still have been nondeductible.⁶⁸ The difference is that the courts could have employed a more direct analysis. Indeed, several of the opinions exude an almost palpable tension.⁶⁹ The courts seem to want to hold that the amounts are interest, presumably because they feel either nondeductibility or inclusion in income is the right result, but they have to deflect the problem posed by the absence of a loan.⁷⁰

The judicial hand-wringing could end if courts simply acknowledged that although the amounts are compensatory, they are not interest because there is no lending transaction. The amounts are more appropriately characterized as damages. The real question is — damages for what? Concluding that they are damages for delay, as many courts have already acknowledged in the process of calling the amounts interest,⁷¹

67. Although the amount would be characterized as damages under the proposed analysis, it is probably not damages on account of personal injury, as required by § 104, unless the nonpayment is found to be the result of a traditional tort-type claim. For a short discussion of § 104, see *infra* note 162.

68. In *West v. Commissioner*, 61 T.C.M. (CCH) 1694 (1991), if the amount had been damages, it would have been nondeductible because it was attributable to a personal, rather than a business or income producing, activity. I.R.C. § 262. No provision allows a deduction for damages stemming from personal activities. See *Stern v. Carey*, 119 F. Supp. 488 (N.D. Ohio 1953) (amounts paid by individuals arising out of automobile accident found not deductible as a casualty loss); *Mullohand v. Commissioner*, 16 B.T.A. 1331 (1929) (damages paid on account of automobile accident that occurred when a car was used for pleasure, not business, held not deductible as a casualty loss).

69. See, e.g., *320 East 47th St. Corp.*, 243 F.2d 894 (the word interest put in quotation marks throughout); *Tiefenbrunn*, 74 T.C. 1566 (the court is apparently so uncomfortable calling the amounts interest that it puts the word in quotes); *Smith*, 59 T.C. at 107 n.1 (the court avoids confronting the issue by stating that “[t]he terms ‘detention damages,’ ‘interest,’ ‘delay damages,’ and ‘payment for delay in compensation’ will be used interchangeably herein”).

70. See, e.g., *Wheeler v. Commissioner*, 58 T.C. 459 (1972) (amount added to judgment to compensate for delay treated as interest and taxed as ordinary income). In that case the court noted that “[o]rdinarily, interest is received pursuant to a contractual promise, but a taxpayer may realize interest income from a nonconsensual withholding of his property.” 58 T.C. at 462. This observation shows that the court understood that, at a minimum, the absence of a consensual lending transaction raised a question about the propriety of characterizing the amount as interest. The court would not have had to face that issue if it had analyzed the amounts in question as damages. Under the damages analysis, the amounts would still have been included in the taxpayer's income because they substituted for an amount (interest) that is ordinary income. The difference is that the damages analysis would have made it unnecessary for the court to struggle to conclude that the amounts were interest.

71. See *Spangler v. Commissioner*, 323 F.2d 913, 916 (9th Cir. 1963); *320 East 47th St. Corp. v.*

reaches the right result without confusing the law. If the amounts were damages for delay and not for personal injury, section 104 would not necessarily exclude them from the recipient's income.⁷² Delay damages would also fail to receive the favorable treatment accorded amounts received in exchange for property.⁷³ Courts could therefore reach the right result in a much more theoretically direct and correct manner than is possible under the substitution analysis now employed.

At its core, the damages analysis differs from the substitution analysis because it focuses on the nature of the agreement between the parties.⁷⁴ Using a damages analysis, courts would determine what the

Commissioner, 243 F.2d 894, 896 (2d Cir. 1957); *Tiefenbrunn v. Commissioner*, 74 T.C. 1566, 1571 (1980); *Smith v. Commissioner*, 59 T.C. 107, 112 (1972); *Wheeler v. Commissioner*, 58 T.C. 459, 462 (1972).

72. The courts should not find it difficult to conclude that amounts which specifically compensate for a harm separate from the tort-type personal injury are not part of the personal injury itself. Of course, such a conclusion might create an inequity among: (1) those who receive a series of payments which might be said to contain an interest element; (2) those who receive a lump sum plus prejudgment interest; and (3) those who receive a lump sum which contains an amount designed to compensate for the delay in receipt but which is not specifically designated as interest. Only the individual who receives the lump sum plus prejudgment interest would not be allowed to exclude the entire amount received. Whatever the demerits of such an inequity, it exists under the current law to the same extent as it would if the proposed analysis were adopted. *Compare* *Aames v. Commissioner*, 94 T.C. 189 (1990) (amount separately stated not excludable); *and* *Rev. Rul. 76-133*, 1976-1 C.B. 34 (interest on fund not excludable) *with* *F. L. McShane*, 53 T.C.M. (CCH) 409 (1987) (total amount excludable); *and* *Rev. Rul. 79-313*, 1979-2 C.B. 75 (total amount excludable); *and* *Rev. Rul. 79-220*, 1979-1 C.B. 741 (total amount excludable). *See* *Dodge*, *supra* note 4.

73. Amounts which compensate for the sale or exchange of property would be part of the amount realized and thus would either offset basis or produce capital gain. *Cf.* *Johnson & Co. v. United States*, 149 F.2d 851 (2d Cir. 1945) (amount labeled interest on a condemnation award treated as interest for federal income tax purposes even though the total amount of the award plus the amount designated as interest was less than the taxpayer's basis in the property condemned.) I.R.C. § 1001. Under certain circumstances, amounts which represent compensation for the property might even be eligible for nonrecognition treatment. *See, e.g.*, I.R.C. §§ 1031, 1033, 1034.

74. The Service itself has used just such an analysis to conclude that an amount which compensates a taxpayer for additional taxes due as a result of a misrepresentation by the other party to a contract constitutes damages and is a nontaxable return of capital.

In *Gen. Couns. Mem. 39,697* (Jan. 27, 1988), the Service declined to find that the amount received by the taxpayer from the breaching party was income, because the receipt of the amount was not tantamount to payment of the taxpayer's tax liability by another (citing *Old Colony Trust v. Commissioner*, 279 U.S. 716 (1929)). Instead, the Service noted that the taxpayer had been damaged by the breach and concluded:

[T]he fact that the reimbursement for the damage is measured by the amount of the increased tax liability does not alter the fact that X's capital has been impaired by the damage. Thus, even though the extent of the damage is measured by the increased tax liability, the reimbursement is a return of additional expenses attributable to the contract

Gen. Couns. Mem. 39,697, at 9.

The Service's willingness to distinguish between the measure of an amount and the character of

parties intended and tax the resulting payment accordingly. If the parties did not intend to enter into a lending transaction, the amounts paid should not be treated as interest.

The proposed analysis is consistent with the Supreme Court's approach to determining whether a debt exists. In *United States v. Centennial Savings Bank FSB*,⁷⁵ the Court held that although early withdrawal penalties which a bank collected from depositors of CDs were income, they were not income from the discharge of indebtedness. The analysis which the Court used to reach that conclusion is very similar to that proposed here.⁷⁶ Both look to the nature of the relationship between the parties to determine the appropriate tax treatment of the resulting transfer of funds.⁷⁷

The taxation of deficiency interest ought similarly to be grounded in an examination of the relationship between the parties. The government

the amount is not new. In Rev. Rul. 57-47, 1957-1 C.B. 23, the Service ruled that an amount received by a taxpayer from a preparer to compensate the taxpayer for the tax due as a result of the preparer's mistake was not income to the taxpayer, notwithstanding that the receipt of the amount had the same effect as the payment of the taxpayer's tax liability by the preparer. In Rev. Rul. 57-47 the Service reversed the position it had taken in *Clark v. Commissioner*, 40 B.T.A. 333 (1939), *nonacq.*, 1939-2 C.B. 45, *acq.*, 1957-1 C.B. 4.

75. 111 S. Ct. 1512 (1991).

76. Reversing the decisions below in *Centennial*, the Supreme Court held that the early withdrawal penalties did not constitute income from the discharge of indebtedness because the penalties were not paid by the depositors to discharge the bank's liability to repay the entire amount initially deposited. *Id.* at 1517. The Court found the existence of a consensual relationship to borrow and lend determinative of the existence of a debt. It noted that to determine whether a discharge of indebtedness had occurred, "it is necessary to look at both the end result of the transaction and the repayment terms agreed to by the parties at the outset of the debtor-creditor relationship." *Id.* at 1518. In *Centennial*, the terms of the CD provided that in the case of early withdrawal the bank would be liable to the depositor only for the amount of principal deposited and interest accrued up to the date of withdrawal, minus the penalty. The Court found that the depositor had not forgiven the bank's obligation to pay because the reduction in the amount due was part of the terms of the original agreement. Indeed, the court concluded that the depositor could not have forgiven the bank's obligation to repay the amount otherwise due because the agreement did not require the bank to pay the full amount in the event of an early withdrawal. *Id.*

77. This analysis has the virtue of allowing the tax treatment of an amount to follow the reason the amount was paid. Thus, it allows taxation to follow the substance, not the form, of a transaction. As the Supreme Court noted close to sixty years ago in one of the most famous cases in tax law, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). This principle is firmly established in the tax law. *See, e.g.*, *Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966); *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), *aff'd*, 544 F.2d 1045 (9th Cir. 1976). *See generally* Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365 (1988); Mitchell M. Gans, *Re-examining the Sham Doctrine: When Should an Overpayment Be Reflected in the Basis?*, 30 BUFF. L. REV. 95 (1981); Hoffman F. Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 TUL. L. REV. 355 (1963).

ought not treat itself as entering into a debtor-creditor relationship with taxpayers who underpay their taxes unless it wants to assume the role of financier. Treating deficiency interest as interest treats the government as if it were a lender and encourages the use of the tax system as a tool of corporate finance. Because such a role is inappropriate for the government, and because it is at least as sound to treat deficiency interest as damages, the latter course should be seriously considered. Deficiency interest can be viewed as damages that compensate the government for the taxpayer's retention of the amount of tax due. An examination of the controversy surrounding the deductibility of corporate deficiency interest will illustrate the benefits of adopting a more precise analysis.

III. THE CONTROVERSY OVER THE DEDUCTIBILITY OF CORPORATE DEFICIENCY INTEREST

Individuals cannot deduct deficiency interest.⁷⁸ Corporations can.⁷⁹

78. Temp. Treas. Reg. § 1.163-9T (1987). The Service takes the position that interest paid by individuals on income tax deficiencies is personal interest regardless of the source of the income with respect to which the tax liability arises. Temp. Treas. Reg. § 1.163-9T(b)(2)(i) (1987). Since § 163(h) disallows a deduction for personal interest, any interest which is characterized as personal under the temporary regulations will not be deductible (unless the regulations are found to be invalid). The temporary regulations exempt from the definition of personal interest any deficiency interest other than income tax deficiency interest and deficiency interest which arises out of a C corporation's tax liability. Temp. Treas. Reg. § 1.163-9T(b)(2)(iii) (1987). Some commentators have assailed the position taken in the regulations, arguing that it lacks statutory or other support. See David R. Brennan & Susan L. Megaard, *Deducting Interest on Noncorporate Trade or Business Tax Deficiencies: Uncertainty Exists Under the New Temporary Regulations*, 13 REV. TAX'N INDIVIDUALS 22 (1989); John Y. Taggart, *Denial of the Personal Interest Deduction*, 41 TAX LAW. 195, 260-62 (1988). For a discussion of the impact of the Service's position on the treatment of deficiency interest paid or incurred by individuals and on the tax preparer's ability to take an aggressive, and contrary, position without incurring liability for penalties, see William L. Raby, *Is It a Business Expense When the Self-Employed Pay Interest on Deficiencies or Accounting Fees?*, 54 TAX NOTES 683 (1992).

Brennan and Megaard argue that the temporary regulations go too far in classifying all deficiency interest as personal interest. Although they believe that classifying as personal any deficiency interest which would not qualify as a § 162 trade or business expense follows logically from the statute and legislative history, Brennan and Megaard maintain that extending that classification to all deficiency interest, including that arising from a business related deficiency, follows neither from the statute nor the legislative history. Indeed, they assert that the position which the Service took in the temporary regulations can be traced to a statement made in the JOINT COMMITTEE'S GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 100th Cong., 1st Sess. 266 (Comm. Print 1987) [hereinafter GENERAL EXPLANATION]. Brennan & Meggard, *supra*, at 26.

79. I.R.C. § 163(a). While the corporate interest deduction is neither unlimited nor unrestricted, the limitations and restrictions upon it have arisen primarily out of a desire to curb the use of debt for disfavored or abusive transactions. Thus, I.R.C. § 163(e) provides rules for the deduction of original issue discount, and I.R.C. § 163(e)(5) provides special rules pursuant to which a portion of the original issue discount attributable to certain "high yield obligations" (as defined in

During the fall of 1990 this disparity prompted one Congressman to introduce a bill which would have provided equal treatment.⁸⁰ Instead of restoring the deduction for deficiency interest paid or incurred by individuals, however, the bill would have eliminated the deduction for corporations.⁸¹ Both corporate taxpayers and the tax bar cried foul and

I.R.C. § 163(i) is not deductible, but instead is treated as a dividend; I.R.C. § 163(f) denies an interest deduction for interest paid or incurred on certain "registration-required obligations" which are not in registered form; I.R.C. § 163(g) reduces the amount of the interest deduction for interest paid or incurred on indebtedness with respect to which a § 25 mortgage credit certificate has been issued; and I.R.C. § 163(j), the so-called "earnings stripping" provision, denies an interest deduction for interest paid by a corporation to a related person if the corporation has excess interest expense for a year (as defined in I.R.C. § 163(j)(2)(B)) and a debt equity ratio of more than 1.5 to 1.

Other provisions also limit the deductibility of interest. *See, e.g.*, I.R.C. § 264 (disallowing interest on debt used to purchase or carry a single premium life insurance, endowment or annuity contract or any life insurance policies covering the life of officer, employees or similar individuals); I.R.C. § 265 (disallowing interest incurred to purchase or carry tax-exempt securities); I.R.C. § 266 (disallowing carrying charges chargeable to a capital account); I.R.C. § 267 (disallowing interest with respect to transactions between related persons); I.R.C. § 272(b)(1)(M) (limiting a corporation's ability to carry back net operating losses attributable to corporate equity reduction transactions ("CERTs")); I.R.C. § 279 (disallowing a deduction for interest on certain corporate acquisition indebtedness); I.R.C. § 1055 (addressing the treatment of redeemable ground rents and real property subject to liabilities). Notwithstanding the foregoing limitations, the general rule remains one of deductibility.

80. On September 6, 1990, Rep. Fortney Stark (D. Cal.) introduced the "Interest Equity Act of 1990," H.R. 5557, 101st Cong., 2d Sess. (1990); *see also* 136 CONG. REC. H7219 (daily ed. Sept. 6, 1990). Although the so-called "Democratic Alternative" introduced by the House Ways and Means Committee on October 15, 1990, did not contain any provision like Rep. Stark's proposal, the Senate Finance Committee's "Revenue Reconciliation Act of 1990" contained a provision practically identical to the Stark proposal. *See Ways and Means Releases Summary of Democratic Budget Alternative*, 90 TAX NOTES TODAY 211-7, Oct. 16, 1990, available in LEXIS, Fedtax Library, TNT File; *Senate Finance Comm. Report for Revenue Reconciliation Act of 1990*, 90 TAX NOTES TODAY 212-31, Oct. 16, 1990, available in LEXIS, Fedtax Library, TNT File. Section 7462 of the Senate bill would have added § 163(k) to the Code. The new section would have been entitled "Disallowance of Deduction for Interest on Unpaid Corporate Taxes."

The proposal had a very simplistic objective: equalizing the treatment of corporations and individuals. That objective is simplistic because corporations are taxed differently from individuals in many respects. For example, corporations are subject to a different alternative minimum tax, are entitled to a deduction for all or part of the amount of dividends received, cannot deduct capital losses except to the extent of capital gains, are not subject to the concept of adjusted gross income, receive no standard deduction or personal exemptions, and incur no gift tax liability when they make gifts.

For a more thorough exploration of the differences in the income taxation of corporations and individuals, see BORIS I. BITTKER & JAMES J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* §§ 5-1 to 5-10 (5th ed. 1987). The principle of horizontal equity does not require that all taxpayers be treated similarly; it requires only that similarly situated taxpayers be treated similarly. The focus of the inquiry should therefore be on whether corporate and individual taxpayers are similarly situated with respect to the payment of interest on tax deficiencies.

81. The bill would have equalized the situation by adding a provision which would have disallowed any deduction for any deficiency interest paid by any taxpayer. Thus, section 2 of the bill would have added a new subsection to § 163, as follows:

promptly mounted a full court press to demonstrate the folly of such a misguided idea.⁸²

In large part, they succeeded. The Revenue Reconciliation Act of 1990⁸³ does not deny corporations a deduction for deficiency interest. It does, however, increase the rate of interest in the case of large underpayments, defined as those totaling \$100,000 or more for any taxable year.⁸⁴

(k) Disallowance of deduction for interest paid on tax obligations.

(1) In general. In the case of any taxpayer, no deduction shall be allowed under this chapter for interest on tax obligations paid or accrued during the taxable year.

(2) Interest paid or accrued on tax obligations. For purposes of this subsection, the term 'interest paid or accrued on tax obligations' means any interest paid or accrued on the following amounts:

(A) Any amount required to be paid by the Internal Revenue Code of 1986;

(B) Any amount for which a deduction is allowed under Section 164 of the Internal Revenue Code of 1986;

(C) Any additions to taxes that are described in (A) and (B) above; or

(D) Any amount for which a tax credit is allowed under Section 901 or 903 of the Internal Revenue Code of 1986.

The new provision would have applied to payments made after January 1, 1991. *Id.* § 3.

Because § 163(k), as proposed, would have disallowed all deductions for deficiency interest, it would have made it clear that Congress did not disagree with the Treasury's interpretation of the scope of § 163(h)(2), as reflected in Temp. Treas. Reg. § 1.163-9T (1987). Far from disapproving of that interpretation, Congress would have almost explicitly approved it. For a critique of the position taken in Temp. Treas. Reg. § 1.163-9T, see Brennan & Megaard, *supra* note 78.

82. On October 15, 1990, Tax Notes published a letter by James S. Eustice, of counsel for the firm of Kronish, Lieb, Wiener & Hellman, New York, dated September 27, 1990, in which Mr. Eustice enumerated at least ten reasons why Rep. Stark's bill should be rejected as "tax policy at its worst." *Letters to the Editor*, 49 TAX NOTES 355, 356 (1990). Mr. Eustice was not alone in his opposition to Rep. Stark's bill.

On September 26, 1990, several members of the Section of Taxation of the American Bar Association, speaking for themselves and not for the American Bar Association or the Section of Taxation, filed extensive Comments on Rep. Stark's bill. See *ABA Section Members Oppose Bill Denying Corporations a Deduction for Interest Paid on Tax Deficiencies*, 90 TAX NOTES TODAY 200-26, Sept. 28, 1990, available in LEXIS, Fedtax Library, TNT File. The Comments concluded that "the proposal has nothing to recommend it and should not be included in any deficit reduction package." *Id.*

On September 26, 1990, William M. Paul, of Covington & Burling, wrote to Roy Strowd, Attorney Advisor at Treasury's Office of Tax Legislative Counsel, enclosing a list of 14 points for the Office of Tax Policy to consider in evaluating Rep. Stark's bill. *Covington and Burling Suggest Numerous Reasons Why Interest Disallowance Proposal is Inappropriate*, 90 TAX NOTES TODAY 210-56, Oct. 15, 1990, available in LEXIS, Fedtax Library, TNT File.

