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What Are the Real Requirements for Interest Deductibility? An Analysis of Revenue Procedure 94-27

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WHAT ARE THE REAL REQUIREMENTS FOR INTEREST DEDUCTIBILITY? AN ANALYSIS OF REVENUE PROCEDURE 94-27

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I. INTRODUCTION

Historically, in order for a taxpayer to claim interest as a legitimate personal income tax deduction, the taxpayer had to satisfy the section 163 requirements of the Internal Revenue Code[1] (I.R.C.).[2] Over the years,

1. The Internal Revenue Code (I.R.C.) is Title 26 of the United States Code.

2. Section 163 of the I.R.C. is the I.R.C.'s "interest deductibility" section for interest paid by taxpayers. I.R.C. § 163 (1988 & Supp. V 1993). Under the general rule of interest deductibility, "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." *Id.* § 163(a).

Congress and the Internal Revenue Service (IRS) have altered the rules defining the types of deductible interest.[3] Despite many revisions of the I.R.C., the general rule requiring that the taxpayer actually pay the interest on the taxpayer's own indebtedness has not wavered.[4]

On April 11, 1994, the IRS, in publishing Revenue Procedure 94-27,[5] took a step away from the stringent rule established in I.R.C. § 163(a).[6] Revenue Procedure 94-27 and the accompanying announcement[7] proclaimed that "[a]mounts paid in connection with the acquisition of a principal residence (including seller-paid points) will be treated as points that are deductible for the taxable year during which they are paid by a cash basis taxpayer if certain requirements are satisfied."[8] Allowing the deduction of seller-paid points is a significant change to the IRS's former policy of allowing deductions only on buyer-paid points.[9]

The IRS justifies its change of position by focusing on the apparent "substance" of the payment of points in the home mortgage transaction.[10] In an apparent attempt to sway the substance-over-form[11] pendulum in the direction of the taxpayer, the IRS may have pushed too hard. Contrary to the focus of I.R.C. § 163, the new procedure does not require that the taxpayer actually "pay" the interest or that the interest be on the taxpayer's own "indebtedness."[12] While this change in policy benefits home-buying taxpayers, the new tax deductions will cost the federal government billions of dollars.[13]

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3. *See infra* notes 76-93 and accompanying text.

4. Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1932); *see* I.R.C. § 163(a).

5. Rev. Proc. 94-27, 1994-15 I.R.B. 17. Revenue Procedures, Revenue Rulings, and Treasury Regulations assist in administering the Internal Revenue Code. A Revenue Procedure is a "statement of procedure affecting the rights or duties of taxpayers or other members of the public under the tax laws that should be a matter of public knowledge even though it does not affect a particular taxpayer's rights and duties." LEWIS D. SOLOMON ET AL., FEDERAL TAXATION OF ESTATES, TRUSTS AND GIFTS 23 (1989). A Revenue Ruling is an "official interpretation[] of tax law by the Internal Revenue Service, and take[s] the form of a discussion of law on assumed facts." *Id.* A Treasury Regulation "constitute[s] the most formal and authoritative administrative interpretation of the Internal Revenue Code." *Id.*

6. Rev. Proc. 94-27, 1994-15 I.R.B. 17. This revenue procedure only applies to cash method taxpayers. *Id.*

7. IRS News Release IR-94-28 (Mar. 28, 1994).

8. Rev. Proc. 94-27, 1994-15 I.R.B. 4. "A 'point' is usually a fee equal to 1% of the total loan value and is paid to the lending institution to lower the interest rate." Huntsman v. Commissioner, 905 F.2d 1182, 1183 n.2 (8th Cir. 1990). For a detailed explanation of "points," see James E. Tierney, *Pointing the Way Through Section 461(g): The Deductibility of Points Paid in Connection with the Acquisition or Improvement of a Principal Residence*, 71 NEB. L. REV. 1095 (1992).

In computing the basis of a newly purchased residence, the taxpayer must adjust the basis to reflect the amount of seller-paid points. Rev. Proc. 94-27, 1994-15 I.R.B. 17. The new revenue procedure states that the taxpayer must "subtract[] the amount of any seller-paid points from the purchase price of the residence in computing the basis of the residence." *Id.*; *see also* Treas. Reg. § 1.1273-2(g)(5), Example 3 (1994).