On September 28, 1990, a group of nearly 90 corporations and industry associations wrote to Kenneth W. Gideon, Assistant Treasury Secretary For Tax Policy, to voice their opposition to the proposed disallowance of interest paid on corporate tax underpayments. *Corporations Oppose Limiting Deductions for Interest Paid on Tax Obligations*, 90 TAX NOTES TODAY 210-54, Oct. 15, 1990, available in LEXIS, Fedtax Library, TNT File.

83. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11341(a), 104 Stat. 1388-1470 (1990).

84. The Act amended § 6621 by adding § 6621(c). Section 6621(c) provides that 30 days after the earlier of either the date that the first letter of proposed deficiency is sent (the 30-day letter) or

The increase is two percentage points and applies only after the taxpayer receives a notice of deficiency or proposed deficiency.⁸⁵ Practitioners have dubbed the increased rate "hot interest."⁸⁶

The enactment of the hot interest provision does not resolve the question of the proper federal income tax treatment of deficiency interest. Under current law, corporate taxpayers can easily use the federal government as an unquestioning provider of funds at costs that have nothing to do with the creditworthiness of the corporation, the value or existence of collateral, or the length of time for which the loan will be outstanding. The net operating loss carryback provisions,⁸⁷ the quick refund proce-

the date that the deficiency notice provided by § 6212 is sent (the 90-day letter), interest on certain large underpayments of tax due from corporate taxpayers will begin to accrue at a rate five percentage points above the federal short-term rate, rather than the usual three percentage points above the federal short-term rate, as provided by § 6621(b). In cases where the deficiency procedures do not apply, interest begins to accrue at the increased rate 30 days after the Service sends the first notice of assessment or proposed assessment. Section 6621(c) generally applies to interest which accrues after December 31, 1990.

On December 14, 1990, the Treasury issued a Notice of Proposed Rulemaking and Temporary Regulations (T.D. 8325, 1991-1 C.B. 233) implementing § 6621(c) and setting forth certain transitional rules. The Service has suggested that the only way to avoid the imposition of the higher rate of interest is either to pay the tax or make a deposit in the nature of a cash bond pursuant to Rev. Proc. 84-58, 1984-2 C.B. 501. See *Corporate Taxes, Increased Interest Rate Applies to Amounts Being Litigated in Tax Court*, BNA DAILY TAX REP., Dec. 31, 1990, available in LEXIS, Fedtax Library, BNA/DTR File.

85. This provision, too, has been assailed as "a poorly-thought-out, ill-advised attempt to raise revenues through manipulation of tax procedural rules." Richard C. Stark, *The Hot Interest Nightmare*, 50 TAX NOTES 1409, 1417 (1991). See also Donald C. Alexander & Michael I. Saltzman, principal authors, *NYSBA Calls for Change in Large Corporate Underpayment Provisions*, 91 TAX NOTES TODAY 125-77, June 11, 1991, available in LEXIS, Fedtax Library, TNT File, reprinted sub nom. *New York State Bar Association Tax Section Committee on Practice and Procedure, Report on Section 6621(c) Providing for Increased Interest Rate on Large Corporate Deficiencies and Temp. Reg. 301.6621-3T*, 52 TAX NOTES 203 (1991) (hereinafter *Report on Section 6621(c)*). That it may have been poorly thought out is not surprising, however, because it was the product of a political compromise, and received little deliberate thought. *Id.* at 204-05.

The proposed regulations under § 6621(c) have also produced considerable controversy. See, e.g., *Public Comments on Proposed Regulations*, 51 TAX NOTES 34-36 (1991), noting six separate comment letters filed by: Price Waterhouse (91 TAX NOTES TODAY 71-27), the Chemical Manufacturers Association (91 TAX NOTES TODAY 72-21), Ernst & Young (91 TAX NOTES TODAY 73-32), Sun Company (91 TAX NOTES TODAY 73-33), the Tax Section of the District of Columbia Bar Association (91 TAX NOTES TODAY 73-34), and KPMG Peat Marwick (91 TAX NOTES TODAY 73-35), all available in LEXIS, Fedtax Library, TNT File. All of those comments were critical. At a hearing held on April 2, 1991 on the proposed regulations, those who testified were also critical of the proposals. See Juliann Avakian-Martin, *IRS Lukewarm to Industry Coolness Over Proposed Hot Interest Regs*, 51 TAX NOTES 13 (1991).

86. See, e.g., Stark, *supra* note 85; Avakian-Martin, *supra* note 85.

87. Section 172 allows a taxpayer to carryback a net operating loss 3 years. I.R.C. § 172(b). Thus, a taxpayer that takes a return position which results in a net operating loss for that year may use that position to obtain a refund of taxes previously paid.

dure⁸⁸ and the length of time that it takes to settle a tax controversy⁸⁹ all make that possible.⁹⁰ By taking an aggressive return position, a financially distressed corporate taxpayer can receive (or free up) capital on terms which no commercial lender would provide.⁹¹ By treating deficiency interest as interest and allowing corporate taxpayers to deduct it, the Code treats such taxpayers as if they had actually borrowed from a commercial lender. Such favorable treatment invites exploitation because a taxpayer that frees up capital either by underpaying its taxes or by receiving a refund which it must ultimately repay is in a very different position from a taxpayer that borrows from a commercial lender. An examination of the quick refund procedure shows the extent to which this is true.

Under the quick refund procedure, a taxpayer can file a claim for a refund of amounts paid for a taxable year affected by a net operating loss carryback.⁹² The Service must act on the claim within 90 days.⁹³ In

88. Section 6411 allows taxpayers to file a claim for a tentative carryback adjustment for a taxable year affected by a net operating loss carryback. Section 6411(d) allows a taxpayer to obtain a quick refund of tax due under § 1341(b) (relating to repayments of amounts received under a claim of right). Section 6425 allows the taxpayer to obtain an even quicker refund of an overpayment of estimated tax. The Service has to act on an application for such a refund in 45 days. Treas. Reg. § 1.6425-3 (1970).

Section 6405(b) provides that § 6405(a), which requires submission of information on any refund claim for more than \$1,000,000 to the Joint Committee on Taxation 30 days prior to payment, does not apply to credits or refunds due as a result of a tentative carryback adjustment.

89. Although much has been said and written about a tax court backlog, the length of time it takes to settle a tax controversy is attributable to more than any tax court backlog that might exist. It takes time for an audit to begin and even more time to finish. It is not unusual for the process to take several years. Once a deficiency is assessed, resolution through the courts is not immediate. See Meade Whitaker, *Some Thoughts on Current Tax Practice*, 7 VA. TAX REV. 421 (1988); William F. Nelson & James J. Keightley, *Managing the Tax Court Inventory*, 7 VA. TAX REV. 451 (1988).

90. That taxpayers can use the quick refund procedure to obtain a quick infusion of cash from the federal government does not suggest that the provisions which allow it are inherently flawed. The provisions exist for sound reasons, and the length of time it takes to resolve tax matters often results from the complexity of the matters and from other factors unrelated to the taxpayer's desire to obtain quick cash. See *supra* note 89. Nevertheless, the existence of the provisions and the frequency with which they are used suggests that there is an opportunity for taxpayers to obtain funds on terms very different from those which the typical commercial lender would require.

91. The Supreme Court recognized this possibility as early as 1942. In *Meilink v. Unemployment Reserves Comm'n*, 314 U.S. 564, 567 (1942), the Court noted: "A rate of interest on tax delinquencies which is low in comparison to the taxpayer's borrowing rate - if he can borrow at all - is a temptation to use the state as a convenient, if involuntary, banker by the simple practice of deferring the payment of taxes."

92. I.R.C. § 6411(a).

93. I.R.C. § 6411(b). Treas. Reg. § 301-6411-1(a) (1967); Treas. Reg. § 1.6411-3(a) (1974); Rev. Rul. 78-369, 1978-2 C.B. 324, amplified by Rev. Rul. 84-175, 1984-2 C.B. 296; see Pearl Zarnow v. Commissioner, 48 T.C. 213 (1967); Rev. Rul. 67-313, 1967-2 C.B. 413. The claim is filed on form 1139 (corporations) or 1045 (individuals). Treas. Reg. § 1.6411-1(b) (1960). See HARROP A. FREE-

addition to the speed with which the Service must act on the claim, the procedure is notable because the Service's review is limited to the correctness of mathematical computations and the application of the text of the law.⁹⁴ Moreover, the Service will issue the refund even when the amount of the refund is in excess of \$1,000,000, which would normally require the Joint Committee's concurrence.⁹⁵ The quick refund procedure thus gives taxpayers a tremendous opportunity to receive an infusion of funds, subject only to the usual rules regarding the reasonableness of positions taken on tax returns. Indeed, the authors of a treatise on tax practice openly acknowledge that the quick refund procedure serves to inject "a new transfusion of financial blood into a loss corporation."⁹⁶

No commercial lender would remit funds after verifying only the mathematical correctness of the application. Of course, the ease with which a taxpayer can receive money under the quick refund procedure might be justified on the ground that the taxpayer is only asking for its own money back. Such a taxpayer, the argument would run, should have to do no more to obtain that money than if the taxpayer had merely failed to remit it in the first place.⁹⁷ Yet, in that argument lies the problem. As a matter of policy, a taxpayer that either receives a quick refund or is simply deficient in the payment of its tax liability *ab initio* is in such a different position from one who borrows money from a commercial lender that it should be treated differently for tax purposes. The addi-

MAN & NORMAN D. FREEMAN, *THE TAX PRACTICE DESKBOOK* ¶ 7-1, at 7-22 (1973) & Supp. at S7-10 (1990); MICHAEL I. SALTZMAN, *IRS PRACTICE AND PROCEDURE* ¶ 11.03, at 11-12 (2d ed. 1991).

94. Thus, regulations specifically preclude the examining officer from making adjustments in "the amount claimed on the return as a deduction for depreciation because he believes that the taxpayer has claimed an excessive amount; likewise, he will not include in gross income any amount not so included by the taxpayer, even though such officer believes that such amount is subject to tax and properly should be included in gross income." Treas. Reg. § 1.6411-3(b) (1974). Rev. Rul. 78-369, 1978-2 C.B. 324, confirms that the taxpayer's claim must be allowed if it contains no omissions or errors of computations. Indeed, in the situation posed in that ruling, the claim was allowed even though a deficiency had been proposed for the year to which the net operating loss was carried and the proposed deficiency exceeded the amount of the tax plus the amount of the loss.

95. I.R.C. § 6405. See *supra* note 88.

96. FREEMAN & FREEMAN, *supra* note 93, ¶ 7-1, at 7-22 & Supp. at S7-10; see also SALTZMAN, *supra* note 93, ¶ 11.03, at 11-12 ("[A] business may have an urgent need for a prompt refund of tax . . .").

97. One difficulty with this argument is that it does not apply to all refunds. The procedure with respect to refunds other than the quick refunds allowed by §§ 6411 and 6425 differs from the procedure for regular refunds both in the length of time in which the Service must act and in the standard of review which it must apply. I.R.C. §§ 6404, 6405; see FREEMAN & FREEMAN, *supra* note 93, ¶ 7-1, at 7-8 to 7-11, 7-18 to 7-22 & Supp. at S7-5.

tional amounts paid, though labeled interest in both cases, are so different that they merit different tax treatment.

A tax system that fails to recognize and treat these additional amounts differently fails to treat transactions in accordance with their substance. Such a system also encourages the use of taxation as a tool of corporate finance, which is both expensive for the government⁹⁸ and inequitable with respect to individual taxpayers. It also calls into question the characterization of deficiency interest as interest.

A. *The Difference Between Interest and Damages*

Interest has long been defined as an amount paid for the use or forbearance of money.⁹⁹ The traditional analysis has stopped there, and much energy has been spent trying to identify amounts which embody those characteristics.¹⁰⁰ But perhaps the analysis should continue. To determine whether an amount is interest or something else, the law should begin by identifying the elements of a transaction in which interest unquestionably exists.

A commercial lending transaction provides the perfect benchmark for comparison.¹⁰¹ In a commercial transaction one party transfers

98. Even if the rate at which the government borrows money was precisely the same as the deficiency interest rate, the existence of a tax deficiency leaves the government in a loss position because of the transactional costs of asserting and collecting the deficiency and the costs inherent in the existence of deficiencies which the government never discovers, assesses and collects.

99. See *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965); *Deputy v. DuPont*, 308 U.S. 448, 498 (1940); *Old Colony R.R. v. Commissioner*, 284 U.S. 552, 560 (1932) (defining interest as "the amount which one has contracted to pay for the use of borrowed money"); *Investors Ins. Agency v. Commissioner*, 677 F.2d 1328, 1333 (9th Cir. 1982). In *United States v. Childs*, 266 U.S. 304 (1924), the Court explained that interest was "a means of compensation. Bouvier[*'s* Law Dictionary] defines it to be 'a consideration paid for the use of money or for forbearance in demanding it when due.'" *Id.* at 307.

100. See *supra* note 8.

101. Commercial interest provides an ideal standard for comparison for several reasons. First, in a commercial lending transaction the parties are, by hypothesis, dealing at arm's length. Second, the Code itself sets transactions undertaken by parties dealing at arm's length as the standard by which the tax characterization of specific transactions are measured. See, e.g., I.R.C. § 482 (adopting the arm's length standard to determine the real nature of transactions between related parties); Treas. Reg. § 20.2031-1(b) (as amended in 1965) (defining fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts"). The arm's length standard appears to be the tax law's equivalent of the tort law's reasonable person.

Third, the Supreme Court agrees. In *Meilink v. Unemployment Reserves Comm'n*, 314 U.S. 564 (1942), the Court looked to commercial interest to determine whether an amount set by a California statute represented interest due priority even in bankruptcy, or a penalty, not entitled to such priority. It also noted that the legislature's decision to "include compensation to the state for the increased costs of administration in the exaction for delay in paying taxes" did not convert the amount

money to a second party and the second party agrees to repay the amount transferred, with interest to compensate the first party for having parted with the money. Like the transactions which result in the payment of interest under the traditional analysis, a commercial transaction involves one party's use or forbearance of another's money. It fits the traditional and accepted definition of the term interest.¹⁰²

However, a transaction that results in the payment of commercial interest possesses at least one other characteristic which the law ought to consider. Commercial interest results from a voluntary transaction in which the parties expect an extension of credit to exist. Voluntariness is also a common element in many of the transactions in which courts have struggled to identify the existence of interest. Such transactions, which include interest free loans and installment sales as well as transactions that contain original issue discount, all involve consensual transactions, the economic consequences of which are both expected and intended.¹⁰³ Taxpayers and the government have differed only about what those economic consequences are.

The suggestion that there should be a consensual extension of credit in any transaction found to carry an amount labeled interest follows from the seminal definition of interest. The law should not conclude that an amount was paid for the "use or forbearance of money"¹⁰⁴ unless one party allows another to use its money or willingly forbears its collection.¹⁰⁵ Two factors should coalesce. There should be an extension of

into a penalty. *Id.* at 567. Unfortunately, the Court limited its analysis to distinguishing interest from penalties and did not consider whether the compensatory nature of the amounts in question made them something else. *See also* *Dupont v. Dupont*, 308 U.S. 488, 498 (1940).

102. *See supra* note 99.

103. In all of these transactions, as well as in other delayed payment transactions, the parties agree on the amount to be paid and the time at which it is to be paid.

104. The Supreme Court has so defined interest. *See supra* note 99.

105. The tax court has noted that "for a transaction to be considered a loan, both parties to the transaction at the time the funds were furnished must have reached an actual agreement to establish a debtor-creditor relationship." *Barrow v. Commissioner*, 45 T.C.M. (CCH) 935, 937-38, 937 n.2 (1983). More recently, the tax court has emphasized the importance of the existence of a loan. In *Albertson's Inc. v. Commissioner*, 95 T.C. 415 (1990), the tax court had to decide whether an amount designated as interest under certain nonqualified deferred compensation arrangements and accrued by the employer was deductible as interest when accrued. The court held that it was not interest because there was no loan. First, the court reviewed the standard definitions of interest and concluded that "[i]mplicit in these . . . definitions of interest is the concept that interest is a payment for the use of money that the lender had the legal right to possess, prior to relinquishing possession rights to the debtor." *Id.* at 421. The court concluded that the amounts in question did not "constitute liabilities owed to the [employees] for the 'forbearance' of money whose payment had become due." *Id.* at 422. As the court noted:

The fact that certain amounts are described as interest by the parties to an agreement

credit and the extension of credit should be consensual. Courts have long recognized the need to find an extension of credit.¹⁰⁶ Perhaps they should now acknowledge the importance of consent.

The terms "use" and "forbearance" imply a voluntary act.¹⁰⁷ The

and are calculated by applying a percentage rate per annum to some principal amount does not mean that the amounts will be deductible as interest for income tax purposes. *Autenreith v. Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940), *aff'g*. 41 B.T.A. 319 (1940).

[The employees] never had any legal basis to demand payment of the deferred amounts, and [the employer] never had an obligation to pay deferred compensation in the year in issue. [The employer] could not have "borrowed" something from the [employees] that [the employees] never had the right to possess. One cannot forgo something to which one *never* had a right. One cannot lend that which one *never* had a right to possess, and [the employer] cannot *borrow* money that it *always* had the right to possess.

Id. at 423 (emphasis in original).

Although *Albertson's* addresses what is essentially a question of timing because the court need not decide whether the amounts, when actually paid, represent interest, it is nonetheless illuminating. The court's analysis is perceptive, and supports the conclusion that deficiency interest is not interest. As with the amounts deferred by the employer in *Albertson's*, a taxpayer who has been assessed a deficiency should not be treated as a borrower of money which it is claiming is its own money. *Albertson's* stands for the proposition that an amount should not be treated as interest for tax purposes unless there is a loan. Like the employer in *Albertson's*, a taxpayer who must pay the amount of a deficiency does not pay interest thereon because there is no loan.

106. For example, in *Autenreith v. Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940), *aff'g*. 41 B.T.A. 319 (1940), the court noted that "in order to be deductible [interest] must be paid on indebtedness, which, under the Revenue Acts, means on an unconditional and legally enforceable obligation for the payment of money." See also *Commissioner v. Park*, 113 F.2d 352 (3d Cir. 1940); *Barrow v. Commissioner*, 45 T.C.M. (CCH) 935, 937-38, 938 n.2 (1983); *Albertson's Inc. v. Commissioner*, 95 T.C. 415 (1990).

Similarly, the Supreme Court has acknowledged the need to find an extension of credit, a loan, before finding income from the discharge of indebtedness. In *United States v. Centennial Sav. Bank FSB*, 111 S. Ct. 1512 (1991), discussed in the text accompanying notes 75-77, *supra*. The significance of *Centennial* is not in its holding but in the Court's analysis. To the extent that the Court began by deciding whether the parties had created an indebtedness, *Centennial* supports the analytical approach suggested here.

107. *Id.* The Court's employment of the terms use and forbearance in tandem contemplates a voluntary, not a manipulative, exploitative or otherwise nonconsensual, act. Use or forbearance can fairly be distinguished from seizure, confiscation or impoundment, all of which imply an absence of voluntariness or consent. WEBSTER'S NEW TWENTIETH CENTURY DICTIONARY 2012 (Deluxe Color, Unabridged 2d ed. 1977) defines the term "use" as:

1. the act of using or the state of being used. usage; 2. the power or ability to use; as, he has regained the *use* of his hand. 3. the right or permission to use; as, he granted them the *use* of his name. 4. the need, opportunity, or occasion to use; as, we will have no further *use* for his services. 5. way of using. 6. the quality that makes a thing useful or suitable for a given purpose; advantage; usefulness; worth; utility. 7. the object, end, or purpose for which something is used. 8. function; service. 9. constant, continued, customary, or habitual employment, practice, or exercise, or an instance of this; custom; habit; practice; wont. 10. in law, (a) the enjoyment of property, as from occupying, employing, or exercising it; (b) [influenced by OFr. *ues*, gain, from L. *opus*, a work.] profit, benefit, or advantage, especially that of lands and tenements held in trust by an

retention of money owed notwithstanding that the party to whom it is owed has demanded payment produces a transaction which does not involve a consensual extension of credit. Instead, it produces a transaction in which one party injures another. Thus, any amounts eventually paid to the injured party should be treated as damages. Where a tax deficiency exists, the government has demanded payment and has not consented, either explicitly or implicitly, to the taxpayer's retention of the amounts due¹⁰⁸ — the government has been involuntarily injured by the taxpayer's retention of the amount owed. The amounts due from the taxpayer should therefore not be treated as interest, but as damages.