9. *See* Rev. Proc. 92-12, 1992-1 C.B. 663 (as modified by Rev. Proc. 92-12A, 1992-1 C.B. 664).

10. "[P]oints paid by the seller of the property should be viewed as an adjustment to the purchase price of the home." IRS News Release IR-94-28 (Mar. 28, 1994).

11. *See infra* notes 24-75 and accompanying text.

12. *See* Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18.

13. Approximately 80% of home sales in 1993 involved payment of a median of $2,500 in seller-paid points. Ronald S. Ross, *Seller-Paid Points Now Deductible*, THE TAX ADVISER, Sept. 1994, at 572.

This Note addresses the effect of Revenue Procedure 94-27 on the requirements of interest deductibility. Section II of this Note briefly examines the evolution of the judicially created substance-over-form doctrine and provides a basis for understanding the change in the IRS's position regarding seller-paid points.[14] In order to scrutinize the extent to which the IRS has wandered from its previous interest deductibility requirements, Section II also provides an explanation of interest deductibility, including a discussion of the deductibility of qualified residence interest and points.[15]

Section III of this Note analyzes the IRS's reasoning behind the latest procedural change for points deductibility and attempts to fit this reasoning into the judicially created substance-over-form mold.[16] Section III also examines how far the IRS strayed from I.R.C. § 163 by eliminating the requirements that the taxpayer actually pay the interest and that the interest be on the taxpayer's own indebtedness.[17] Additionally, Section III provides a tax-planning tip that takes advantage of the additional leeway the IRS granted taxpayers in the new revenue procedure.[18] Section IV recommends the IRS extend its new concept of "paid" to encompass all points paid by taxpayers in qualified home mortgage transactions. Finally, Section IV concludes that the IRS should clarify the new revenue procedure to include the requirement of taxpayer "indebtedness."

II. BACKGROUND

When it changed its approach to the deductibility of seller-paid points, the IRS seemingly took a substantial step away from its stringent rules regarding interest deductibility. A thorough appraisal of the reasoning behind, and the implications of, Revenue Procedure 94-27 requires an examination of both the substance-over-form doctrine and the courts' and IRS's positions on the deductibility of interest and points. This Section briefly discusses the courts' and the IRS's use of the substance-over-form doctrine in income tax law.[19] Additionally, this Section provides a discussion on interest deductibility in general,[20] qualified residence interest deductions,[21] and points deductions.[22] Finally, this Section addresses Revenue Procedure 94-27.[23]

Accordingly, Revenue Procedure 94-27 could cost the federal government more than $3 billion in tax deductions. *Id.*

14. *See infra* notes 24-75 and accompanying text.
15. *See infra* notes 76-135 and accompanying text. See also *supra* note 8 for a definition of "points."
16. *See infra* notes 136-56 and accompanying text.
17. *See infra* notes 157-220 and accompanying text.
18. *See infra* notes 221-27 and accompanying text.
19. *See infra* notes 24-75 and accompanying text.
20. *See infra* notes 84-93 and accompanying text.
21. *See infra* notes 96-99 and accompanying text.
22. *See infra* notes 100-18 and accompanying text.
23. *See infra* notes 119-35 and accompanying text.

A. Substance-Over-Form

The substance-over-form principle in tax law is similar to the "legislative purpose" theory of statutory interpretation.[24] Many courts consult legislative history to determine the purpose of a statute when interpreting statutory language.[25] Leading scholars agree that, unless the plain language of a statute clearly answers the question before the court, the preferred statutory interpretation is that which best advances the purpose of the statute.[26] In this same vein, courts look to the purpose supporting the enactment of tax codes when deciding unclear tax cases.[27] To give full effect to the statutory purpose, courts use the substance-over-form doctrine to ascertain the true nature of tax transactions.[28]

The Supreme Court's earliest pronouncement of the substance-over-form doctrine was in *Weiss v. Stearn*.[29] In *Weiss*, the Court stated: "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder we must regard matters of *substance* and not mere *form*."[30] The substance of the transaction may be very different from the form in which the taxpayer chooses to characterize it.[31] Due to courts' ever-present challenge to do justice to the statutory purpose of the tax codes,[32] the substance-over-form principle is now known as "the cornerstone of sound taxation."[33]

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24. The "legislative purpose" theory of statutory interpretation calls for courts to refer to legislative history in order to interpret the given statute in a way that best advances the purpose of the legislature when it enacted the statute. WILLIAM N. ESKRIDGE, JR. & PHILIP P. FRICKEY, CASES AND MATERIALS ON LEGISLATION: STATUTES AND THE CREATION OF PUBLIC POLICY 571 (1988).