Courts have recognized the importance of a consensual extension of credit to a finding that an amount is interest for tax purposes.¹⁰⁹ In a series of cases involving the condemnation of property by a state, courts made clear that interest requires a voluntary extension of credit in the exercise of the power to borrow. Thus, courts have consistently held that an amount labeled interest paid by a state in connection with the con-

other. 11. in liturgy, the particular form of ritual or liturgy practiced in a given church, diocese, etc.; as, the Lutheran *use*. 12. common occurrence. [Rare.]

It defines the term forbearance as:

1. the act of forbearing. 2. the quality of being forbearing; self-control; patient restraint. Have a continent *forbearance*, till the speed of his rage goes slower. -Shak. 3. in law, an extension of time for the payment of a debt.

Id. at 715. All of the foregoing definitions imply a consensual act.

108. *See infra* text accompanying notes 144-56.

109. Even the early cases seem to have recognized the importance of consent. *See* cases cited *supra* note 99. In *Old Colony v. Commissioner*, 284 U.S. 552 (1932), the Court noted that "the usual import of the term [interest] is the amount which one has contracted to pay for the use of borrowed money." *Id.* at 560. In *Deputy v. Dupont*, 308 U.S. 488 (1940), the Court also recognized that finding a consensual agreement to borrow and lend was essential to a finding of something that could be characterized as interest for federal income tax purposes. In that case the Court began by acknowledging the importance of finding an indebtedness and then went on to explain that "although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of the [predecessor of § 163]." *Id.* at 497. The Court in *Dupont* specifically rejected the notion that all carrying charges could be interest even though all of them might give rise to an obligation. *Id.*

In 1957 the Court of Appeals for the Second Circuit used the existence of consent to analyze the question of whether an amount labeled interest on a condemnation award should be considered interest for purposes of the personal holding company tax. *See 320 East 47th St. Corp. v. Commissioner*, 243 F.2d 894 (2d Cir. 1957). In that case, the court saw the issue as whether interest included amounts paid for the use of money without the taxpayer's consent. *Id.* at 896. Unfortunately, like the Ninth Circuit in *Commissioner v. Raphael*, 133 F.2d 442 (9th Cir. 1943), the Second Circuit in *320 East 47th St. Corp.* relied on *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84 (1934), to reach its decision. It concluded that the amount in question was interest because Congress must have meant to include such amounts within the definition of personal holding company income. The court apparently did not feel that it could reach what it thought was the correct result—including the amounts in income—without concluding that they were interest.

demnation of a taxpayer's property is not interest within the meaning of section 103 because the amount is not paid in the exercise of the state's borrowing power.¹¹⁰ In *Holley v. United States*,¹¹¹ the court specifically distinguished cases in which the state had purchased land from cases in which it had condemned it. It noted that the purchase cases involved a consensual transaction whereas the condemnation cases did not.¹¹² The court thus made the existence of a consensual transaction determinative.

The analysis that the courts have employed in this area is sound — the courts determine the purpose of the statutory provision and use that

110. See, e.g., *Stewart v. Commissioner*, 714 F.2d 977 (9th Cir. 1983); *Drew v. United States*, 551 F.2d 85 (5th Cir. 1977); *American Nat'l Bank v. United States*, 421 F.2d 442 (5th Cir. 1970); *Holley v. United States*, 124 F.2d 909 (6th Cir.), *cert. denied*, 316 U.S. 685 (1942); *Conyngnam v. Commissioner*, 81 F.2d 1017 (3d Cir. 1936) (per curiam); *Robinson v. Commissioner*, 80 F.2d 1018 (2d Cir. 1935), *cert. denied*, 298 U.S. 663 (1936); *J. & J. Rogers Co. v. Helvering*, 80 F.2d 1014 (2d Cir. 1936) (per curiam); *Baltimore & O.R.R. v. Commissioner*, 78 F.2d 460 (4th Cir. 1935); *United States Trust Co. v. Anderson*, 65 F.2d 575 (2d Cir.), *cert. denied*, 290 U.S. 683 (1933); *Williams Land Co. v. United States*, 31 F. Supp. 154 (Ct. Cl. 1940); *Posselius v. United States*, 31 F. Supp. 161 (Ct. Cl. 1940); *Wiltzie v. United States*, 3 F. Supp. 743 (Ct. Cl. 1933), *cert. denied*, 291 U.S. 664 (1934); *King v. Commissioner*, 77 T.C. 1113 (1981); *Schoen v. Commissioner*, 30 B.T.A. 1075 (1934); *Bandes v. Commissioner*, 28 B.T.A. 99 (1933); *Bliss v. Commissioner*, 27 B.T.A. 803 (1933); *Isham v. Commissioner*, 26 B.T.A. 1040 (1932); *Klein v. Commissioner*, 26 B.T.A. 745 (1932); *Barrow v. Commissioner*, 45 T.C.M. (CCH) 935 (1983); Rev. Rul. 72-77, 1972-1 C.B. 28, *superseding* Gen. Couns. Mem. 10,043, 10-2 C.B. 124 (1931); *Iske v. Commissioner*, 39 T.C.M. (CCH) 1161 (1980), *aff'd*, 636 F.2d 1225 (8th Cir. 1980) (affirming tax court in unpublished opinion), *cert. denied*, 451 U.S. 909 (1981).

Although these cases purport to determine whether the obligation to pay a percentage rate is an "obligation" within the meaning of § 103 or its predecessors, and with one exception (*Holley v. United States*, 124 F.2d 909 (6th Cir.), *cert. denied*, 316 U.S. 685 (1942), where the court found the amount labelled interest to be part of the award itself, following the reasoning of *Seaboard Air Line Ry. v. United States*, 261 U.S. 299 (1923), see *supra* notes 27-29 and accompanying text), do not explicitly consider whether the amounts are interest, it is the reasoning employed by all of these courts, and even by the Service, that is significant. It is significant that the courts explicitly consider whether the amounts are paid in the exercise of the state's (or municipality's) borrowing power, and that their conclusion that they are not is determinative of whether the amounts are exempt from federal income tax under § 103 or its predecessors. That most of these courts do not consider the interest question separately is simply another example of the problem addressed in this Article: the assumption that compensatory amounts measured by a percentage rate are interest.

111. 124 F.2d 909 (6th Cir.), *cert. denied*, 316 U.S. 685 (1942).

112. The court in *Holley* held:

The decisions cited by appellant deal with situations where interest on obligations actually created by the borrowing power was held to be exempt under the statute. Cases where landowners voluntarily sold property to governmental units [Commissioner v. Meyer, 2 Cir., 104 F.2d 155; Kings County Development Co. v. Commissioner, 9 Cir., 93 F.2d 33] [*cert. denied*, 304 U.S. 559 (1938)] are not controlling here.

124 F.2d at 911. In so doing the court accepted the distinction between consensual transactions, which can give rise to the extension of credit and the payment of interest, and transactions which are not consensual. See also *Kings County Dev. Co. v. Commissioner*, 93 F.2d 33, 34 (9th Cir. 1937), *cert. denied*, 304 U.S. 559 (1938).

purpose to establish whether the amounts in question should constitute interest.¹¹³ The Service has also employed this analysis.¹¹⁴ The analysis, as employed by the courts and by the Service in the condemnation cases, asks the question suggested here: Did the transaction involve a consensual extension of credit? If it did, the amounts should be treated as interest. If it did not, they should not.

As in the condemnation cases, the existence of a consensual extension of credit should be critical in determining whether an amount is interest generally. Using such an analysis will ensure that amounts will be treated as interest for tax purposes only when doing so is consistent with the purpose for the existence of the interest deduction.¹¹⁵ Although Congress failed to set forth its original reason for enacting an interest deduction,¹¹⁶ the deduction is now acknowledged to be necessary to achieve equity between those who possess and those who borrow capital.¹¹⁷ By treating the cost of capital as a cost of producing income, the interest deduction reduces the cost of capital and thus encourages capital

113. See *supra* notes 110-12 and accompanying text.

114. Rev. Rul. 72-77, 1972-1 C.B. 28. In that ruling the Service held:

The obligation of a State to pay compensation for property taken for public purposes arises as a result of the exercise of a State's power of eminent domain, not as a result of, or in the course of, the exercise of a State's borrowing power. Therefore, a tax upon the interest paid on such an obligation does not adversely affect the State's power to borrow money.

Although the Service began its analysis correctly, it made a common misstep when it failed to consider whether the state's failure to provide compensation in eminent domain proceedings, as an exercise of its borrowing power, made the unpaid amounts something other than interest. One possible explanation of the Service's failure to take this extra analytical step is that the issue before it was only whether the amounts in question were interest for the purposes of the § 103 exemption. Finding that the amounts did not fall into the exception, the Service did not need to reach the question of how the amounts should be classified.

115. An emphasis of the consensual nature of a transaction should not inhibit the tax law's ability to find hidden interest. See *supra* note 8 and accompanying text.

116. See, e.g., Asimow, *supra* note 1, 749-50; Alvin C. Warren, *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1586 (1974); Michael Asimow, *Principle and Prepaid Interest*, 16 UCLA L. REV. 36, 62-63 (1968). See also Calvin H. Johnson, *Is An Interest Deduction Inevitable?*, 6 VA. TAX REV. 123 (1986); Michael J. MacIntyre, *An Inquiry Into the Special Status of Interest Payments*, 1981 DUKE L.J. 765, 774; Alan Gunn, *Is An Interest Deduction For Personal Debt a Tax Expenditure?*, 1979 CANADIAN TAX'N 46 (Winter).

117. In *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), the court articulated the reason for the existence of the interest deduction as follows: "[I]f an individual or corporation desires to engage in purposive activity, there is no reason why a taxpayer who borrows for that purpose should fare worse from an income tax standpoint than one who finances the venture with capital that otherwise would have been yielding income." *Id.* at 741. See also William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 625 (1971).

formation.¹¹⁸ However, by permitting taxpayers to contest the assessment of a proposed deficiency prior to paying it, the government is seeking neither to reduce the cost of capital nor promote capital formation.¹¹⁹ If the amounts due as a result of the delay in payment of taxes are to be deductible, policies germane to tax administration and enforcement should determine their deductibility. Policies applicable to the deductibility of qualitatively different, consensually determined amounts are inapposite, and should be irrelevant.

Consider two bilateral transactions. In the first transaction, one party loans another \$100. The parties agree that repayment will occur on a date certain and will include interest at a stated rate. On the appointed date the borrower repays the loan, with interest at the stated rate. In the second transaction, one party performs a service for another and the other party agrees to pay therefor on a date certain. On the appointed date the recipient of the services refuses to pay.¹²⁰ The service provider then brings a lawsuit and receives an award of \$100, the value of the services provided, plus an amount labeled interest from the date the money was due. Now consider whether the recipients of the monies in those two transactions are in the same position.

In the first transaction one party agreed to lend another money, and to collect a specific amount for so doing. The transaction is the prototypical commercial lending transaction. In this transaction, one party allows another to use its money or agrees to forbear the collection thereof until an appointed time. There is consent to the postponement of receipt and therefore there is no injury. The amount labeled interest in this

118. In *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 301 (Ct. Cl. 1967), the Court of Claims noted that "[i]nterest, like an ordinary business expense, is allowed as a deduction from income because it is a cost of producing income." Interest payments are as much a part of producing income as any other business expense, thus, denying deductibility would make the tax "pro tanto" a levy on gross income.

119. I.R.C. § 6213. See SALTZMAN, *supra* note 93, ¶ 1.05[1], at 1-29 to 1-30 ("Under the deficiency method, a taxpayer may, without first paying the tax in issue, file a petition in the U.S. Tax Court for a redetermination of the amount of the deficiency the Service claims is due."); see also *Lyddon & Co. v. United States*, 158 F. Supp. 951 (Ct. Cl.), *cert. denied*, 358 U.S. 832 (1958); *Gunn v. Mathis*, 157 F. Supp. 169 (W.D. Ark. 1958). See generally James K. Wilkens & Thomas A. Matthews, *A Survey of Federal Tax Collection Procedure: Rights and Remedies of Taxpayers and Internal Revenue Service*, 1986 ALASKA L. REV. 269; J. Wendell Bayles, *Jurisdiction in Bankruptcy to Contest Tax Liability and Arrest Collection Efforts*, 26 WASHBURN L.J. 423 (1987).

120. The same situation exists when there is a sale of goods rather than the provision of services, and raises the question of whether what is commonly referred to as interest on trade credit in the commercial world is properly viewed as interest or is more accurately viewed as liquidated damages. See SCHWARTZ & SCOTT, *supra* note 13, at 548-53 (quoting JAMES C. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 450-52 (4th ed. 1977)).

transaction is treated as interest because it is the kind of amount which can constitute a cost of doing business.

In the second transaction one party injured another by failing to pay the amount due when it was due. The amount labeled interest in the second transaction is not the type of amount which is an expected cost of doing business and should not be treated under the same rules that govern general costs of doing business. The absence of consent creates an injury and should prevent the amounts paid from being classified as interest.

Two elements should coalesce for interest to exist: there should be a debt¹²¹ and the existence of the debt should arise out of a consensual transaction. Although deficiency interest arises in a situation in which there is a debt, deficiency interest would not be treated as interest under the proposed two pronged test because deficiency interest does not involve the voluntary extension of credit. The government neither transfers money to the taxpayer nor consents to the taxpayer's retention of money.¹²² Nor does the government forbear the collection of the amounts due¹²³ — it is only injured by nonpayment. If an amount paid

121. Courts have long held that interest cannot exist without an underlying indebtedness. *See, e.g.,* *Knetsch v. United States*, 364 U.S. 361 (1960); *Deputy v. DuPont*, 308 U.S. 488, 497-98 (1940); *Investors Ins. Agency v. Commissioner*, 677 F.2d 1328, 1333 (9th Cir. 1982); *Commissioner v. Meyer*, 104 F.2d 155 (2d Cir. 1939); *Baltimore & O.R.R. v. Commissioner*, 78 F.2d 460 (4th Cir. 1935). Indebtedness is an "unconditional and legally enforceable obligation for the payment of money." *Autenreith v. Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940), *quoted in Investors Ins. Agency*, 677 F.2d at 1333. Merely the possibility of a future debt is not indebtedness. *See Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976); *Hutchinson v. United States*, 90-2 U.S. Tax Cas. (CCH) ¶ 50,573 (D. Or. 1990).

122. That there may be an indebtedness in such a situation is not enough. As the Supreme Court noted in *Deputy v. Dupont*, 308 U.S. 488 (1940), that there may be an indebtedness is insufficient because not all indebtedness gives rise to what the Code should characterize as interest. *Id.* at 498.

123. The government does not forbear the collection of the tax, because the government has not consented to the delay in payment. The Code establishes the time at which the payment of tax is due. I.R.C. §§ 6072-6075. The government's failure to seize a taxpayer's assets immediately upon the assessment of a deficiency does not proceed from consent to the existence of the deficiency, but from the structure of our system of government which affords taxpayers constitutional protection of property interests. Thus, §§ 6331-6344 provide detailed rules for the seizure of property for collection of taxes. The Code also ensures that taxpayers will not be deprived of property without due process. Section 6213(a), which provides for a period of time (currently, 90 days) between assessment and collection so that a taxpayer may contest the assertion in tax court, is designed to protect the taxpayer's due process rights. *See Stonecipher v. Bray*, 653 F.2d 398, 403 (9th Cir. 1981); *Gunn v. Mathis*, 157 F. Supp. 169, 177 (W.D. Ark. 1957). The Fifth Circuit has noted that the predecessor of § 6213 (26 U.S.C. [1939] § 272(a)) was "not enacted as a mere idle gesture. The Commissioner is as bound as the taxpayer is by its terms. This is made plain by the language of the statute." *Maxwell v. Campbell*, 205 F.2d 461, 463 (5th Cir. 1953). The Ninth Circuit held that the predecessor of § 6213 (26 U.S.C. [1926] § 274(a)) served as a guarantee to the taxpayer that he shall not be deprived

to compensate for an injury is to be deductible at all, a policy other than that which governs the tax treatment of the costs of doing business or which responds to the desire to encourage capital formation ought to support the deduction.

An analysis of the relative positions of the parties to a tax controversy reveals that deficiency interest differs from commercial interest, and thus from the type of charge which ought to be deductible as interest, in at least two significant respects. First, unlike commercial interest, deficiency interest does not reflect the risks assumed by the parties. It is the product of a statute which neither distinguishes between the varying risks taken by the government with respect to different taxpayers nor takes into account the expected term of any loan that might exist. Economically, it bears little resemblance to commercial, arms-length interest.

Second, unlike commercial interest, deficiency interest is not the product of a transaction which involves the consensual advancement of credit. At no point does the taxpayer agree to borrow and the government agree to lend, and at no point does the government actually lend any money. Nor does the government consent to the taxpayer's late payment of the amount of tax due and voluntarily forbear its collection.

These two distinctions between commercial interest and deficiency interest are explored further below.

1. *The Irrelevance of Risk or Duration.* In a commercial transaction the amount charged as interest normally bears some relationship to factors such as the risk taken by the lender and the duration of the borrowing.¹²⁴ Thus, the greater the risk, the higher the return.¹²⁵ The

of administrative process, and must be read in the light most favorable to the taxpayer. *Ventura Consol. Oil Fields v. Rogan*, 86 F.2d 149, 155 (9th Cir. 1936), *cert. denied*, 300 U.S. 672 (1937). Even the cases which hold that notice and an opportunity to be heard need not always precede a collection action do so on the ground that a taxpayer's ability to sue for a refund protects her due process rights. *See, e.g., Phillips v. Commissioner*, 283 U.S. 589, 599 (1931); *Johnston v. Commissioner*, 429 F.2d 804 (6th Cir. 1970); *Brown v. Lethert*, 360 F.2d 560 (8th Cir. 1966).

124. These are only two of the factors which parties dealing at arms length use in setting the interest rate for a specific loan. *See* EUGENE R. BRIGHAM, *FUNDAMENTALS OF FINANCIAL MANAGEMENT* 60-64 (4th ed. 1986). In a commercial transaction, the characteristics of both the loan and the borrower affect the interest charged. *See* JAMES C. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 450-52 (4th ed. 1977). Thus, although the prime rate serves as a benchmark for the typical loan transaction, the actual interest rate charged varies with a number of factors. *Id.*

The Supreme Court agrees, noting in *Meilink v. Unemployment Reserves Comm'n*, 314 U.S. 564, 567 (1942) that "[i]t is common knowledge that interest rates vary not only according to the general use value of money but also according to the hazard of particular classes of loans."