25. *See, e.g.*, United Steelworkers v. Weber, 443 U.S. 193 (1979). In this landmark civil rights case, the Supreme Court based its decision on the original legislature's purpose in enacting Title VII. *Id.* at 207. The Court held, "Congress did not intend to limit traditional business freedom to such a degree as to prohibit all voluntary, race-conscious affirmative action." *Id.* In his dissent, Justice Rehnquist also relied on the legislature's purpose in stating, "The purpose of [Title VII] is to eliminate . . . discrimination in employment based on race, color, religion or national origin." *Id.* at 231 (Rehnquist, J., dissenting).

26. *See, e.g.*, ESKRIDGE & FRICKEY, *supra* note 24, at 571 (referring to comments of Henry Hart and Albert Sacks of Harvard Law School, in 1958).

27. *See* Helvering v. Clifford, 309 U.S. 331, 334 (1940) (looking to Congress' purpose in enacting § 22(a) of the Revenue Act of 1934 in deciding the case).

28. *See, e.g.*, *id.* at 335-37. The *Clifford* Court held that contrary to the trust arrangement, which purported to make the husband the trustee of securities for his wife, the husband was, in substance, the owner of the fund. *Id.* at 336-37. "To hold otherwise would . . . let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties . . . ." *Id.*

29. 265 U.S. 242 (1924).

30. *Id.* at 254 (emphasis added); *see also* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) ("To permit the true nature of a transaction to be disguised by mere formalism . . . would seriously impair the effective administration of the tax policies of Congress.").

31. *See Court Holding Co.*, 324 U.S. at 334.

32. *See* Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935) (stating that "the act itself gives evidence that, on occasion anyway, the purpose of a transaction should be the guide").

33. Estate of Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961).

In the landmark substance-over-form case, *Old Colony Trust Co. v. Commissioner*,[34] the United States Supreme Court analyzed whether an employer's payment of an employee's income taxes constituted additional taxable income to the employee.[35] The employer paid the taxes assessable against the employee's salary directly to the Government and never in "form" paying the employee.[36] Although neither the employer nor the employee identified the payment of the income taxes as "income" and the employee never actually received the payment "in form," the Court determined the payment was, in effect, compensation for services rendered.[37] In substance, the payment, therefore, was "income" under the Revenue Act of 1918.[38] The Court's rationale that "the form of the payment is expressly declared to make no difference,"[39] is still followed today.[40]

1. Use of the Substance Over Form Doctrine to Benefit the IRS

Since the inception of federal income taxation, courts and the IRS have focused on identifying the substance of taxpayers' transactions.[41] The genesis of the substance-over-form doctrine occurred when the IRS brought suit against taxpayers to inhibit taxpayers from improperly avoiding statutory tax consequences.[42] Both the IRS and the courts continue to employ the substance-over-form principle to thwart taxpayers who attempt to disguise the "form" of their transactions and thus avoid adverse tax consequences.[43] Generally, experts consider the substance-over-form doctrine as an "additional (and

34. 279 U.S. 716 (1929)

35. *Id.*

36. *Id.* at 720.

37. *Id.* at 729-31.

38. *Id.* at 731.

39. *Id.* at 729.

40. Diedrich v. Commissioner, 457 U.S. 191 (1982) (holding that under the substance-over-form doctrine, a taxpayer realizes taxable income if the taxpayer makes a gift of property on the condition that the donee pay the resulting gift taxes); Crane v. Commissioner, 331 U.S. 1 (1947) (holding that under the substance-over-form doctrine, relief from the obligation of a nonrecourse mortgage constituted income to the taxpayer); Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935) (holding that under the substance-over-form doctrine, an attempted corporate reorganization to avoid adverse tax consequences was, in fact, not a reorganization within the intent of the statute).

41. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) (holding that "[a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title"); Gregory v. Helvering, 293 U.S. 465, 470 (1935) (holding that "[t]he whole undertaking, though conducted according to the terms of [the statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else"); Lucas v. Earl, 281 U.S. 111, 115 (1930) (stating that "the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it").

42. *E.g.*, Weiss v. Stearn, 265 U.S. 242 (1924).

43. *E.g.*, Estate of Sachs v. Commissioner, 88 T.C. 769, 778 (1987) (holding that gift tax paid by the donee in a net gift arrangement is in substance paid by the donor), *aff'd in part and rev'd in part*, 856 F.2d 1158 (8th Cir. 1988); Goldstein v. Commissioner, 364 F.2d 734, 741 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967) (disallowing taxpayer's asserted interest deduction since underlying activity was not "purposive").

somewhat autonomous) . . . principle[] for deciding tax disputes" in favor of the IRS.[44] Accordingly, the courts and the IRS have not widely accepted taxpayers' use of the substance-over-form doctrine for the taxpayers' benefit.[45]

Although several earlier cases applied the substance-over-form doctrine,[46] the most widely cited case endorsing the use of the doctrine in favor of the Government is *Helvering v. Gregory*.[47] In this landmark case, the sole shareholder of a corporation separated assets from her corporation in order to create a second corporation.[48] The shareholder's sole motivation was to avoid adverse tax consequences by way of "reorganizing" her corporation as authorized by the Revenue Act of 1928.[49] The shareholder contended that her gains under the former corporation should not be taxed since the gains were lawfully distributed to the new corporation pursuant to a plan of reorganization.[50]

The *Gregory* court acknowledged that the taxpayer had transferred the assets according to the letter of the statute.[51] Nonetheless, the court held the gains should be treated as taxable income because the "substance" of the transaction did not have a foundation in a legitimate business purpose and therefore was not in compliance with the purpose of the statute.[52] Judge Learned Hand, writing for the court, stated that "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes . . . ."[53] A court, therefore, must consider the purpose of a statute when ascertaining the true meaning of its words.[54]

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44. Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 864 (1982). Experts also consider the business purpose doctrine and the step transaction doctrine as principles courts employ in order to find in favor of the IRS in tax disputes. *Id.* The Court first employed the business purpose doctrine in Gregory v. Helvering, 293 U.S. 465 (1935). In holding that the form of the tax transaction was a substantive sham, the *Gregory* Court found that the transaction had "no business or corporate purpose." *Id.* at 469. For a discussion of the business purpose doctrine, see BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 3.1 (1988 & Supp. 1995). When using the step transaction doctrine, a court must examine all the steps of an integrated transaction as a whole, as opposed to examining the steps separately. *See id.*

45. *See infra* notes 63-75 and accompanying text.

46. Corliss v. Bowers, 281 U.S. 376, 378 (1930) (stating that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed"); Lucas v. Earl, 281 U.S. 111, 114 (1930) (asserting that the case "is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act"); Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929) (stating that the "form of the payment is expressly declared to make no difference"); Irwin v. Gavit, 268 U.S. 161, 167 (1925) (holding that a "gift" of bequested income was taxable income because "[a]part from technicalities we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it").

47. 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). The decision in *Gregory* "has left echoes in every corner of the tax law." Isenbergh, *supra* note 44, at 867.

48. *Gregory*, 69 F.2d at 810.

49. *Id.*

50. *Id.*

51. *Id.* at 811.

52. *Id.*

53. *Id.* at 810-11.

54. *See id.*

In *Gregory*, the taxpayer was not dealing with any party other than herself.[55] Courts generally allow the Government to invoke the substance-over-form doctrine successfully in these "self-dealing" transactions.[56] In order to effectuate the purpose of the revenue codes, however, courts also apply the doctrine liberally in favor of the Government when taxpayers enter into transactions with related parties[57] or conduct arm's length transactions with other parties.[58]

2. Use of the Substance Over Form Doctrine to Benefit Taxpayers

In general, the substance-over-form doctrine is a tool that courts use to interpret revenue statutes and tax-related transactions in favor of the Government.[59] In search of the most favorable tax consequences, however, some taxpayers have attempted to employ the doctrine to their own benefit.[60] Taxpayers attempting to persuade courts and the IRS to look at substance over form in the taxpayers' favor have encountered reactions ranging from emphatic rejection to general acceptance.[61] Since taxpayers typically control the form of their transactions, taxpayers have traditionally been unsuccessful in convincing

55. *Id.* at 810.