125. Various factors go into the evaluation of risk. Thus, the borrower's level of debt-to-equity

longer the term of the loan, the higher the charge.¹²⁶ Other factors are also important. Commercial lenders consider the amount of the loan, so that generally the larger the loan, the lower the interest rate.¹²⁷ Even the geographical location of both borrower and lender affect the interest rate.¹²⁸

Deficiency interest rates are not set with regard to any of those factors. The rate charged bears no relationship to the risk of nonpayment or the taxpayer's financial condition. It bears no relationship to the length of time during which the taxpayer owes the money, or to the amount of money owed.¹²⁹ The deficiency interest rate is strictly formulaic, set at the rate at which the government has to pay interest on its own short-term indebtedness, plus 3 percentage points.¹³⁰ Unlike a commercial interest rate, which depends to a large extent on the borrower's circumstances,¹³¹ deficiency interest thus depends on one factor, and that factor relates only to the government's circumstance. Because it focuses on detriment to the party who is owed rather than on attributes of the party

capital, deposit balances, and net income level may all affect the rate. See OLIVER G. WOOD, JR. & WILLIAM C. BARKSDALE, JR., *HOW TO BORROW MONEY* 50 (1981). Lenders will also consider the size and credit history of the borrower. See ELVIN F. DONALDSON & JOHN K. PFAHL, *CORPORATE FINANCE POLICY AND MANAGEMENT* 249 (3d ed. 1969). The existence of security for the loan is also significant. *Id.*

126. As one basic finance text states, "interest rates on [long] term loans have been slightly higher . . . than the [same] rate the bank would charge the same company on a short term loan or line of credit." *Id.* at 249-50; see also NEIL H. JACOBY & RAYMOND J. SAULNIER, *TERM LENDING TO BUSINESS* 104 (1942); Joseph Bankman & William A. Klein, *Accurate Taxation of Long Term Debt: Taking Into Account the Term Structure of Interest*, 44 *TAX L. REV.* 335 (1989). There are exceptions to this general rule, however. During periods of high inflation, short term loans may carry higher rates than long term loans.

127. JACOBY & SAULNIER, *supra* note 126, at 104; HAIM LEVY & MARSHALL SARNET, *PRINCIPLES OF FINANCIAL MANAGEMENT* 44 (1988).

128. DONALDSON & PFAHL, *supra* note 125, at 249. See generally KENNETH W. SPARKS, *SUCCESSFUL BUSINESS BORROWING* 73-77 (1986).

129. Although the Code requires the daily compounding of deficiency interest, I.R.C. § 6622, the rate itself does not vary with the length of time the deficiency is outstanding.

130. I.R.C. § 6621(a)(2). The Code defines the federal short-term rate as the rate determined "by the Secretary in accordance with § 1274(d)." Section 1274(d) provides that the Federal short-term rate is the "rate determined by the Secretary based on the average market yield (during any 1-month period selected by the Secretary and ending in the calendar month in which the determination is made) on outstanding marketable obligations of the United States with remaining periods to maturity of 3 years or less." I.R.C. § 1274(d)(1)(C)(i).

That the Code sometimes provides for a rate higher than that set by § 6621, as it does in § 6621(c), is consistent with the argument that deficiency interest is not really interest but is intended to accomplish other goals.

131. The borrower's credit history and the risk involved in the loan are two of these. See *supra* notes 124-28 and accompanying text.

who owes, deficiency interest more closely resembles damages than commercial interest.

The formulaic nature by which the deficiency interest rate is set makes it even more unlike commercial interest. The additional percentage apparently reflects the additional costs which the government expects to incur as a result of a taxpayer's noncompliance,¹³² as well as the knowledge that some deficiencies will be outstanding for a short period of time while others will be outstanding for a long period of time.¹³³ The amount of the increase due to those factors is not tailored to the circumstances of the particular taxpayer in question, as it would be in the typical commercial situation.

The additional percentage serves as an inducement to payment of the amount due.¹³⁴ Nevertheless, the additional percentage does not convert deficiency interest into a penalty.¹³⁵ No part of the additional

132. The Supreme Court has so acknowledged, albeit in the context of state determined deficiencies. See *Meilink v. Unemployment Reserves Comm'n*, 314 U.S. 564, 567 (1942).

133. Deficiencies that are outstanding for a longer term would ordinarily carry a rate of interest which is higher than the federal short-term rate. See *supra* note 126. Any desire to average out the rate to account for the different periods of time during which deficiencies may be outstanding does not convert deficiency interest into true interest, however. It is the absence of any relationship between the term of one taxpayer's retention of money and the rate charged, and the absence of a consensual extension of credit that distinguishes deficiency interest from commercial interest.

134. The Supreme Court once noted that a deficiency interest rate higher than that applicable to commercial transactions was reasonable because "[d]elinquent taxpayers as a class are a poor credit risk; tax default, unless an incident of legitimate tax litigation, is, to the eye sensitive to credit indications, a signal of distress." *Meilink v. Unemployment Reserves Comm'n*, 314 U.S. 564, 567 (1942). While that observation may have been apt with respect to the unpaid employment taxes which the Court considered in *Meilink*, it is not necessarily apt with respect to federal income taxes generally. Unlike employment taxes, the determination of which is relatively straightforward and free from controversy, the determination of the proper amount of federal income tax due is often quite difficult and controversial. The existence of a federal income tax deficiency cannot generally be said to indicate anything about the creditworthiness or financial condition of the taxpayer. It is precisely this inability to make reasonable generalizations about the financial status of taxpayers as a group that makes deficiency interest so unlike commercial interest. See *generally infra* note 138.

135. Much of the opposition to the proposal to deny the deductibility of deficiency interest has taken the position that denying the deduction for corporate deficiency interest is tantamount to making such interest a penalty. See *generally supra* note 82. That position must rest on the assumption that the only difference between interest and a penalty is the deductibility of the former but not the latter under current law. Courts have long held that deficiency interest is not a penalty, for reasons that have nothing to do with its deductibility. *United States v. Childs*, 266 U.S. 304, 309-10 (1924) (deficiency interest defined as compensation, not penalty); *Grauvogel v. Commissioner*, 768 F.2d 1087, 1090 (9th Cir. 1985) (I.R.C. § 6601(a) interest not a penalty but merely compensation in the nature of interest on a loan); *Johnson v. United States*, 602 F.2d 734, 738 (6th Cir. 1979) (pre-judgment interest represents compensation for the value of holding money over a period of time); *Avon Prods., Inc. v. United States*, 588 F.2d 342, 343 (2d Cir. 1978) (interest not a penalty but intended to compensate the government for delay in payment of a tax); *Vick v. Phinney*, 414 F.2d 444, 448 (5th Cir. 1969) (interest merely compensatory, not a penalty); *Jones v. United States*, 371

amount of deficiency interest depends on fault, nor is any part of it assessed on the basis of any element of intentional misbehavior. To say that a provision induces compliance is not to say that it punishes non-compliance.¹³⁶ Indeed, much of the invective against deficiency interest has missed the point because those who believe that to assess it is inappropriate have maintained that deficiency interest is not interest because it is a penalty.¹³⁷ More likely, deficiency interest is not interest because it is damages.¹³⁸

Deficiency interest bears a relationship to one thing only: the rate at which the federal government borrows money. Deficiency interest sim-

F.2d 442 (Ct. Cl. 1967) (interest is a charge for use of tax money which the government was deprived of using due to late payment). These courts are correct in holding that deficiency interest is not a penalty, because it serves to compensate the government for the loss of the funds, not to punish the taxpayer. *See also Meilink*, 314 U.S. 564, 567, in which the Court came to the same conclusion with respect to deficiency interest imposed by a state statute.

136. Other provisions of the Code have also acted as inducements to compliance. The present version of § 6621(c), the "hot interest" provision, will encourage prompt payment. *See generally Stark, supra note 85.* Indeed, it is the mismatching of the label (interest) and the purpose or effect (induced compliance) that makes this provision ill conceived. It calls something interest when that thing is not interest at all. Similarly, the old version of § 6621(c), which provided for an increase in the interest rate on substantial underpayments attributable to tax motivated transactions, (§ 6621(c), as in existence until December 1989, defined a substantial underpayment as any underpayment exceeding \$1,000 and applied an interest rate of 120 percent of the regular § 6621 rate to such underpayments) was intended both to deter such transactions and to compensate the government for the additional drain which such transactions place on the system. H. REP. NO. 841, 99th Cong., 2nd Sess. (1986); *see also* 132 CONG. REC. 7807 (1986). Those objectives do not serve to convert those amounts into penalties, but neither do they allow the amounts to be classified as interest. They actually serve to make the amounts like contractually determined liquidated damages. *See supra note 62 and accompanying text.* An examination of whether the amounts labeled penalties under the Code might more properly be characterized as damages is beyond the scope of this Article. *Cf. GENERAL EXPLANATION, supra note 78, at 1272* (section 6651 penalty intended to compensate the government for costs of collection).

137. *See Garbis & Fisher, supra note 47.*

138. The additional percentage serves to make deficiency interest like liquidated damages. Indeed, some commentators see liquidated damages provisions as a necessary inducement to compliance. *See generally Goetz & Scott, supra note 62.* Thus, stipulated damages clauses will be enforced even though they serve to induce compliance with the terms of a contract. *See generally KENNETH W. CLARKSON ET AL., Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351 (1978). Such clauses are particularly appropriate when the amount of the damage suffered would be difficult to measure. *See generally MCCORMICK, supra note 13, at § 146* (defining the difference between liquidated damages and penalties). Deficiency interest is similar to stipulated damages because measuring the damage to taxpayer morale and voluntary compliance which results from the existence of large deficiencies owed by certain taxpayers, as well as the costs of enforcement, would be difficult indeed.

The additional percentage is perhaps even more akin to contractually determined liquidated damages than the base rate. The additional percentage is an amount unrelated to the commercial interest rate, and is designed to set a rate of compensation for harms that are difficult to measure. *See supra text accompanying notes 132-34.*

ply compensates the government for what it has lost as a result of the late payment of the tax.¹³⁹ Compensation is the language of damages. Damages are amounts paid for harm inflicted as a result of the actions of another.¹⁴⁰ A taxpayer's late payment of taxes injures the government by depriving it of the use of money to which it was entitled. Deficiency interest compensates the government for that injury.¹⁴¹ The use of a percentage rate to measure the amount of compensation due the government is sound,¹⁴² but it does not suffice to transmute compensation into interest. In order for an amount to be interest another element should exist — there should be consent to an extension of credit.¹⁴³

139. Courts agree. In cases where deficiency interest is considered courts define such interest as "compensation". See *United States v. Childs*, 266 U.S. 304, 309-10 (1924); *Johnson v. United States*, 602 F.2d 734, 738 (6th Cir. 1979); *Vick v. Phinney*, 414 F.2d 444, 448 (5th Cir. 1969); *Golden v. United States*, 84-1 U.S. Tax Cas. (CCH) ¶ 9408, at 83,997 (W.D. Wash. 1984). Compensation is not a term used when two parties have open dealings—it is the language of damages. Compensation makes a party whole again, returning it to the status which it would have reached absent the intervening event. Deficiency interest is "merely compensation for delayed payment in the nature of interest on a loan." *Grauvogel v. Commissioner*, 768 F.2d 1087, 1090 (9th Cir. 1985) (emphasis added). An interest calculation is the simplest way to differentiate the damage due to the existence of large and small deficiencies over differing periods of time; merely because the amount assessed has the "nature" of interest does not make it interest in its true form.

140. See generally SAMUEL WILLISTON, 11 WILLISTON ON CONTRACTS § 1338 (3d ed. 1969).

141. Courts have long recognized the compensatory purpose of deficiency interest, usually in the context of distinguishing enforceable interest from nonenforceable penalties. Unfortunately, courts have rarely taken the additional step of analyzing whether the compensatory nature of deficiency interest does more than make it nonpunitive. See, e.g., *Grauvogel v. Commissioner*, 768 F.2d 1087, 1090 (9th Cir. 1985) ("[s]ection 6601(a) is not a penalty for late payment but merely compensation for delayed payment in the nature of interest on a loan"); *Johnson v. United States*, 602 F.2d 734, 738 (6th Cir. 1979) (prejudgment interest provided under § 6601 is not of a "punitive character"; it represents compensation for the value of holding of money over a period of time); *Avon Prods., Inc. v. United States*, 588 F.2d 342, 343 (2d Cir. 1978) ("it is a clearly established principle that interest is not a penalty but is intended only to compensate the government for delay in payment of a tax"); *Vick v. Phinney*, 414 F.2d 444, 448 (5th Cir. 1969) ("[i]nterest, in tax cases as in others, is merely compensatory; it is not a penalty"); *United States v. Goldstein*, 189 F.2d 752, 755 (1st Cir. 1951) ("[i]nterest is compensation for the use of money and is exacted because of a delay in payment of the tax"); *Owens v. Commissioner*, 125 F.2d 210, 213 (10th Cir.) ("[i]nterest . . . is intended to compensate the government for the delay in payment of the tax"), cert. denied, 316 U.S. 704 (1942); *Jones v. United States*, 371 F.2d 442, 450 (Ct. Cl. 1967) ("interest is not a penalty but a charge for the use of money, and the government unquestionably was deprived of the use of these taxes"); *Time, Inc. v. United States*, 226 F. Supp. 680, 686 (S.D.N.Y. 1964) (interest is given to compensate the government for a delay in payment of the tax).

142. Courts have acknowledged that the use of an interest rate to measure the amount of damages is sound. See *supra* notes 27-29 and accompanying text.

143. The courts have long established that the assessment of interest requires the existence of a loan. For example, in *Taylor v. Commissioner*, 27 T.C. 361 (1956), the tax court found that a debt did not exist where the taxpayer used her own funds to set up commodity accounts for her relatives, even though the taxpayer's relatives executed notes for the amounts in question. Therefore, money which the taxpayer received from her relatives pursuant to a note was not includable in the tax-

2. *The Absence of Consent.* Although deficiency interest arises from a transaction in which there is a debt, it should not be treated as interest for tax purposes because there is no consent to the existence of that debt.¹⁴⁴ Like the recipient of the services in the second transaction

payer's income as interest. To reach that conclusion, the court looked to the intention of the parties and found that the taxpayer did not expect to be repaid and that her relatives did not feel obligated to repay her. Further repayment was explicitly contingent upon the success of the investments. *See* *Midkiff v. Commissioner*, 96 T.C. 724 (1991) (amounts added to a leasehold condemnation action were not deductible interest because there was no enforceable obligation to pay the principal amount); *Dunlap v. Commissioner*, 74 T.C. 1377 (1980), *rev'd on other grounds*, 670 F.2d 785 (8th Cir. 1982) (interest that accrued while an obligation was unenforceable was deductible because unenforceability was not within the taxpayer's control); *Jordan v. Commissioner*, 60 T.C. 872 (1973), *aff'd per curiam*, 514 F.2d 1209 (8th Cir. 1975) (amount added to the original purchase price of stock in a recession offer was not interest because there was never a debt).

Similarly, although courts have held that where interest accrues on an unenforceable debt the accrued interest is deductible once the loan becomes a legally enforceable obligation, those holdings are grounded on the eventual enforceability of the debt. For example, in *Investor's Ins. Agency v. Commissioner*, 677 F.2d 1328 (9th Cir. 1981), *aff'g* 72 T.C. 1027 (1979), the Court of Appeals for the Ninth Circuit held that the amounts paid before an enforceable debt existed were interest. The payment in question arose as a result of a guarantee that a joint venture would distribute profits by a specified date. Under the terms of the agreement, if the joint venture did not distribute profits by that date, the taxpayers were entitled to receive a return of their initial contribution to the venture plus six percent simple annual interest from the date of the contribution. The taxpayers took the position that the amount labeled interest was really a return of capital, and therefore could not be interest for personal holding company tax purposes. Both the tax court and the court of appeals disagreed. They found that the interest may have been calculated during a period when there was no enforceable debt, but that once the debt became enforceable the amount due was interest regardless of the manner in which it was measured. 677 F.2d at 1330-31. The courts thus analyzed the nature of the amount separately from the manner of measurement.

In *Investor's Ins. Agency* the court of appeals found support in a line of cases in which corporations issued bonds on a date later than their stated dates and computed interest from the stated dates. *See, e.g.*, *Commissioner v. Philadelphia Transp. Co.*, 333 U.S. 883 (1949), *aff'g per curiam* 174 F.2d 255 (3rd Cir. 1949), *aff'g* 9 T.C. 1018 (1947); *Commissioner v. Pressed Steel Car Co., Inc.*, 152 F.2d 280 (3d Cir. 1945) (*per curiam*), *cert. denied*, 328 U.S. 838 (1946); *Commissioner v. Columbia River Paper Mills*, 126 F.2d 1009 (9th Cir. 1942); *Monon R.R. v. Commissioner*, 55 T.C. 345, 362-363 (1970); *Ernst Kern Co.*, 1 T.C. 249 (1942); *Oregon Pulp & Paper Co.*, 47 B.T.A. 772 (1942); *but see Commissioner v. Drovers Journal Pub. Co.*, 135 F.2d 276 (7th Cir. 1943) (court refused to allow a deduction for interest attributable to a period before the issuance of the debt). In those cases, the courts held that since the interest had accrued at the time of payment and since there was an enforceable debt obligation in existence at that time, the calculation of the amount of interest from a period prior to the issuance of the bond was immaterial. In effect, the manner of calculating the interest affected only the rate of interest charged, not the characterization of the amount as interest. Today, §§ 1272-1275 would generally preclude the deduction of the accrued amounts up front.

144. Although the taxpayer may dispute the existence of the debt, once the validity of the deficiency is ascertained either judicially or by mutual consent, the debt exists. The disputed debt doctrine, which makes it clear that no debt can be said to exist until its validity is ascertained, is consistent with this analysis. The disputed debt or contested liability doctrine was first enunciated by the Board of Tax Appeals in *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939). In *Sobel*, there was a dispute as to both liability for the debt and the amount of the debt. *Id.* at 1265. The tax court in *Colonial Sav. Ass'n*, 85 T.C. 855 (1985), *aff'd*, 854 F.2d 1001 (7th Cir. 1988), interpreted

discussed above,¹⁴⁵ the taxpayer merely inflicts an injury on the government by failing to pay the amount when it becomes due. The taxpayer has retained and used money due the government. The absence of governmental consent to such retention and use forecloses the possibility of characterizing the transaction as a loan.

Taxpayers do not have the government's consent to the late payment of taxes, neither explicitly nor implicitly. Neither the existence of the deficiency interest provision, the taxpayer's ability to challenge a deficiency in the tax court without first paying the amount of the deficiency,¹⁴⁶ nor the existence of the quick refund procedure¹⁴⁷ suggests that the obligation to pay the amount of tax imposed by the Code is a matter of choice. The Code unequivocally imposes on every taxpayer an absolute obligation to pay the amount due thereunder.¹⁴⁸ The existence of both civil¹⁴⁹ and criminal¹⁵⁰ sanctions for failure to timely pay the

Sobel to require that there be a liquidated debt before the doctrine of discharge of indebtedness could apply. Under the *Sobel/Colonial Savings* interpretation, the disputed debt or contested liability doctrine would prevent discharge of indebtedness income only if the amount of the debt, rather than its enforceability, was in dispute. In *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), *rev'g Zarin v. Commissioner*, 92 T.C. 1087 (1989), the Government argued for this interpretation of the doctrine, but the Third Circuit rejected it. *Zarin*, 916 F.2d at 116. In *Zarin*, the Third Circuit articulated the contested liability doctrine as follows:

Under the contested liability doctrine, if a taxpayer, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute would be treated as the amount of debt cognizable for tax purposes. The excess of the original debt over the amount determined to have been due is disregarded for both loss and debt and accounting purposes.

Id. at 115. Thus, a taxpayer who disputes the existence of a debt will not have income from the discharge of indebtedness when she comes to an agreement requiring the payment of less than the amount originally claimed to have been owed. For tax purposes, a debt might as well not exist until the amount of it is fixed by a court or by agreement between the parties.