56. BITTKER & MCMAHON, *supra* note 44, ¶ 3.1.

57. Thornock v. Commissioner, 94 T.C. 439 (1990) (disallowing taxpayers to claim losses from their partnership's investment in computer leasing because the transaction involved multiple related parties); Setliff v. Commissioner, 53 T.C.M. (CCH) 1295, 1297 (1987) (stating that "an absence of arm's-length dealing requires us to consider whether the form and substance of the transaction were the same") (citation omitted); Gordon v. Commissioner, 85 T.C. 309, 325-26 (1985) (asserting that when "both parties to the transactions in question are related, the level of skepticism as to the form of the transaction is heightened").

58. *See, e.g.*, Knetsch v. United States, 364 U.S. 361, 366 (1960) (holding that the substance of the transaction entered into between the taxpayer and the insurance company was not in compliance with the chosen form, and, therefore, the taxpayer did not incur any indebtedness); Falsetti v. Commissioner, 85 T.C. 332, 348 (1985) (concluding that the purported property sale was never consummated, and, therefore, the taxpayers did not have any interest in the property).

59. *See supra* notes 40-62 and accompanying text.

60. *E.g.*, Frank Lyon Co. v. United States, 435 U.S. 561, 581-84 (1978) (allowing the taxpayer to claim deductions that the Commissioner attempted to disallow due to a sale and leaseback arrangement that had the appearance of a sham transaction); Weiss v. Stearn, 265 U.S. 242, 252 (1924) (holding that the taxpayers, previous stockholders of a sold corporation, actually sold only half of their interest and exchanged the remainder for new stock).

61. *See generally* William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381 (1991) (analyzing the "one-way rule" in which the substance-over-form doctrine is generally used only by the IRS against the taxpayer); J. Bruce Donaldson, *When Substance-Over-Form Argument is Available to the Taxpayer*, 48 MARQ. L. REV. 41 (1964-65) (highlighting some pre-1964 taxpayer success stories using the substance-over-form doctrine); Robert T. Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 TAX LAW. 137 (1990) (focusing on whether a taxpayer may be precluded by his form from being heard on the merits of its claims of substance); Christian A. Johnson, Note, *The Danielson Rule: An Anodyne for the Pain of Reasoning*, 89 COLUM. L. REV. 1320 (1989) (noting that the "Danielson Rule," developed by the Third Circuit, which precludes taxpayers from arguing that the economic reality or substance of the original agreement was different from its terms, has been taken out of context and overused by many courts).

courts or the IRS to look beyond the form of a transaction in their favor.[62] In 1943, Judge Learned Hand articulated that:

> It is true that the Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat his corporation as a different person from himself; but that is a rule which works only in the Treasury's own favor; it cannot be used to deplete the revenue.[63]

Judge Hand's attitude is still prevalent in many modern courts.[64]

Occasionally, however, a taxpayer successfully convinces a court to invoke the substance-over-form doctrine in the taxpayer's favor.[65] In such a case, the court may allow the taxpayer to recharacterize a certain transaction from its original form for purposes of tax analysis.[66] *Baldwin Locomotive Works v. McCoach*[67] provides an early example of a court invoking the substance over form doctrine in favor of the taxpayer. In *Baldwin*, the taxpayer asserted that a book entry that reflected income from an upward adjustment in the value of assets was, in substance, not income, but simply a reflection of valuation of the company's property.[68] The court sustained the taxpayer's contentions that no income was actually derived, although the form of the transaction presented an apparent gain on the corporation's books.[69] The court, therefore, looked to the substance of the transaction, as opposed to the form, in determining the tax consequences to the taxpayer.[70] On rare occasions, the IRS has also allowed taxpayers to present the substance of a transaction to override the form of the transaction.[71]

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62. *See* Estate of Durkin v. Commissioner, 99 T.C. 561, 575 (1992) (denying the taxpayer the right to restructure decedent's interest in a corporation in accordance with its alleged substance; "[t]o hold otherwise would at a minimum be an untoward invitation to the kind of mispricing and concealment that petitioners attempted here").

63. United States v. Morris & Essex R.R., 135 F.2d 711, 713 (2d Cir.), *cert. denied*, 320 U.S. 754 (1943).

64. *See* Estate of Durkin, 99 T.C. at 575 (stating that "[i]f a party disavows the form of a transaction, the Commissioner may be whipsawed between one party claiming taxation based on the form, and the opposite party claiming taxation based on the substance"); Bolger v. Commissioner, 59 T.C. 760, 767 n.4 (1973) (asserting that "the taxpayer may have less freedom than the Commissioner to ignore the transactional form that he has adopted").

65. Commissioner v. Bagley & Sewall Co., 221 F.2d 944 (2d Cir. 1955) (holding that, in spite of the fact that the form indicated capital loss treatment, the IRS will allow the taxpayer to classify the loss as a business loss for tax treatment); United States v. Kintner, 216 F.2d 418 (9th Cir. 1954) (holding that because a state law forbids medical practice by corporations, and because essential corporate characteristics were present in the taxpayer's medical partnership, the partnership could receive corporate treatment for a qualified pension plan); Jacobs v. Commissioner, 32 T.C.M. (P-H) 382 (1963) (allowing taxpayer the full deduction for alimony paid despite the wording of the divorce decree, which appeared to incorporate a significantly smaller amount as alimony than was actually paid).

66. *See, e.g.*, *Jacobs*, 32 T.C.M. (P-H) at 382 (allowing the taxpayer a different alimony deduction than the "form" of the transfer transaction appeared to provide).

67. 221 F. 59 (3d Cir. 1915).

68. *Id.* at 60.

69. *Id.*

70. *Id.*

71. Rev. Proc. 94-27, 1994-15 I.R.B. 17 (allowing taxpayers to claim points paid by the seller in the

B. *The Evolution of Points Deductibility*

In 1932, the Supreme Court defined deductible interest as "the amount which one has contracted to pay for the use of borrowed money."[72] This definition continues to guide courts and the IRS when discerning whether to classify a given payment as deductible interest under the I.R.C.[73] Section 163, the interest section of the I.R.C.,[74] allows deductions for interest paid on a qualified residence.[75] Points are fees paid to lower the interest rate on a loan for the acquisition of a qualified residence.[76] Nevertheless, it has not always been clear whether points fall under the rubric of allowable deductions for qualified residence interest.[77] The distinction between allowable interest deductions and other charges incurred in the acquisition of a residence is not always easily ascertained.[78] In order to better understand the IRS's present position on the deductibility of points,[79] this Section examines the predecessor statutes to the new revenue procedure.

1. The Deductibility of Interest Paid on Indebtedness—I.R.C. § 163

Prior to the codification of section 163 of the 1939 I.R.C., the Supreme Court wrestled with what constituted deductible interest under the similarly worded Revenue Act of 1921.[80] The United States Supreme Court, in *Old Colony Railroad v. Commissioner*, stated that in determining whether a given payment constitutes deductible interest under the Revenue Act of 1921, courts should assume that Congress intended the term "interest" to have its usual, ordinary, and everyday meaning.[81] The Court defined interest as "the amount which one has contracted to pay for the use of borrowed money."[82] The *Old*

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purchase of primary residence); Rev. Rul. 55-540, 1955-2 C.B. 39 (allowing taxpayers, as well as the IRS, to use the principle that treats certain leases of equipment as sales). The IRS initiated Revenue Procedure 94-27 because of repeated attempts by taxpayers to characterize seller-paid points as deductible interest on their tax returns. Telephone Interview with James Roy, Office of Assistant Chief Counsel (Income Tax and Accounting), IRS (Aug. 4, 1994); *see also Recent Decisions - Tax Law*, 54 VA. L. REV. 527, 534 (1968).

72. Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1932).