145. See *supra* text accompanying notes 120-21.

146. The tax court has deficiency jurisdiction only. See generally I.R.C. §§ 6213, 7442. Congress' provision of a forum in which taxpayers can litigate a tax controversy without first paying the deficiency asserted alleviates the hardship caused by having to pay asserted deficiency before being able to contest its validity, but it can hardly be seen as an endorsement of the nonpayment of taxes actually due. See generally *Cheek v. United States*, 111 S. Ct. 604 (1991); Deborah A. Geier, *The Tax Court, Article III, and the Proposal Advanced by the Federal Courts Study Committee: A Study in Applied Constitutional Theory*, 76 CORNELL L. REV. 985 (1991).

147. The quick refund procedure puts a loss corporation in the same position it would have been in if it had incurred the loss in the year to which the Code permits a carryback. See *supra* notes 96-97 and accompanying text. Its existence rests on the notion that the taxpayer is entitled to the amount refunded. Its existence does not imply governmental consent to the use of the procedure as a tool of corporate finance.

148. The Supreme Court's willingness to hold that a taxpayer's sincere belief that the payment of taxes is unconstitutional precludes a finding that he willfully evaded the payment thereof does not make the taxpayer's belief correct, as the Court has itself acknowledged. See *Cheek v. United States*, 111 S. Ct. 604 (1991).

149. See I.R.C. § 6651 (imposing penalties for failure to file a tax return or pay tax); I.R.C.

amount of taxes due shows that Congress did not intend to give taxpayers the option of paying now or paying later, with interest.¹⁵¹ The obligation is to pay when due. Failure to do so is not punished unless it results from negligence or a purposeful act or omission, but it is not condoned.¹⁵²

The Code reflects a Congressional desire for a pay-as-you-go system. It requires employers to withhold the amount of a taxpayer's expected tax liability¹⁵³ and requires taxpayers generally to make estimated tax payments.¹⁵⁴ Although the amount of the actual tax liability is determined on an annual basis and must necessarily await the conclusion of the taxable year, the existence of the requirement for withholding by payors and the payment of estimated taxes by payees shows that the gov-

§ 6652 (imposing penalties for failure to file information returns); I.R.C. § 6653 (imposing penalties for failure to pay a stamp tax); I.R.C. §§ 6654-6655 (imposing penalties for failure to pay estimated taxes due from individuals and corporations, respectively); I.R.C. § 6656 (imposing a penalty for failure to deposit taxes). See also I.R.C. § 6652 (imposing accuracy related penalties); I.R.C. § 6663 (imposing a civil fraud penalty); I.R.C. §§ 6671-6713 (imposing various additional penalties and providing rules for the application thereof).

150. See, e.g., I.R.C. § 7201 (crime to attempt to evade or defeat tax); I.R.C. § 7202 (crime to fail to collect or pay over any tax); I.R.C. § 7203 (crime to willfully fail to file a return, supply information, or pay tax); see also I.R.C. §§ 7204-7232 (creating various other crimes involving the nonpayment of taxes due or the filing or returns).

151. In *Cheek*, 111 S. Ct. 604, 613, the Court observed that it did "not believe that Congress contemplated that such a taxpayer, without risking criminal prosecution, could ignore the duties imposed upon him by the Internal Revenue Code and refuse to utilize the mechanisms provided by Congress to present his claims of invalidity to the courts and to abide by their decisions."

152. Deficiency interest is not punishment, as courts have repeatedly held. See *supra* note 135. That the government does not punish the late payment of taxes when that late payment is due to disagreement over the interpretation or application of the law does not mean that it expects, condones, or is unharmed by that late payment.

153. I.R.C. § 3402.

154. I.R.C. § 6654. Although no statutory provision explicitly requires the payment of estimated tax, § 6654 has the effect of imposing such a requirement in many cases because failure to make estimated tax payments in accordance with §§ 6654(c) and 6654(d) will result in the imposition of an estimated tax penalty, unless one of the exceptions in § 6654(e) applies. For a recent discussion of the role of withholding and estimated taxes, see *Abrams v. Brady*, 59 U.S.L.W. (BNA) 2704 (1991).

Recent legislation that extended unemployment benefits and paid for the cost of doing so by making the rules which require the payment of estimated taxes more restrictive demonstrates the Congressional desire (perhaps even the fiscal imperative) to require the remittance of taxes as the amounts on which they are levied are earned or otherwise received. See Emergency Unemployment Compensation Act of 1991, Pub. L. No. 102-164, § 403, 105 Stat. 1049 (1991) (amending I.R.C. § 6654(d)). Indeed, the Congressional need or desire to require remittance of tax liability when income is earned or received is so strong that making the corporate estimated tax provisions more restrictive was considered the method of funding the extension of certain provisions which would have expired in 1991 absent an extension. See Tax Extension Act of 1991, Pub. L. No. 102-227, § 201, 105 Stat. 1686 (1991) (amending I.R.C. § 6655(d)); see also Bennett Milton, *Extenders Get Six-Month Reprieve*, 53 TAX NOTES 998 (1991).

ernment does not intend any extension of credit with regard to the taxes actually due.¹⁵⁵ Recent changes to the estimated tax rules require the remittance of a greater portion of the tax expected to be due, thus underscoring the absence of the government's consent to a taxpayer's retention of tax due.¹⁵⁶

To treat deficiency interest as interest is to approve the notion that deficiency interest is an amount paid in a taxpayer's exercise of its borrowing power. Such treatment ratifies and encourages taxpayers' use of the tax system as a tool of corporate finance, and makes a mockery out of the obligation to pay taxes on a date certain. To do so is also unsound because it treats as interest amounts which are paid under circumstances which fail to correspond to the definition of that term in the commercial world.¹⁵⁷ It treats as interest amounts which are more accurately characterized as damages.

B. *Treating Deficiency Interest as Damages*

Because the deficiency interest rate is determined by statute, not by the specific costs incurred by the government with respect to a particular late payment of tax, deficiency interest is unlike damages received in litigation.¹⁵⁸ Nevertheless, an amount need not be determined in the context of litigation to be classified as damages.¹⁵⁹ It need only be evident that the amount is designed to compensate one party for injury caused by another's wrong.¹⁶⁰ Deficiency interest is designed to do just that.¹⁶¹ Thus, it is more appropriate to treat deficiency interest as damages.

155. This does not suggest that the government is consenting to an extension of credit in those situations in which no payment of estimated taxes is required. *See, e.g.*, I.R.C. § 6654(1)(2), which generally exempts estates, grantor trusts and testamentary trusts from the requirement of making estimated tax payments for two years after a decedent's death. Rather, those situations can be viewed as concessions to administrative convenience.

156. *See supra* note 154.

157. *See supra* notes 129-33 and accompanying text.

158. Like liquidated damages, the amount of interest charged is not subject to litigation. While there is certainly litigation over the imposition of interest, it is analogous to the litigation over the question of whether a particular liquidated damages clause applies in a given case. Once a court decides that the provision applies, the provision itself, not the court, sets the rate at which damages will be paid. Similarly, in a tax case, a court may decide that no interest is due, but if interest is due, § 6621 provides the rate.

159. Liquidated damages are, by definition, damages, even though they are not determined in the context of litigation. *See generally* ARTHUR L. CORBIN, 5 CORBIN ON CONTRACTS § 990 (1964).

160. *See* Goetz & Scott, *supra* note 62. Courts and commentators have confused the compensatory purpose of a payment with its character as interest. Thus, in *Sharp v. Commissioner*, 75 T.C. 21 (1980), the court held that a payment required by a state statute was not interest because the payment was intended to discourage frivolous appeals, not to compensate one party for another's use of the money. While the court may have been correct as to the purpose of the state statute, the court

1. *The Tax Treatment of Damages.* The tax law has long required the tracing of damages to the item for which they substitute and has taxed damages by reference to that item.¹⁶² Thus, the deductibility of damages is determined by reference to the origin of the claim from which they arise. Damages paid on claims incurred in carrying on a trade or business or in the production or collection of income are therefore deductible.¹⁶³ By contrast, when the damages relate to a nondeductible capital expenditure, neither the courts nor the Service will allow a tax-

misanalyzed the issue by assuming that a compensatory purpose would have sufficed to render the amount interest.

161. As in the classic case of a breached contract, the breaching party secures an undue benefit, and the injured party loses an expected benefit; the breaching party here is the taxpayer, and the injured party is the government. See Goetz & Scott, *supra* note 62, at 558.

Many courts that discuss the assessment of deficiency interest do so in the language of the contract breach. They view the government as being "deprived of the use of money," *Vick v. Phinney*, 414 F.2d 444, 448 (5th Cir. 1969), see also *Jones v. United States*, 371 F.2d 442 (Ct. Cl. 1967), and they view the taxpayer as enjoying the undeserved benefit of the opportunity to use the money due the government. See, e.g., *United States v. Goldstein*, 189 F.2d 752, 755 (1st Cir. 1951) (taxpayer had use of government's money); *Owens v. Commissioner*, 125 F.2d 210, 213 (10th Cir. 1942) (taxpayer seen to "enjoy the delay" when taxes are deficient); *Ross v. United States*, 148 F. Supp. 330, 333 (D. Mass. 1957) (taxpayer must pay because he had use of the government's money). See *supra* note 139 and accompanying text.

162. *United States v. Gilmore*, 372 U.S. 39, 49 (1963). In the Court's words, "the origin and character of the claim with respect to which an expense was incurred . . . is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not." *Id.* The receipt of damages follows the same rule, so that damages are taxed in the same way the amounts for which they compensate would have been taxed. See *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955).

Section 104 stands as a notable exception to this rule. This provision excludes from income "damages received . . . on account of personal injuries or sickness. . . ." Courts have been willing to hold that amounts received as compensation for tort or tort-type injuries are excluded by this provision even when the amounts represent lost wages or similar, and otherwise taxable, amounts. See *Burke v. United States*, 929 F.2d 1119 (6th Cir.), *cert. granted*, 112 S. Ct. 47 (1991); *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990); *Rickel v. Commissioner*, 900 F.2d 655 (3d Cir. 1990); *Byrne v. Commissioner*, 883 F.2d 211 (3d Cir. 1989); *Thomason v. Commissioner*, 866 F.2d 709 (4th Cir. 1989); *Bent v. Commissioner*, 835 F.2d 67 (3d Cir. 1987); *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986); *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983); *Catron v. United States*, 582 F. Supp. 8 (N.D. Okla. 1983); *but see* Rev. Rul. 85-143, 1985-2 C.B. 55. Because § 104 is a statutory exception to the general rule and proceeds from particular policy considerations, its existence does not affect the argument made here, which is premised upon the application of the general rule. For a recent and thoughtful analysis of § 104, see Dodge, *supra* note 4.

163. See I.R.C. §§ 162 and 212. Courts have allowed a corporation to deduct damages paid in settling a lawsuit where the corporation could have been found liable for negligent entrustment of a company car. *Kopp's Co. v. United States*, 636 F.2d 59 (4th Cir. 1990). The Service even acknowledges that a corporation can deduct punitive damages paid for breach of contract and fraud in connection with the ordinary conduct of its business operations. Rev. Rul. 80-211, 1980-2 C.B. 57. Cf. *James E. Caldwell & Co. v. Commissioner*, 234 F.2d 660 (6th Cir. 1956), *rev'g* 24 T.C. 597 (1955) (damages paid by a corporation for the fraudulent business activities of its officers held deductible).

payer to deduct them.¹⁶⁴

The foregoing treatment is consistent with the general inclusion of damages in income,¹⁶⁵ and with the characterization of damages received by reference to the amounts they replace.¹⁶⁶ It also provides a logical and theoretically clean way to determine the proper treatment of interest on tax liabilities.¹⁶⁷

2. *Taxing Deficiency Interest Like Damages.* If an amount paid as interest on a tax liability might more properly be viewed as damages (deficiency damages?), then it ought to be treated as such for federal income tax purposes.¹⁶⁸ Since damages are deductible only if the amount to

164. For example, in *Anchor Coupling Co. v. United States*, 427 F.2d 429 (7th Cir. 1970), the court held that a corporation could not deduct damages paid to settle litigation which sought specific performance of an alleged contract. To reach that conclusion the court applied the origin of the claim doctrine. Since the litigation involved a claim on the corporation's assets, the court agreed with the Service and made the corporation capitalize the payments. Similarly, in *Arthur H. Dugrenier, Inc. v. Commissioner*, 58 T.C. 931 (1972), the tax court denied the deductibility of amounts paid to settle a claim based on fraudulent concealment. Since the litigation involved the sale of the corporation's assets, the court held that the payments were a nondeductible capital expenditure.

165. *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955).

166. See *Hort v. Commissioner*, 313 U.S. 28, 31 (1941) (the amount received in settlement of a claim was "essentially a substitute for rental payments which [§ 61] expressly characterizes as gross income, [such that] it must be regarded as ordinary income"); *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113-14 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944) ("The test is not whether the action was one in tort or contract but rather the question to be asked is 'In lieu of what were the damages awarded?' . . . Where the suit is not to recover lost profits but is for injury to good will, the recovery represents a return of capital and, with certain limitations . . . is not taxable."). Cf. *Greene v. Commissioner*, 47 T.C.M. (CCH) 190 (1983) (treble damages held taxable as ordinary income even though taxpayer contended that they were awarded for loss of goodwill when court concluded that treble damages are punitive and not compensatory). The Service agrees; see *Rev. Proc. 67-33*, 1967-2 C.B. 659 (acknowledging that settlements are taxed like damage awards and, like damage awards, are taxed by reference to the nature of the amounts for which they substitute).

167. The conclusion that deficiency interest is damages would not require repeal of provisions like § 453A(c), which requires taxpayers to pay interest on the deferred tax liability attributable to certain installment obligations. Section 453A is an anti-abuse provision. It was designed to curtail the benefits of installment reporting. H.R. Conf. Rep. No. 1037, 100th Cong. 2d Sess. (1988), *reprinted in* [1988] 4 *Stand. Fed. Tax Rep. (CCH)* § 2887. If Congress believes that by permitting certain taxpayers to report gain on the installment basis it is making a loan to those taxpayers, then requiring the taxpayers to pay a charge for the money loaned is fair. Treating that charge as interest, as § 453A(c)(5) specifically provides, is also fair. The crucial inquiry is whether Congress wants to put the government in the position of a lender. If it deliberately decides to do so, as it apparently has in connection with installment reporting, the tax treatment should be consistent with that decision. When Congress has not deliberately decided to put the government in the position of lender, the treatment of the charge should not proceed as if it had.

168. Taxation ought to follow the economic substance of transactions unless policy considerations suggest otherwise. In this case, they do not. Denying deductibility to deficiency interest will not unfairly discriminate against taxpayers who choose not to borrow and instead pay the deficiency,

which they relate is deductible, under the proposed analysis deficiency interest would clearly be deductible only if federal income taxes were deductible.¹⁶⁹ Because federal income taxes are not deductible, defi-

because those taxpayers are in an economically different position and have entered into an economically different transaction than those subject to an outstanding deficiency. *See infra* Part IV. By contrast, maintaining the deductibility of deficiency interest will continue to allow certain taxpayers to use the government as an involuntary lender and will encourage the filing of returns that take aggressive return positions. That is unsound tax policy. A system already struggling with an increasing compliance gap and a declining audit rate (*see* Jeffrey A. Dubin et al., *The Changing Face of Tax Enforcement, 1978-1988*, 43 *TAX LAW*. 893 (1990)) can ill afford to encourage actions which will only exacerbate those problems.

169. As the Service has put it, damages or "payments made in settlement of lawsuits are deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of . . . business." Rev. Rul. 80-211, 1980-1 C.B. 57 (citing Rev. Rul. 78-210, 1978-1 C.B. 39) (amounts paid for malpractice judgments deductible as a business expense); *see* Kornhauser v. United States, 276 U.S. 145, T.D. 4222, 7-2 C.B. 267 (1928) (attorney's fees arising from a defense in a suit brought by a partner deductible as business expense); *Mulgrew Blacktop, Inc. v. United States*, 311 F. Supp. 570 (S.D. Iowa 1969) (corporation's payment of settlement arising from officer's accident in operating a corporate vehicle deductible as a business expense); *Cochrane v. Commissioner*, 23 B.T.A. 202 (1931) (payment for loss to client due to taxpayer's error deductible as a business expense), *acq.*, 10-2 C.B. 14 (1931); Rev. Rul. 69-491, 1969-2 C.B. 22 (premiums paid by bank to cover liability for wrongful acts of officers deductible as business expenses). Thus, damages that result from actions taken in the ordinary course of a taxpayer's business are deductible. *See, e.g.*, *United States Freight Co. v. United States*, 422 F.2d 887 (Ct. Cl. 1970) (down payment forfeited as liquidated damages deductible as a business expense); *Caldwell & Co. v. Commissioner*, 234 F.2d 660 (6th Cir. 1956) (compromise payments in settlement of fraud charge deductible as business expenses), *rev'g* 24 T.C. 597 (1955); *Helvering v. Hampton*, 79 F.2d 358 (9th Cir. 1935) (judgment due to fraudulent activities deductible as a business expense); *Ostrom v. Commissioner*, 77 T.C. 789 (1984) (damages paid to client due to fraudulent statements in a stock purchase deductible as business expense); *Mack v. United States*, 82-1 U.S. Tax Cas. (CCH) ¶ 9228 (D. Nev. 1982) (trustee allowed to deduct payment to beneficiary for loss on stock purchase as a business expense); *Milner Enterprises, Inc. v. United States*, 65-2 U.S. Tax Cas. (CCH) ¶ 9661 (S.D. Miss.) (compensatory damages paid to the United States deductible as a business expense); *Dancer v. Commissioner*, 73 T.C. 1103 (1980) (payment arising out of car accident that occurred while traveling on business deductible as a business expense); *DeVito v. Commissioner*, 39 T.C.M. (CCH) 152 (1977) (value of property transferred in settlement of litigation for breach of employment contract deductible as a business expense); *Colonial Eng'g Co. v. Commissioner*, 22 T.C.M. (CCH) 1476 (1963) (settlement of judgment for damages for causing loss of business profits deductible as business expense).

By contrast, courts have refused to allow a deduction for damages resulting from activities not related to the ordinary course of the taxpayer's business. *See, e.g.*, *Rees Blow Pipe Mfg. Co. v. Commissioner*, 342 F.2d 990 (9th Cir. 1965) (payment of damages attributable to a capital expenditure not deductible as a business expense); *Portland Gasoline Co. v. Commissioner*, 181 F.2d 538 (5th Cir. 1950) (compromise payment made in connection with a reorganization not deductible because part of the capital investment); *Stern v. Carey*, 119 F. Supp. 488 (N.D. Ohio 1953) (amount paid in satisfaction of judgment for personal injuries resulting from automobile accident are not deductible as a casualty loss); *Nelson v. Commissioner*, 30 T.C.M. (CCH) 1423 (1971) (payment to relieve seller of future liability held to be capital in nature and not deductible); *Mulholland v. Commissioner*, 16 B.T.A. 1331 (1929) (damages for personal injuries caused by taxpayer's automobile, where injuries were caused on a pleasure trip, do not come within the purview of property losses which may be deducted under the casualty loss provision).

ciency interest should not be deductible either.¹⁷⁰

More is at stake than the determination of the tax rate.¹⁷¹ Defi-

170. The nonpayment of federal taxes gives rise to deficiency payments. These payments, however, do not proceed exclusively from the nature of trade or business conduct. Although the Internal Revenue Code taxes income irrespective of its source (see I.R.C. § 61), it does not allow a federal business income tax deduction. See *infra* note 171 for a discussion of the effect of the absence of a federal income tax deduction. Since tax obligation is what gives rise to deficiency liability, and tax obligation is not considered a business obligation for purposes of current tax deductibility, damages for neglecting that obligation should also be treated as nonbusiness and nondeductible, unless such nondeductibility would be contrary to sound public or tax policy. It is not. See *infra* text accompanying notes 172-88.