73. *E.g.*, O'Rourke v. Commissioner, 59 T.C.M. (CCH) 228 (1990) (relying on the definition of interest set forth in I.R.C. § 163, the court held that deductible investment interest was the amount that had been "paid . . . on indebtedness").

74. The general rule of interest deductibility is that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." I.R.C. § 163(a) (1988).

75. *Id.* § 163(h). See *infra* note 96 for a definition of "qualified residence interest".

76. See *supra* note 8 for a definition of "points."

77. *See infra* notes 100-04 and accompanying text.

78. *See infra* notes 86-104 and accompanying text.

79. *See* Rev. Proc. 94-27, 1994-15 I.R.B. 17.

80. Old Colony R.R. v. Commissioner, 284 U.S. 552, 559 (1932). Section 234 of the Revenue Act of 1921 allowed as a deduction from a corporation's gross income all "interest . . . on its indebtedness." *Id.*

81. *Id.* at 561.

82. *Id.* at 560.

Colony Railroad Court articulated that this definition conformed to "what is usually called interest by those who pay and those who receive [it] . . . and that the words of the statute . . . do not refer to some esoteric concept derived from subtle and theoretic analysis."[83] Although rather simplistic, the Court's definition of interest continues to guide courts in determining interest deductibility.[84]

Until the Tax Reform Act of 1969, taxpayers could deduct virtually any payment on indebtedness that fit the definition of "interest" pursuant to I.R.C. § 163.[85] Because of this Congressional leniency, taxpayers took advantage of being able to spend at will and share the debt with the Government.[86] Thus, in 1969, Congress began statutorily restricting interest deductions to curb taxpayer spending and increase revenue.[87] The most devastating restriction for taxpayers came with the Tax Reform Act of 1986.[88] Pursuant to the 1986 Act, the IRS granted taxpayers a phase-out period and then completely disallowed most personal interest deductions.[89]

2. The Deductibility of Qualified Residence Interest - I.R.C. § 163(h)

Prior to the Tax Reform Act of 1986, there was no need to address the deductibility of "qualified residence interest" separately because taxpayers could deduct virtually all interest on indebtedness pursuant to the general interest provisions of I.R.C. § 163.[90] In the Tax Reform Act of 1986, however, Congress disallowed taxpayer deductions for personal interest with only five

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83. *Id.* at 561.

84. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 145 (1974) (stating that "[e]arned original issue discount serves the same function as stated interest. . . . [I]t is simply 'compensation for the use or forbearance of money'") (citation omitted); Deputy v. DuPont, 308 U.S. 488, 498 (1940) ("In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In the absence of clear evidence to the contrary, we assume that Congress has used these words in that sense.") (citing *Old Colony R.R.*, 284 U.S. 552); Salley v. Commissioner, 464 F.2d 479, 485 (5th Cir. 1972) (holding that the taxpayer did not pay interest under the theory of interest presented in *Old Colony R.R.*).

85. Prior to 1969, taxpayers had to meet four judicially created requirements in order for interest to be deductible: "(1) there was a true interest expense, (2) the payment was paid or incurred within the taxable year, (3) the payment was made on a valid, existing debt, and (4) the underlying indebtedness belonged to the taxpayer claiming the deduction." Deborah Whitt, *Interest Deductions after the Tax Reform Act of 1986 and the Revenue Act of 1987*, 6 B.U. J. TAX LAW 85, 86 (1988) (footnotes omitted).

86. *See id.* at 87.

87. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 221(a), 83 Stat. 487, 574-76 (1969).

88. I.R.C. § 163(h)(1) (1988). For an overview of I.R.C. § 163 before the Tax Reform Act of 1986, see Calvin H. Johnson, *Is an Interest Deduction Inevitable*, 6 VA. TAX REV. 123 (1986); Stanley A. Koppelman, *Tax Arbitrage and the Interest Deduction*, 61 S. CAL. L. REV. 1143 (1988); Michael J. McIntyre, *An Inquiry Into the Special Status of Interest Payments*, 1981 DUKE L.J. 765 (1981).

89. Section 163(h)(1) of the I.R.C. reads as follows, "In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year." I.R.C. § 163(h)(1).