Cases such as *Standing v. Commissioner*, 28 T.C. 789 (1957), *aff'd*, 259 F.2d 450 (4th Cir. 1958), where the tax court held that both deficiency interest and the expenses of litigating a tax controversy were deductible from gross income in adjusted gross income calculations, do not address the issues raised here because in those cases the court assumed deficiency interest was true interest. The court had only to decide whether the interest was related to the taxpayer's business or personal activity. Cases such as *Reise v. Commissioner*, 35 T.C. 571, *aff'd*, 299 F.2d 380 (7th Cir. 1962), where the court held that state income taxes and interest on both federal and state income taxes were attributable to a taxpayer's trade or business and therefore allowable as a deduction when computing net operating loss, are also inapposite because those cases treated deficiency interest as true interest and not as part of the tax. Thus, although the Service eventually agreed with the courts that deficiency interest on taxes due on business income ought to be treated as a business expense (Rev. Rul. 70-40, 1970-1 C.B. 50 (superseding Rev. Rul. 58-142, 1958-1 C.B. 147)) and allowed individual taxpayers to deduct them in determining the amount of a net operating loss under a system in which all interest is deductible, that agreement does not end the debate. Rev. Rul. 70-40, 1970-1 C.B. 50 and the cases it cited, assumed that deficiency interest was true interest. Neither that ruling nor the cases it cited answer the question of whether deficiency interest ought to be deductible if viewed as damages directly related to the obligation to pay the tax. See *Priv. Ltr. Rul. 91-26-014* (June 28, 1991) (fees for tax advice and tax preparation held deductible from adjusted gross income, not from gross income, because "only remotely connected" to the taxpayer's business).

171. While it is undoubtedly true that one could craft a tax system in which the tax itself was a deductible amount (that is, a tax-exclusive system) which would impose tax at an effective rate comparable to that imposed under the present (tax-inclusive) system, the general equivalence between such systems does not require that deficiency interest be deductible. For a thorough discussion of the tax-inclusive/tax-exclusive issue, see Harry L. Gutman, *Reforming the Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183 (1983); Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259 (1983).

Although deficiency interest can easily be traced to the payment of tax, deficiency interest, whether it is really interest or damages, is different from the underlying tax in at least one very important respect. Unlike the tax with respect to which it accrues, deficiency interest arises due to a voluntary act or omission of the taxpayer. A taxpayer who incurs a tax liability has no choice about the payment of the tax liability, but she does have a choice with respect to the accrual of deficiency interest. Even if the theory on which the deficiency is assessed is so far fetched that the taxpayer could never have divined it on her own, once the deficiency is assessed the taxpayer can choose to pay it and stop the accrual of deficiency interest.

The tax system itself can be structured on either a tax-inclusive or tax-exclusive basis because the liability for the tax accrues to all similarly situated taxpayers in the same way. That assumption allows a mathematician to take a tax inclusive rate and convert it into an equivalent tax exclusive rate. When taxpayers can exercise the power of choice to place themselves in economically dissimilar positions notwithstanding that they have liability for the same amount of tax, mathematics alone cannot put them in the same position again unless it acquires the benefit of hindsight. (Even

ciency interest lacks a deductible origin because in general, only costs of doing business are deductible and federal income taxes are not considered such a cost, even for corporations.¹⁷² Not all costs incurred by corporations are considered costs of doing business,¹⁷³ and not all are deductible.¹⁷⁴

Congress has implicitly acknowledged that not all activities in which a corporation engages are motivated by the exigencies of business.¹⁷⁵ Even a corporation's very existence may be deemed motivated by non-business considerations.¹⁷⁶ Many so-called anti-abuse provisions¹⁷⁷ were necessary because Congress recognized that the actions of corporations are not always motivated by business objectives. The adoption of such provisions suggests that Congress does not accept the proposition that since a corporation is organized for the purpose of engaging in a business, everything that it does must necessarily be connected to that business.¹⁷⁸

probability theory would be inadequate because the most it could hope to do is predict an outcome, but it could not ensure fair treatment in all cases.) The denial of the deduction more accurately reflects the difference in positions and will operate in harmony with the taxpayer's choice.

172. Some of the points made here also suggest a more thorough examination of the proper treatment of other costs of complying with the federal income tax laws, both for individuals and for corporations. A detailed examination of the proper treatment of the costs of contesting a tax liability, including the cost of paying interest on any underpayment, must wait for another day. For now it suffices to note that even if such other costs are currently deductible, that does not mean that they should continue to be so.

173. See *Indopco, Inc. v. Commissioner*, 1992 U.S. LEXIS 1374, *11 n.5, *19 nn.7-8 (Feb. 26, 1992) (endorsing decisions which recognized that not all costs incurred by corporations are costs of doing business).

174. This discussion will focus on treatment of deficiency interest incurred by corporations because deficiency interest paid or incurred by individuals is not deductible under current law. Temp. Treas. Reg. § 1.163-9T(b)(2)(i) (1987). While some commentators disagree with this position both in general, and to the extent that it makes nondeductible deficiency interest paid or incurred in connection with an individual's conduct of a trade or business, see *infra* note 78, focusing the discussion on corporate deficiency interest suffices for purposes of illustrating the effect of the proposed analysis.

175. See, e.g., I.R.C. § 162(k) (denying a deduction for expenses incurred in connection with a redemption); I.R.C. § 274 (denying a deduction for certain expenses even though the expense is incurred by a taxpayer, including a corporation, in connection with its business); I.R.C. § 280G (denying a deduction for golden parachute payments made by a corporation); and I.R.C. § 280F (limiting depreciation deductions with respect to luxury automobiles and other listed property).

176. See, e.g., I.R.C. §§ 269, 269A and cases like *Fogelsong v. Commissioner*, 691 F.2d 848 (7th Cir. 1982), which would not have arisen if it were axiomatic that a corporation exists to carry on a business, and that all of its activities are dedicated to that end. See also I.R.C. § 482.

177. See, e.g., I.R.C. § 541 (personal holding company tax); I.R.C. § 531 (accumulated earnings tax); I.R.C. § 341 (collapsible corporations). See also I.R.C. §§ 11(b)(2), 280H, 444 (provisions applying to personal service corporations).

178. The need to determine whether a particular activity in which a corporation engages is related to the conduct of its trade or business is not limited to the prevention of abuse. While some of the provisions mentioned above were directed at arguably abusive situations, others represent

No corporation is engaged in the business of paying federal income taxes. While business activities may generate tax liability, the payment of that liability is not a trade or business. As Mrs. Gregory learned over half a century ago,¹⁷⁹ the reduction of federal income tax liability is not part of a corporation's business. As Mr. Davis learned more recently, even a corporation's business needs do not determine the federal income tax consequences of particular transactions.¹⁸⁰ Courts have been steadfast in their refusal to give tax effect to transactions entered into solely to reduce federal income tax liability, even though tax liability directly affects a corporation's bottom line.¹⁸¹ Instead, courts have required that taxpayers adduce the existence of a nontax purpose for a transaction before giving the transaction its intended tax effect.¹⁸²

The payment of deficiency interest is no more closely connected to the conduct of a taxpayer's business than are the actions taken to effect a

Congressional recognition that some of the activities in which a corporation engages have both business and nonbusiness motives, and it is often difficult to distinguish between the two. *See, e.g.*, I.R.C. § 274(n) (limiting, but not denying, the deduction for business meals).

179. *Gregory v. Helvering*, 293 U.S. 465 (1935) (transaction designed solely to reduce tax liability lacked a business purpose and was not given effect for federal income tax purposes). For a discussion of some of the considerable commentary on *Gregory*, see *infra* note 181.

180. *United States v. Davis*, 397 U.S. 301 (1970) (a redemption was treated as a dividend even though the taxpayer had entered into the transaction to fulfill the corporation's business needs).

181. *Gregory*, 293 U.S. 465; *Knetsch v. United States*, 364 U.S. 361 (1960), and their progeny, one of the most recent of which is *Hutchinson v. United States*, 90-2 U.S. Tax Cas. ¶50,573 (D. Or. 1990). *See* Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659, 663 n.13 (1989) (noting that "[a] Lexis search in 1988 revealed over 1100 cases citing *Gregory*"). Much scholarly thought has been devoted to analyzing courts' reaction to tax motivated transactions. *See* Saul I. Levmore, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, 136 U. PA. L. REV. 1019 (1988); Alan Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733 (1978); Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968); Fuller, *supra* note 77; Ralph S. Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021 (1953).

Even if one disagrees with the judicial treatment of tax motivated transactions, what is important is simply that the existence of those cases shows that courts have been unwilling to accept the general proposition that everything that a corporation does is related to its business. In *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff'd*, (7th Cir. unpublished opinion, Sept. 15, 1989), which allowed a taxpayer to obtain the desired tax result even though the court acknowledged that the transaction was structured in a particular form in order to achieve that result, the court took pains to find other economic consequences to the actions which the taxpayer had taken.

182. This has come to be referred to as the business purpose doctrine. For an excellent discussion of the business purpose doctrine, see BITTKER & EUSTICE, *supra* note 80, at ¶ 14.51, and the many articles cited therein. Although the doctrine, in at least one of its formulations, has come under severe criticism recently, (*see* Moore, *supra* note 181), and taxpayers have even been able to withstand its assertion (*see* *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff'd*, (7th Cir. unpublished opinion, Sept. 15, 1989)), it cannot yet be pronounced dead. Indeed, taxpayers would like to be able to articulate it on their own behalf. Robert T. Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 TAX LAW. 137 (1990).

transaction whose sole objective is the reduction of a taxpayer's federal income tax liability. Admittedly, the payment of deficiency interest affects a business's bottom line, and it is the business activity which generates the tax liability in question. But filing a federal income tax return and taking positions thereon is no more related to a corporate taxpayer's business than engaging in a transaction designed exclusively to reduce the tax liability reflected on the return, or paying the tax itself. The test should be something more than "but for."

Not all business-related disbursements made by a corporation are deductible.¹⁸³ Federal income taxes are not, dividends are not, and neither are the costs of acquiring certain nondepreciable assets, such as goodwill.¹⁸⁴ Not even all amounts denominated interest are deductible.¹⁸⁵ An assertion that corporate deficiency interest ought to be fully deductible because the identity of the obligor conclusively establishes its link to a business activity is therefore incorrect.¹⁸⁶ The deductibility of the expense ought to be determined by the nature of the underlying cause of the expense.¹⁸⁷

The recharacterization of deficiency interest as damages will allow Congress (or perhaps the courts¹⁸⁸) to determine the tax treatment of the amount by reference to the substance of the economic transaction it ef-

183. The Supreme Court has held that even professional fees incurred by a corporation may not be deductible. *Indopco, Inc. v. Commissioner*, 1992 U.S. LEXIS 1374, at *16 (Feb. 26, 1992).

184. On July 25, 1991, Rep. Rostenkowski introduced H.R. 3035, 102d Cong., 1st Sess., 137 CONG. REC. H5908-02 (1991), which would dramatically change the tax law by permitting taxpayers to amortize goodwill and certain other acquired intangibles ratably over a 14 year period. The bill would reverse the decisions in cases like *Ithaca Indus., Inc. v. Commissioner*, 97 T.C. No. 16 (August 12, 1991) and *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3d Cir. 1991), *petition for cert. filed*, 60 U.S.L.W. 3536 (U.S. Feb. 4, 1992) (No. 91-1135), where the courts held that the value of the assembled workforce and paid subscriber lists, respectively, were assets indistinguishable from goodwill and were therefore nonamortizable. For a good analysis of some of the implications of the bill, see Ronald A. Pearlman, *The Amortization of Acquired Intangible Assets: A Subject Whose Time May Have Come*, TAX NOTES, Aug. 26, 1991, at 1083. For additional commentary, see Lee A. Sheppard, *Amortization of Intangibles: Something Out of Nothing*, TAX NOTES, Aug. 26, 1991, at 984; Tim Gray, *Winners and Losers in Rosty's Intangibles Bill*, TAX NOTES, Aug. 26, 1991, at 982.

185. See, e.g., I.R.C. §§ 163(e)(5), 163(f), 163(j), 279.

186. See ABA Section of Taxation Comments and William H. Paul letter, *supra* note 82.

187. The foregoing analysis might lead to the conclusion that the legal, accounting and other expenses incurred by a business in ascertaining and contesting its tax liability should also be nondeductible under § 162. And perhaps they should be. After all, not all legal, accounting and similar expenses incurred by a corporation are deductible. See *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426 (3d Cir. 1990), *aff'd sub nom. Indopco, Inc. v. Commissioner*, 1992 U.S. LEXIS 1374 (Feb. 26, 1992). In any event, if Congress wishes to retain the deductibility of such expenses it can do so by adding a provision like § 212(b)(3) to § 162.

188. Although it would be easiest for Congress to address this issue by legislation, the term

fects, and to consider the policies which a particular treatment would advance. Unmasking deficiency interest as damages is the first step in that long overdue process.

IV. THE DIFFERENCE BETWEEN CONTESTING WHILE OWING AND BORROWING TO CONTEST.

Treating deficiency interest as damages might also provide a conceptually sound rationale for distinguishing between those who contest a deficiency and incur a charge, and those who borrow money from a third party lender and use the proceeds to pay a deficiency while continuing to contest it. Under a system that treats deficiency interest as damages, a corporation that chose to contest a deficiency and then lost or settled the contest would owe deficiency interest which it could not deduct. If instead of contesting an unpaid deficiency, the corporation borrowed from a third party, used the proceeds to pay the amount of the deficiency, and then contested the assessment by filing claim for refund, the interest due the third party would be deductible under current law.¹⁸⁹ This apparent disparity in treatment has been hailed as a reason to reject the proposal to make deficiency interest nondeductible.¹⁹⁰

The disparity in treatment is troublesome only if the two transactions are economically similar, and the disparity exists only if the current treatment of interest expense is correct. In this case, the two transactions are not similar and the differences between them justify the difference in the way in which the federal income tax system treats them. In addition, as Part V will demonstrate, the current treatment of interest expense is not necessarily correct.

The two transactions are not similar because a corporation that chooses not to pay the deficiency is in a very different position from a corporation that borrows from a third party to pay the deficiency. True, both corporations incur debts, but the debts arise from fundamentally different transactions and therefore merit different treatment.

The corporation that does not pay the deficiency may ultimately be

"interest" has been traditionally defined by judicial opinion, not legislation. *See supra* notes 99, 109-10.

189. The addition of § 6621(c), the hot interest provision, creates a disparity in some situations even under current law. In cases where the increased interest rate applies, taxpayers might have different economic consequences depending on whether they borrow to pay the deficiency or contest the deficiency and then become liable for hot interest in addition to regular deficiency interest. Indeed, that is one of the reasons the provision has received such vehement opposition. *See supra* note 85.

190. *See supra* note 82.

found to owe money, but it has not borrowed it. The government has not consented to the existence of a debt. Indeed, the government's position is the antithesis of consent — when the government asserts a deficiency it is taking the position that the corporation has retained money which should have been paid to the government, and the time for payment is past due. If the deficiency is sustained, the corporation will pay the government an amount in addition to the tax due which is determined without regard to the corporation's financial position or the length of time during which it used the funds. In general, it will also be required to pay the entire amount all at once. But if the deficiency is not sustained, it will not pay any amount at all. It will be as if no debt had ever existed.¹⁹¹

The corporation that borrows from a third party and uses the proceeds to satisfy the government's claim also owes a debt. However, unlike the delinquent taxpayer, the debt it owes is the product of a consensual transaction. The corporation pays interest on a prescribed schedule. Unlike the government, the commercial lender voluntarily forbears collection. In addition, the corporation retains the obligation to pay back the amount of the loan, plus interest, regardless of what happens to the deficiency. The infusion of cash it has received is only temporary and will have to be repaid in all events. The argument that a taxpayer who borrows and pays the deficiency is in the same economic position as one who has to pay the deficiency, plus interest, is therefore flawed.

The foregoing comparison helps to demonstrate why many of the arguments against changing the deductibility of corporate deficiency interest are unpersuasive.¹⁹² Although these arguments are replete with tables and charts which purport to illustrate the economic effect of any change in the law,¹⁹³ the arguments omit an essential point — neither the deficiency nor the deficiency interest is due until a final determination is made.¹⁹⁴ Unlike those who borrow from a commercial lender, a taxpayer who has failed to pay a deficiency need make no payments of either principal or interest while the determination of ultimate liability is pending.

Those who focus on the ability to borrow from third party lenders¹⁹⁵

191. See *supra* note 144.

192. See, e.g., Stark, *supra* note 85, at 1417; *Report on Section 6621(c)*, *supra* note 85. See also *supra* note 82.

193. See sources cited *supra* notes 82-85.

194. See *supra* note 85.

195. See sources cited *supra* note 85.

overlook the twin advantages of using funds in a manner which does not cause a cash drain and using funds that may never have to be paid to the claimant. The reality is that the need to pay commercial interest over the life of a loan at rates that will probably vary depending on the length of that life and the creditworthiness of the borrower will make commercial interest significantly different and less attractive than contesting the deficiency without payment.¹⁹⁶

If deficiency interest were not deductible to corporations while most commercial interest continued to be, there would be a difference in the tax treatment of those who contest a deficiency first and pay later, and those who borrow from a third party to pay the deficiency prior to contesting it. Those who take the latter position would find the after-tax cost of the contest lower because of the deductibility of the interest on the commercial loan.¹⁹⁷ The need to take into account the deductibility of interest on the amount of the deficiency ultimately found to exist would alter the way in which taxpayers manage tax controversies.¹⁹⁸

Changes in the management of tax controversies could even be salutary. Arguments that a change in the deductibility of deficiency interest will result in decreased access to the tax court and the necessity to consider the making of partial payments show the extent to which taxpayers have used the tax system as a tool of corporate finance.¹⁹⁹ The tax court will remain attractive to a taxpayer contesting a deficiency in good faith because a victory results in the taxpayer's having kept its money without any disruption to its cash flow for the payment of interest. The tax court will continue to fulfill its objective of providing a forum in which a taxpayer can litigate a tax controversy without parting with any cash.²⁰⁰

196. Part of the reason for this is that the deficiency interest rate fails to take into account what Professors Bankman and Klein call the term structure of interest. See Bankman & Klein, *supra* note 126.

197. The need to borrow commercially to ensure the deductibility of the interest would lead to particularly anomalous results in situations where the taxpayer ultimately prevailed. In those situations the taxpayer would have incurred the cost of borrowing money which ultimately was found not to be due. Although the government would return the money paid, with interest, the rate paid by the government would probably differ from that paid by the taxpayer to the commercial lender, as would the timing of the inclusion and deduction. The transactions would only occasionally be a wash. In many cases, the differences would favor the taxpayer.

198. See generally Garbis & Fisher, *supra* note 47; Stark, *supra* note 85. Much of the invective against the initial proposal to make deficiency interest nondeductible and the enactment of the hot interest provision amounts to dismay over a change in what had heretofore been considered a fundamental rule of the game. But the change proposed in this Article should not be rejected simply because it will result in change.

199. See *supra* notes 82-85.

200. See *supra* note 146 and accompanying text.

Nothing requires that the tax court be the cheapest forum in which a taxpayer with a strong credit rating and access to the financial markets can litigate a tax controversy.²⁰¹

Moreover, if the tax treatment of deficiency interest has been a driving force behind the management of tax controversies, it is time to level the playing field.²⁰² Leveling the playing field does not mean making deficiency interest low and deductible to everybody. Such a system would only encourage the use of the government as an involuntary financier. The vehemence of the outcries over the initial proposal to deny the deductibility of corporate deficiency interest and over the adoption of the hot interest provision suggests how important such use has become.²⁰³

Leveling the playing field means removing the favorable treatment afforded certain classes of taxpayers. It means providing a forum in which all taxpayers can litigate a tax controversy without first parting with the cash assessed. It does not mean that those who choose to incur an independent liability to a third party commercial lender and to suffer the attendant cash flow drain should be treated in the same manner as those who decline to make such a choice. Although both transactions succeed in giving the taxpayer the use of a certain principal amount, one is not the economic equivalent of the other.

The differences between the commercial loan transaction and the nonpayment of a deficiency might justify a difference in tax treatment of the amount labeled interest even if deficiency interest were true interest. If deficiency interest were true interest, it might still be appropriate to make it nondeductible because it relates to a nonbusiness activity.²⁰⁴ However, under current law, the nature of the activity which the bor-

201. It is interesting to note that practicing lawyers, who are decrying the projected demise of the tax court if deficiency jurisdiction is made less attractive because of changes in the tax treatment of deficiency interest, (at least partially on the grounds that it will shift more tax controversies into courts of general, rather than specialized, jurisdiction (see *supra* notes 82-85)) have as a group also attacked proposals to create a specialized court of tax appeals, on the ground that courts of general jurisdiction serve a needed and salutary function in the development of the tax law. See FEDERAL COURTS STUDY COMMITTEE, TENTATIVE RECOMMENDATIONS FOR PUBLIC COMMENT (1989); William D. Popkin, *Why a Court of Tax Appeals Is So Elusive*, 47 TAX NOTES 1101 (1990) (synopsis of the debate on this issue and an excellent bibliography of recent commentary).

202. See Arthur W. Andrews, *The Use of the Injunction as a Remedy for an Invalid Federal Tax Assessment*, 40 TAX L. REV. 653 (1984-1985); Garbis & Fisher, *supra* note 47; Patrick B. Mathis, *Advanced Payments of Proposed Deficiencies Useful in Today's High Interest Rate Climate*, 56 J. TAX'N 366 (1982); Stark, *supra* note 85, at 1417; Michael Weintraub & Phillip Starr, *Tax Planning for Proposed and Outstanding Federal Tax Deficiencies*, 11 TAX SEC. NEWS 1 (1985).

203. See *supra* notes 85-86.

204. See *supra* notes 172-85 and accompanying text.

rowed funds facilitate does not matter, as *all* corporate interest is generally deductible.

Perhaps that is one of the reasons the proposal to deny the deduction for deficiency interest generated such a maelstrom of controversy:²⁰⁵ it suggests an expansion of the concept of tracing (which makes the deductibility of an amount dependent on the use to which it is put) into heretofore sacred ground. If deficiency interest were treated as damages, it would be nondeductible regardless of the identity of the payor because the deductibility of damages depends on the origin of the underlying claim.²⁰⁶ Under current law, the deductibility of interest, at least for corporations, does not generally depend on the origin of the underlying claim.²⁰⁷ A tax system that allowed a deduction for virtually all corporate interest expense but denied a deduction for deficiency interest (because it characterized deficiency interest as damages) would create an incentive to borrow from commercial lenders to cover the cost of the deficiency. Although the disparate treatment of those who incur deficiency interest and those who borrow to satisfy the deficiency under such a system could be supported academically,²⁰⁸ it might nevertheless produce inequity by favoring well advised and financially strong enterprises.

This potential inequity could be resolved by reformulating the deduction for corporate interest expense. Although the primary aim of this Article has been to suggest an alternative perspective on the nature of amounts which the law has traditionally classified as interest, this new perspective can advance our thinking about the appropriate federal income tax treatment of corporate interest expense. The next part of this Article seeks to begin that process by setting forth a modest proposal for reformulating the federal income tax treatment of corporate interest expense. Although the proposal is not developed fully here, the outline presented may serve as a catalyst for further discussion and debate.

V. A CONCEPTUAL MODEL FOR ESTABLISHING THE DEDUCTIBILITY OF CORPORATE INTEREST EXPENSE

For many years the general rule was that if an amount was interest, it was deductible.²⁰⁹ After the Supreme Court defined interest as an

205. See *supra* note 82.

206. See *supra* notes 170-87 and accompanying text.

207. See *supra* note 79.

208. See *supra* text accompanying notes 190-203.

209. See, e.g., I.R.C. § 163 (1984). See also Charles O. Galvin, *The Deduction of Nonbusiness Interest: An Exercise in Planned Confusion*, 41 TAX LAW. 803 (1988). Commentators have ques-

amount paid "for the use or forbearance of money" in *Deputy v. DuPont*,²¹⁰ the only question remaining was whether a given amount satisfied that definition. In only two situations of general application did compliance with that definition fail to suffice in establishing deductibility.²¹¹ The first was where the borrowed funds allowed a taxpayer to purchase or carry tax exempt securities²¹² and the second was where the borrowed funds were used in connection with an individual taxpayer's investments.²¹³ In those two situations the use of the loan proceeds was important in determining the deductibility of the interest thereon. Tracing deductibility to use was the exception, not the rule.

The Tax Reform Act of 1986 (the "'86 Act"),²¹⁴ eliminated that relatively simple regime.²¹⁵ By adding sections 163(h)²¹⁶ and 469,²¹⁷ the

tioned the policy basis for the corporate interest deduction, but much of the analysis has focused on the treatment of interest paid on long term, unsecured corporate borrowings (corporate securities), and has been prompted by the differing treatment of interest paid on debt and dividends paid on equity. See, e.g., Warren, *supra* note 116. Much attention has also been devoted to an examination of transactions in which an interest element is present but not treated as such for tax purposes. See, e.g., Asimow, *supra* note 1; Halperin, *supra* note 8.

210. 308 U.S. 488, 498 (1940). See also *Old Colony R.R. v. Commissioner*, 284 U.S. 552, 561 (1932).

211. The Code denies a deduction for interest in certain situations which present an opportunity for abuse. Thus, § 267(a)(2) denies an interest deduction to a payor until the related payee includes the interest in income and § 461(h) denies the payor a deduction until economic performance has occurred, that is, until the lender has forgone the use of the funds. See H.R. REP. NO. 861, 98th Cong., 2d Sess. 875 (1984). See also § 246A, which restricts the dividends received deduction with respect to dividends distributed on debt-financed portfolio stock. In addition, § 465, which limits deductions to the extent the payor is at risk, could operate to disallow a deduction for interest. Until its repeal in 1986, § 189 disallowed the deduction for construction period interest. Section 263A now requires the capitalization of interest incurred to acquire certain property. See Cheryl D. Block, *The Trouble With Interest: Reflections On Interest Deductions After the Tax Reform Act of 1986*, 40 FLA. L. REV. 689 (1988).

212. See I.R.C. § 265.

213. See I.R.C. § 163(d). For a history of the introduction of I.R.C. §§ 265 and 163(d), see Taggart, *supra* note 78, at 204-05.

214. Pub. L. No. 99-514, 100 Stat. 2085.

215. See Block, *supra* note 211; Taggart, *supra* note 78; Galvin, *supra* note 209; Curtis J. Berger, *Simple Interest and Complex Taxes*, 81 COLUM. L. REV. 217 (1981).

216. See Pub. L. No. 99-514, § 511(b), 100 Stat. 2085. This provision denies individuals any deduction for what it defines as "personal interest." I.R.C. § 163(h)(1). The provision has the effect of allowing individuals to deduct only interest incurred in carrying on a trade or business, interest incurred with respect to property held for investment or profit, certain interest attributable to passive activities, certain interest paid or incurred in connection with an extension of the time for payment of estate taxes, and "qualified residence interest," which is generally defined to include only interest on a first or second mortgage, with certain limitations. I.R.C. § 163(h)(2).

217. Pub. L. No. 99-514, § 501(a), 100 Stat. 2085. Section 469 limits an individual's ability to deduct amounts attributable to what the provision defines as "passive activities." I.R.C. § 469(a). In general, the provision permits the deduction of amounts attributable to the conduct of such activities only against income generated by those activities.

'86 Act expanded the tracing concept pioneered in sections 265 and 163(d) so much that tracing has now become the rule with respect to individuals. In addition, the '86 Act reversed the nature of the operation of tracing. Rather than operating only to deny an otherwise allowable deduction, tracing is now a necessary precondition to the allowance of the deduction.

Tracing is increasingly important in the case of corporations as well. The much maligned uniform capitalization rules of section 263A show a Congressional desire to treat all acquisition costs consistently, and to treat interest as a cost of acquisition.²¹⁸ Congress has evidently decided to marry the deductibility of interest to the use of the borrowed funds for both corporations and individuals.²¹⁹ By marrying deductibility to use, Congress has eliminated the fungibility of money. The questions now are whether that elimination is correct, and, if it is, whether it should apply to corporations to the same extent as it applies to individuals.

A. *The Marriage of Deductibility to Use Is Sound Tax Policy*

A normative income tax system should distinguish between those expenditures that are discretionary and those that are necessary for the production of income.²²⁰ In general, the federal income tax system

218. See I.R.C. § 263A(f). See also John W. Kindt, *The New Assault on Freedom of Thought: Section 263A of the Internal Revenue Code*, 33 ST. LOUIS U. L.J. 137 (1988); B. Anthony Billings & John Messer, *How to Cope With the Uniform Capitalization Rules*, 15 J. CORP. TAX'N 324 (1989). The recently proposed regulations dealing with the allocation of interest expense between foreign and domestic sources evidence the growth of tracing. See Prop. Treas. Reg. § 1.861-10(e), 56 Fed. Reg. 10397 (1991); see also I.R.C. § 864(e). The concept has even been applied to charitable contributions, which proposed regulations would also require taxpayers to allocate between foreign and domestic source income. See Prop. Treas. Reg. § 1.861-8, 56 Fed. Reg. 10395 (1991). That the expansion of the concept has failed to draw cheers from practitioners is no indictment of its theoretical soundness. See Marianne Burge & Richard M. Hammer, *Price Waterhouse Disagrees With Netting Rule for Interest Allocation*, 91 TAX NOTES TODAY 141-24, July 3, 1991; Kathleen Matthews, *Witnesses Sing Same Old Song at IRS Hearing of CFC Netting Rules*, 91 TAX NOTES TODAY 134-1, June 24, 1991; Daniel R. Mitchell, *Amoco Consolidates Comments on Domestic Source Regulations*, 91 TAX NOTES TODAY 134-53, June 24, 1991; Donald H. Skadden, *AICPA Outlines Comments on Interest Allocation Regs.*, 91 TAX NOTES TODAY 132-54, June 20, 1991; Peter G. Powers, *Smithsonian Pushes for U.S. Source Income Presumption*, 91 TAX NOTES TODAY 138-44, June 28, 1991; all available in LEXIS, Fedtax Library, TNT File. See also Robert Feinschreiber, *Allocation and Apportionment of Interest*, 3 INT'L TAX J. 538 (1977).

219. See GENERAL EXPLANATION, *supra* note 78, at 262-70.

220. As Professor Surrey has eloquently stated:

In terms of the income tax, the normative structure involves the determination of the base of the tax (net income); the accounting period; the taxable unit; and the rate schedule. . . . In the United States . . . the normative concept of net income is the general economic definition of income under the "Haig-Simons" approach, i.e. increase in net economic wealth between two points of time plus consumption during that period.

makes that distinction, except where it specifically seeks to influence behavior through the provision of tax incentives. Determining whether interest ought to be deductible under such a system requires a determination of whether the borrowing was discretionary or necessary.²²¹ The costs of necessary borrowing should be deductible while the costs of discretionary borrowing should not.

Marrying deductibility to use effectuates good tax policy because it ensures that only the costs of necessary borrowing will be deductible. A system that marries deductibility to use treats the costs of obtaining funds with which to engage in an activity as part of the cost of engaging in the activity. Under such a system, interest would be deductible when the purchase or activity which it facilitates is deductible. Embracing such a system requires a rejection of the view that interest is inherently a cost of doing business and therefore ought to be "universally" deductible.²²²

A universal interest deduction makes sense only if the borrowing transaction is independent of the use of the borrowed funds.²²³ Econom-

"Consumption" is broadly applied, and in essence covers all expenditures except those incurred as a cost in the earning or production of income and hence are proper offsets to gross income to arrive at taxable net income.

Stanley S. Surrey, *The Concept of Tax Reliefs—Its Relation to Tax Policy and Budget Policy*, in INTERNATIONAL INSTITUTE OF PUBLIC FINANCE, SUBSIDIES, TAX RELIEFS AND PRICES (Varna Congress, 1977), reprinted in Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225, 229 n.9 (1979).

Thus, a normative income tax excludes necessary expenditures from the determination of the amount subject to taxation by not treating them as consumption to be added to the base. The Code accomplishes that result by allowing the deduction of necessary expenditures in arriving at taxable income. It then deviates from the normative structure by also providing deductions for amounts that represent tax expenditures. See Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget - Response to Professor Bittker*, 22 NAT'L TAX J. 528, 529 (1969).

221. The terms discretionary and necessary are used here in the sense that they are used in a normative income tax system, so that the borrowing will be treated as discretionary when it is not a cost of producing income and necessary when it is.

222. I have taken the term from MacIntyre, *supra* note 116, at 774; see also Johnson, *supra* note 116. A universal interest deduction can be supported on several grounds. A universal interest deduction can be seen as a way of giving "persons without capital the same privilege that persons with capital can enjoy by liquidating taxed investments in order to shift into tax-favored investments." *Id.* at 124. A universal interest deduction can also be seen as the "corollary of the taxation of the lender on the interest received." *Id.* Some commentators even maintain that a universal interest deduction is appropriate because any other system requires tracing and tracing is unadministrable. *Id.* at 125.

223. Characterizing the borrowing transaction without reference to the use of the borrowed funds might follow from the treatment of borrowing in general. Borrowed funds are not income. The classic reason given for that is that the borrower has an obligation to repay. Because the repayment must proceed from after tax dollars, the treatment of the loan as income would result in double taxation, unless a deduction were allowed. For federal income tax purposes, then, borrowed funds are treated as if they were the taxpayer's own. It follows from this that the deductibility of the cost

ically, it is not — taxpayers do not borrow just for the sake of borrowing.²²⁴ They borrow for a reason and they generally use the borrowed funds for a particular purpose. A tax system that fails to treat the cost of borrowing to acquire something as part of the cost of acquiring the item in question breeds inequity — it favors those who can and do borrow over those who either cannot or do not.²²⁵

A fair tax system should treat interest like it treats any other cost of acquiring an item or engaging in an activity.²²⁶ The biggest obstacle to treating interest in that way is the difficulty of ascertaining the relationship between the borrowing and the use of the borrowed funds. As Professor Johnson acknowledged in 1986,²²⁷ and as many taxpayers and tax professionals have discovered since the promulgation of Temp. Treas. Reg. § 1.163-8T in 1987,²²⁸ determining the relationship between borrowing and the use of the borrowed funds can be an administrative and practical nightmare because it requires a determination of *why* the taxpayer borrowed. That determination can be made either subjectively (by asking the taxpayer) or objectively (by reference to the use to which the taxpayer put the borrowed funds). A subjective test is not administrable because it requires an examination of a taxpayer's state of mind, a diffi-

of borrowing could be treated independently of the use of the borrowed funds. In effect, treating the use of the borrowed funds separately could be viewed as consistent with the tax treatment of those funds as the borrower's own.

224. Some proponents of a universal interest deduction argue that such a deduction is necessary to create parity between individuals with capital and those without. See MacIntyre, *supra* note 116. But even that argument rests on the assumption that the taxpayer uses the borrowed funds to acquire an income producing asset, and not for mere consumption.

225. The following example demonstrates the inequity. Taxpayers A and B each have \$100 of income and \$500 of income producing assets during a given taxable period. Both taxpayers need to spend \$100 to acquire jewelry for personal consumption. Taxpayer A uses \$100 of her wealth to do so. Thus, at the end of the period she could still have \$500 of wealth, although \$100 of it will no longer be income producing. She will also have taxable income of \$100.

Taxpayer B borrows \$100 and has to pay \$10 in interest. The borrowing is a personal decision because she could have chosen to use some of her wealth to acquire the jewelry. At the end of the period, Taxpayer B still has \$500 of wealth (the additional \$100 liability offsets the new \$100 asset) and, if interest is deductible, only \$90 of taxable income. Taxpayer B would therefore be in a better tax position than Taxpayer A although that difference stems from their personal decisions to borrow or not. Taxpayer B is also in a better long term position because she still has all of her income producing assets which can continue to produce income even after she has paid off the \$100 loan.

Giving Taxpayer B an interest deduction under those circumstances can be regressive and therefore unfair. It uses personal decisions to lower the tax burden only for those who have greater wealth and therefore greater ability to borrow.

226. Professors Calvin Johnson and Michael MacIntyre have so urged. See Johnson, *supra* note 116, and MacIntyre, *supra* note 116.

227. Johnson, *supra* note 116, at 175-80.

228. T.D. 8145, 1987-2 C.B. 47. See Taggart, *supra* note 78.

cult and time consuming task which is not certain to produce accurate results. The objective test requires tracing the use of the borrowed funds.

Tracing hardly provides a perfect solution. Not only does the fungibility of money make tracing difficult to do as a practical matter,²²⁹ but tracing can also be inaccurate.²³⁰ Nevertheless, the difficulty encountered in establishing the relationship between the borrowed funds and the item or activity they facilitate does not render tracing either futile or inappropriate.²³¹ It simply suggests that in most cases the link between the use of borrowed funds and the deductibility of the interest thereon should be established in general, rather than in specific, terms.

B. *When to Marry: The Application of Tracing*

If the desire to trace the use of borrowed funds proceeds from the

229. See, e.g., *supra* note 225.

230. A taxpayer's use of borrowed funds for the apparent purpose of buying a house does not necessarily mean that the borrowed funds made that purchase possible. The borrowed funds may have only made it possible for the taxpayer to buy the house and retain her portfolio of securities, for example.

The jurisprudence of § 265 illustrates this problem. See *Dillon, Read & Co., v. United States*, 875 F.2d 293 (Fed. Cir. 1989); *Leslie Co. v. Commissioner*, 413 F.2d 636 (2d Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970); *Wisconsin Cheeseman, Inc. v. Commissioner*, 388 F.2d 420 (7th Cir. 1968); *Bishop v. Commissioner*, 342 F.2d 757 (6th Cir. 1965); *Wynn v. United States*, 288 F. Supp. 797 (E.D. Pa. 1968), *aff'd per curiam*, 411 F.2d 614 (3d Cir. 1969), *cert. denied*, 396 U.S. 1008 (1970); *Barenholtz v. United States*, 784 F.2d 375 (Fed. Cir. 1986); *Investors Diversified Servs., Inc. v. United States*, 575 F.2d 843 (Ct. Cl. 1978); *New Mexico Bancorporation v. Commissioner*, 74 T.C. 1342 (1980); *E.F. Hutton Group, Inc. v. United States*, 811 F.2d 581 (Fed. Cir. 1987). See Charles E. Falk & Donna Balon, *Wisconsin Cheeseman Revisited*, 65 TAXES 711 (1987). (I am indebted to Amy A. Welsh and Kendall S. Zylstra, Temple University School of Law, Class of 1991, for educating me on the jurisprudence of § 265 while I was coaching them in a moot court competition involving that provision. The preceding research reflects their work.)

Professor Gunn uses a variation on this argument to defend the interest deduction as a proper part of a normative tax system. Gunn, *supra* note 116. Professor Gunn argues that a taxpayer who borrows to buy business assets and uses her own funds for personal consumption is in the same position as one who borrows for personal consumption and uses her own funds to buy business assets. *Id.* at 47. The only difference between those two taxpayers is their motive for borrowing and Professor Gunn concludes that such a motive "is not only hard to find, it is not even worth looking for." *Id.* Both taxpayers ought to be taxed in the same way and if an interest deduction is appropriate in the case of the first, it ought similarly to be appropriate in the case of the second.

231. Tracing the use of borrowed funds and making deductibility of the interest contingent on the use of the funds for a deductible purpose is both useful and appropriate because borrowing is not aimless. By making the use of the funds determinative, Congress would be acknowledging that the act of borrowing is discretionary. To say that interest ought to be deductible because borrowing is the only way that certain segments of the population can acquire the wherewithal to be on an equal footing with others, as Professor Gunn does, is to give those who are willing to borrow an advantage over those who prefer to save and delay gratification. Gunn, *supra* note 116, at 48. Unless Congress is prepared to say that saving is bad, Congress ought not give preferential treatment to those who forego saving.

desire to distinguish between discretionary borrowing and necessary borrowing, then tracing should occur whenever taxpayers may properly engage in both types of borrowing.²³² Two principles should guide the process of establishing the link between deductibility and use. First, the link should be established on the basis of a general rule which reflects the likely behavior of the majority of taxpayers. Second, the link should be established on the basis of the specific use of the proceeds only when the relationship between the borrowed funds and their use is too strong to ignore, as in the case of purchase money indebtedness.

Individuals present the clearest case for tracing because individuals engage in both discretionary and necessary spending. Discretionary spending is most easily seen as consumption. Because individuals consume and because the tax law distinguishes between expenses that individuals incur for consumption and those they incur for business or profit seeking purposes²³³ it is less difficult to extend the discretionary/necessary distinction to the treatment of interest.²³⁴

In contrast to individuals, corporations are not generally regarded as consumers. It has been easy to assume that because corporations do not consume, all disbursements made by a corporation are caused by a desire to pursue business objectives. Such a view leads to the conclusion that even if tracing is appropriate in the case of individuals, where it is important to distinguish between consumer and nonconsumer borrowing,²³⁵ it is neither necessary nor appropriate in the case of corporations.

This conclusion does not withstand scrutiny. Not all corporate disbursements are deductible. Even interest was not always deductible.²³⁶ Deductibility reflects a judgment about the proper role of a disbursement in the computation of the tax base. If the cost of engaging in a particular transaction has been judged nondeductible, there is little reason to judge

232. See *supra* text accompanying note 218.

233. Compare I.R.C. § 262 with I.R.C. § 162 and § 212.

234. It is interesting to note that *Blueprints for Basic Tax Reform*, the seminal work comparing a model income and consumption tax, would have retained the universal deductibility of interest under both models. See DAVID F. BRADFORD, U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 59, 111-12 (2d ed. 1984). In the case of the cash flow consumption tax, interest paid would be deductible on indebtedness obtained through a qualified account. On indebtedness not obtained through a qualified account, neither repayment of interest nor repayment of principal would be deductible. *Id.* at 112.

235. This distinction is, of course, a rather recent one, having been largely absent from the tax law until 1986. See I.R.C. §§ 163(h) and 469, discussed *supra* notes 216-17.

236. Professor Warren has pointed out that the allowance of an unlimited interest deduction for corporations entered the law in 1918 as a temporary measure designed to ameliorate the effect of the World War I excess profits tax. See Warren, *supra* note 116, at 1585-86; see also Asimow, *supra* note 1.

deductible the cost of borrowing to facilitate the transaction. A tax policy that consistently applied that judgment would present the fewest opportunities for manipulation and abuse. It would treat taxpayers fairly because it would treat the cost of borrowing as part of the cost of the activity that the borrowing facilitates in all cases. It would also require that corporations distinguish between borrowing that facilitates deductible disbursements and borrowing that facilitates nondeductible disbursements.

That distinction need not be made in the same way for individuals as for corporations, however. Because corporations are organized for the purpose of engaging in business and because the expenses of carrying on that business are likely to be deductible under normative principles of taxation, much corporate borrowing should properly be deductible. For corporate taxpayers, then, tracing should be the exception rather than the rule. Corporate interest should remain deductible except in those instances where the corporation borrowed funds needed for an easily identifiable nondeductible disbursement.

1. *The General Rule.* The general rule should proceed from the likely use of the borrowed funds. If business borrowing should be deductible because it is a cost of doing business and the costs of doing business are deductible, then taxpayers who are likely to borrow primarily for business reasons should be subject to a general rule of deductibility of interest. Conversely, taxpayers who are most likely to borrow for discretionary, and therefore nondeductible, purposes should be subject to a general rule of nondeductibility of interest.

Current law draws precisely such a distinction. Corporations can generally deduct interest expense but individuals cannot.²³⁷ Individuals can deduct interest expense only when it is related either to the conduct of a trade or business or to the pursuit of an activity engaged in for profit, or when the interest expense is related to a nonbusiness activity which Congress has chosen to facilitate, such as the purchase of a residence.²³⁸ The general rule of nondeductibility of the interest expense incurred by individuals is sound, just as the general rule of deductibility of corporate interest expense is. These general rules follow the distinctions currently made by the Code.²³⁹

Departures from that general rule should occur only when it is evi-

237. See *supra* notes 78-79 accompanying text.

238. I.R.C. § 163(h).

239. See *supra* text accompanying notes 232-35.

dent that the rationale for the general rule does not apply. Tracing the use of the proceeds can allow individual taxpayers to establish that the cost of borrowing was part of engaging in a deductible activity, and therefore ought to be deductible as well.²⁴⁰ But because most individual activities are not related to the conduct of a trade or business or an activity engaged in for profit, most individual interest ought not be itself deductible. Tracing should only serve to establish the contrary. Because most corporate activities are related to the conduct of the corporate trade or business and are therefore deductible, most corporate interest ought to be deductible. Tracing should only serve to establish the contrary.

2. *The Relevance of Purchase Money Indebtedness.* A general rule of deductibility for corporate interest expense is essentially a presumption that borrowed funds are used for a business purpose. It makes tracing conceptually unnecessary in precisely the cases where it would be most difficult.²⁴¹ The general rule would apply to the deductibility of interest on funds obtained under a line of credit or a general purpose unsecured loan.

Where the facts more directly rebut the presumption of use of the proceeds for a deductible activity, however, tracing is both appropriate and administratively simple. In effect, where there is easily traceable evidence of the use of funds, the general rule of deductibility need not apply. A special rule should then apply. Purchase money indebtedness presents the clearest case for the application of such a special rule.²⁴² While sin-

240. Temp. Treas. Reg. § 1.163-8T (1987).

241. Professor Johnson has urged that interest should be deductible only when it is a cost of producing ordinary income, and that interest incurred to purchase depreciable property does not produce ordinary income because Accelerated Cost Recovery System (ACRS) depreciation, combined with the investment tax credit, can be the economical equivalent of a tax exemption. See Johnson, *supra* note 116, at 138. The demise of ACRS and the investment tax credit brought about by the Tax Reform Act of 1986 make this argument much less persuasive today than it was when it was argued by Professor Johnson. In addition, the use of depreciable property to generate income in excess of depreciation calls into question the equivalence of depreciation to tax exemption for income.

242. Section 265(a)(2) applies such a rule by denying a deduction for interest "on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle." One serious problem in the administration of this provision has been the need to apply it in cases other than traditional purchase money debt. Thus, both the Service and the courts have had to address the situation where, rather than borrowing money and then using that money directly for the purchase of tax-exempt securities, the taxpayer uses the tax-exempt securities as collateral for a loan. See *supra* note 230.

Many of the difficulties which the Service and the courts have encountered would be alleviated by the existence of mechanical tracing rules such as those now contained in Treas. Reg. § 1.163-8T(c)(1) (1987). Those rules, though complex, provide more certainty than the facts and circum-

gling out purchase money indebtedness creates the potential for unfairness and abuse, purchase money indebtedness presents too clear a case to ignore.²⁴³

Where tracing is difficult, as in the case of lines of credit or general unsecured borrowing, it is not unreasonable to make the working assumption that the funds were used for a deductible purpose. Doing so has many of the advantages of adopting a universal interest deduction and is sound for all of the reasons which would make the adoption of such a deduction sound. Where the borrowed funds are represented by purchase money indebtedness, however, the assumption of deductibility is rebutted. The use of the borrowed funds is apparent and linking deductibility to that use is both fair and administrable. In short, marrying deductibility to use in the case of purchase money debt makes sense for the same reasons as does the "origin of the claim" test in the case of damages: it traces in those cases where tracing is easily accomplished.²⁴⁴

It is reasonable to adopt a regime that balances the conceptual purity of tracing with the administrative difficulty of doing so by tracing only when the trace is clear.²⁴⁵ Under such a regime, a taxpayer who does not need to borrow to engage in the nondeductible activity will not do so.²⁴⁶ Only those who need to borrow to engage in the activity will

Proc. 74-8, 1974-1 C.B. 419, *modified by* Rev. Proc. 87-53, 1987-2 C.B. 669; Rev. Rul. 81-200, 1981-2 C.B. 81. The complexity of the rules ought not to prevent their application to corporate interest expense. The rules already apply to individual taxpayers, who, as a group, are far less able to understand them. While the complexity of the rules might be a rationale for their repeal, it does not support their application to individuals only. For an analysis of various methods of effecting an allocation of interest, see Block, *supra* note 211, at 728-42. See also Blake D. Rubin, *Pro-Rata Interest Allocation: The Path Not Chosen*, 36 TAX NOTES 301 (1987).

243. Professor MacIntyre has shown that most U.S. debt is purchase money or other clearly traceable debt, so it is not terribly unfair to single out that kind of debt for special treatment. See MacIntyre, *supra* note 116, at 785 n.56.

244. Professor Block has proposed a variation on this notion. See Block, *supra* note 211, at 710. To take account of the failure of the current tax system to tax unrealized appreciation or to include unrealized gains in earnings and profits, she suggests, at a minimum, that "any borrowing against appreciated property will generate earnings and profits for the corporations to the extent of the previously unrealized appreciation," and notes that I.R.C. § 312(i) already provides for such a result in certain cases. *Id.*

245. In essence, this is what Congress has already done with the enactment of § 265. As discussed in notes 230-31 and accompanying text, *supra*, the difficulties in the administration of § 265 are not insurmountable, nor do they suggest that the provision is conceptually flawed. They suggest only that a more mechanical application is desirable notwithstanding that it may produce less equitable results in particular cases.

246. Because this rule would apply only in the case of a C corporation (deficiency interest incurred by individuals is already nondeductible, see *supra* note 78), there is little concern over creating a potential trap for the ill-advised. Most C corporations have professionals prepare their returns. The issue of deficiency interest will not arise unless there is either a late payment or an

borrow. Where borrowing occurs, then, the link between the funds and their use will be clear. The administrative problem of tracing will disappear and the conceptual reason for tracing will become compelling. Unless one embraces the universal interest deduction, if other costs of engaging in an activity are not deductible the cost of borrowing the money which makes the activity possible should not be deductible either.

The Code already contains at least one corporate provision that takes an approach very similar to that proposed here. Section 246A reduces the dividends received deduction in the case of debt financed portfolio stock.²⁴⁷ This provision requires tracing, but only where the relationship between the debt and the acquisition is direct.²⁴⁸ Like the model proposed here, section 246A requires tracing only when the relationship between the amount borrowed and the use of the proceeds is fairly clear.

As with the discussion of the inequity which could result from the nondeductibility of deficiency interest if all other interest remained deductible,²⁴⁹ the proposed model is subject to the criticism that it will create an artificial distinction between those who can borrow indirectly, through the issuance of commercial paper or by obtaining general purpose lines of credit, and those who must obtain purchase money debt.²⁵⁰ Nevertheless, this distinction would level the playing field with respect to

returns. The issue of deficiency interest will not arise unless there is either a late payment or an assessed deficiency. In both of those situations, it is likely that the taxpayer in question will obtain professional advice.

247. Although § 246A reduces the dividends received deduction rather than the interest deduction and is therefore not precisely analogous, the notable feature of that provision is that the reduction occurs only when there is a direct relationship between the borrowing and the purchase of the stock.

248. Section 246A(d)(3) defines the term 'portfolio indebtedness' as "any indebtedness *directly attributable* to investment in the portfolio stock." (emphasis added). The Service has required a "direct relationship," such as that exhibited where the lender makes a nonrecourse note secured by portfolio stock, between the debt and an investment in stock. Rev. Rul. 88-66, 1988-2 C.B. 34; Priv. Ltr. Rul. 91-41-006 (June 17, 1991); Priv. Ltr. Rul. 89-06-010 (Nov. 7, 1988).

The regulations that prescribe rules for the allocation and apportionment of interest expense for purposes of determining the amount of foreign and domestic source taxable income of a taxpayer also follow a pattern similar to that proposed here. See I.R.C. §§ 861(a)(1), 864(e)(2); Treas. Reg. § 1.861-8(e) (1991). Thus, interest expense is generally allocated according to the taxpayer's assets, except to the extent that the interest expense is attributable to nonrecourse debt that is clearly identified with specific assets. See Treas. Reg. § 1.861-8(e)(2) (1991), Temp. Treas. Reg. § 1.861-9T(a) (1991). In that case, interest expense is allocated to the income generated by that asset. Temp. Treas. Reg. § 1.861-10T(b) (1991). See generally JOSEPH ISENBERG, 1 INTERNATIONAL TAXATION 214-15 (1990); BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION 70-35 to 70-48 (1991).

249. See discussion *supra* Part III.

250. *Id.*

borrowing generally. It would not single out a particular endeavor (the payment of taxes) for different treatment. Congress has moved the law in this direction,²⁵¹ as has the Supreme Court. In *Indopco, Inc. v. Commissioner*,²⁵² the Court narrowed the scope of deductible corporate expenses by closely examining the nature of the benefit that a particular expense generated.²⁵³ The reasoning employed by the Court in *Indopco* suggests keener scrutiny of the benefits generated by particular disbursements, and points the way toward increased restrictions on deductibility of items heretofore regarded as normal costs of doing business.²⁵⁴ As proposed in this Article, where the relationship between the expenditure and the activity that the expenditure facilitated was clear, it was not ignored and was used as the basis for determining deductibility.

The adoption of tracing in the corporate context coupled with recognition of the distinction between interest and damages would require a shift in general policy — the exception and the general rule would switch places. In effect, the tax law would be saying that only amounts paid as a result of consensual lending transactions would be deductible at all, and that even such amounts would be subject to restrictions on deductibility depending on the use to which they were put. Adoption of tracing would necessarily limit the availability of the interest deduction, which would have a profound effect on corporate taxpayers (as well as the federal government). Ultimately, deciding whether enacting such a limit is good policy depends on further development of the benefits and costs of tracing, and a view of what is best for the economy.²⁵⁵

251. Provisions like § 263A, the uniform capitalization rules, represent an attempt to tie deductibility to use because the relationship between the funds and the use to which they are put is too obvious for the tax system to ignore. See GENERAL EXPLANATION, *supra* note 78, at 509-13. Provisions like § 163(h), which limits an individual's ability to deduct personal interest, also tie deductibility to use. Similarly, § 246A limits the deductibility of dividends received but does so by reference to the origin of the process used to purchase the stock.

252. 1992 U.S. LEXIS 1374 (Feb. 26, 1992).

253. The Court made the deductibility of amounts paid for professional fees dependent on the purpose for which the professional fees were incurred. Because the fees facilitated a capital expenditure, the Court denied deductibility, despite the fact that the fees did not give rise to a specific, separately identifiable asset. *Id.* at *16.

254. See Paul M. Barrett & Randall Smith, *High Court Denies Tax Deductions for Takeover Fees*, WALL ST. J., Feb. 27, 1992, at B8.

255. The question whether the current treatment of interest is good for the economy has been hotly and frequently debated. See, e.g., *Leveraged Buyouts and Corporate Debt, Part I, Hearings Before the Senate Finance Committee*, 101st Cong., 1st Sess. 16 (1989); *Tax Policy Aspects of Mergers and Acquisitions, Part I, Hearings Before the House Ways and Means Committee*, 101 Cong., 1st Sess. 10 (1989). See generally Robert Willens, *The Corporate Provisions of the Revenue Reconciliations Act of 1990*, 22 TAX ADVISER 3 (1991); Seth M. Zachary & Jill Greenwald, *Tax Considerations in Leveraged Buyouts From the Lender's Perspective, Focusing on ESOPs*, 42 MAJOR TAX PLAN. 300

VI. CONCLUSION

The law has tended to treat as interest any amount measured by an interest rate, operating under the assumption that the nature of the measurement determines the characterization of the amount. This Article has challenged that traditional view. It has suggested that in many cases, amounts which the law calls interest might more accurately be viewed as damages for late payment.

Determining whether an amount is interest or damages is important because the tax law treats interest and damages differently. Deficiency interest provides a good vehicle for exploring the similarity between interest and damages, and for analyzing the tax consequences of the characterization of an amount as interest or damages. Three things become clear.

First, the distinction between interest and damages was not always as blurred as is today. An analysis of the cases that understood and expressed the distinction reveals that its blurring resulted from a following of holdings without regard to rationales. The distinction is sound, it comports with economic reality and would provide a powerful analytical tool for courts and legislatures. Its lack of prominence in the current legal landscape can easily be rectified by courts willing to engage in thoughtful analysis.

Second, deficiency interest is probably more accurately viewed as damages. Deficiency interest bears few of the indicia of commercial interest, and sound tax policy is not served by treating it in the same way as commercial interest. If deficiency interest is damages it should not be deductible, regardless of the identity of the payor.

Third, acceptance of the proposition that deficiency interest should be treated as damages suggests a re-examination of the nearly universal deductibility of corporate interest expense under current law. That re-examination leads to a conclusion that in general, the deductibility of interest, like that of damages, ought to depend on the ultimate use of the proceeds. In the case of corporations, a model which presumes deductibility but traces in the case of purchase money indebtedness provides a good compromise between accuracy and administrability.

Acceptance of both the suggested distinction between interest and damages and the suggested limitation of interest expense on purchase

(1991 Part 1); Sherry R. Sontag, *Takeovers Get Even Costlier*, NAT'L L.J., Dec. 18, 1989, at 3; Richard D. Belford & Kenneth G. Greenberg, *Employee Benefits*, NAT'L L.J., Dec. 18, 1989, at 16. Further analysis of it is beyond the scope of the piece.

money indebtedness would undoubtedly narrow the scope of the interest deduction. To do so would be consistent with the trend of recent legislation.²⁵⁶ For those who believe the trend should continue, the suggestions made here will provide one more item of ammunition.

256. Recent legislation has persistently narrowed the scope of the interest deduction, both for individuals and for corporations. *See supra* notes 79, 216-219. Not only has § 163 grown from five subsections in 1975 (*see* I.R.C. § 163 (1975)) to eleven subsections in 1991 (*see* I.R.C. § 163 (1991)), but other provisions have specifically limited the deductibility of interest expense. *See, e.g.*, I.R.C. §§ 263(A), 279, 461(h), 469. Certain provisions limit tax benefits otherwise available when the property is financed with debt. *See, e.g.*, I.R.C. § 246(A) (reducing the dividends received deduction available with respect to debt-financed portfolio stock). Bifurcation of debt instruments required by § 163(e)(5) and permitted by the last clause of § 385 promises to make denial of payments previously classified as interest more common. Indeed, bifurcation is becoming a powerful analytical tool. *See* Steven J. Willis, *The Options Aspect of Nonrecourse Loans*, 54 TAX NOTES 441 (1992); Yishai Beer, *Nonrecourse Loans: Do Not Forget to Tax the Option*, 53 TAX NOTES 837 (1991); Robert Feldgarden et al., *Bifurcating Nonrecourse Debt*, 51 TAX NOTES 1462 (1991); Prop. Treas. Reg. § 1.1275(4)(g), 51 Fed. Reg. 12,022 (bifurcating contingent debt instruments); Lee A. Sheppard, *IRS Stance in Staley Underscores Roaring Issues Raised by LYONS*, 53 TAX NOTES 1453, 1455 (1991).