90. I.R.C. § 163 (1954) (current version at I.R.C. § 163 (1988 & Supp. V 1993)). See also *supra* note 89 for a list of the four judicially created requirements that a taxpayer had to meet in order for interest to be deductible.

exceptions. One of the exceptions is a deduction for qualified residence interest.[91] Qualified residence interest includes interest that a taxpayer pays on acquisition indebtedness[92] or home equity indebtedness [93] with respect to any qualified residence of the taxpayer.[94] Under I.R.C. § 163, taxpayers are authorized to take an interest deduction for amounts paid in purchasing or improving either their principle residence or a qualified second residence.[95]

3. The Deductibility of Points

Prior to 1969, the IRS did not consider points to be interest, but, instead, classified points as charges for services rendered.[96] The IRS, therefore, deemed points not deductible.[97] However, in 1969, relying on the definition of interest the Supreme Court espoused in *Old Colony Railroad v. Commissioner*,[98] the IRS changed its position and allowed taxpayers to claim certain points as legitimate interest deductions.[99] Furthermore, in 1976, Congress codified in

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91. The five exceptions to the I.R.C. § 163(h) "[d]isallowance of deduction for personal interest" rule are as follows:

(A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),

(B) any investment interest (within the meaning of subsection (d)),

(C) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(D) any qualified residence interest (within the meaning of paragraph (3)), and

(E) any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163 or 6166 or under section 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

I.R.C. § 163(h)(2)(A)-(E). "The term 'qualified residence' means -- the principal residence (within the meaning of section 1034) of the taxpayer," and one other designated residence. *Id.* § 163(h)(4)(A)(i)(I).

92. "The term 'acquisition indebtedness' means any indebtedness which . . . is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and . . . is secured by such residence," with limitations on indebtedness resulting from refinancing. *Id.* § 163(h)(3)(B)(I)-(II).

93. "The term 'home equity indebtedness' means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed . . . the fair market value of such qualified residence, reduced by . . . the amount of acquisition indebtedness with respect to such residence." *Id.* § 163(h)(3)(C)(I)-(II).

94. I.R.C. § 163(h).

95. *See, e.g.*, Garrison v. Commissioner, 67 T.C.M. (CCH) 2896 (1994) (interpreting whether the residence in question qualified as a "second residence" under I.R.C. § 163(h)(3)); Dively v. Commissioner, 66 T.C.M. (CCH) 557 (1993) (interpreting whether taxpayers were considered to be the "owners" of the house in question in order to properly allow a claim for qualified residence interest under I.R.C. § 163(h)(3)); Huntsman v. Commissioner, 91 T.C. 917 (1988), *rev'd*, 905 F.2d 1182 (8th Cir. 1990) (holding that amounts paid in "refinancing" a primary residence are allowable as qualified residence interest under I.R.C. § 163(h), but not as allowable prepaid interest deductions in the year paid under I.R.C. § 461(g)(2)).

96. Rev. Rul. 67-297, 1967-2 C.B. 87; *see also* Rev. Rul. 57-541, 1957-2 C.B. 319 (stating that the IRS considered points as "financing/application fees and as such [did] not represent interest within the meaning of . . . the Code but represent[ed] legitimate charges for services rendered").

97. Rev. Rul. 67-297, 1967-2 C.B. 87.

98. 284 U.S. 552, 560 (1932) (defining interest as "the amount which one has contracted to pay for the use of borrowed money").

99. *See* Rev. Rul. 69-188, 1969-1 C.B. 54; Rev. Rul. 69-582, 1969-2 C.B. 29 (allowing interest deduction for buyer-paid points).

I.R.C. § 461 the allowable deduction of certain prepaid points as interest.[100] Because points are a form of prepaid interest, the rules for deductibility must be ascertained by reading I.R.C. § 163, the applicable interest deductibility section, in conjunction with I.R.C. § 461(g), the prepaid interest section.[101]

a. The Deductibility of Buyer-Paid Points - I.R.C. § 461(g)(2)

Section 461(g) of the I.R.C. places general limits on the deductibility of prepaid interest. The basic rule is that a taxpayer must defer a deduction for prepaid interest to the period that such payment is properly allocable.[102] Points are a form of prepaid interest.[103] The general rule of I.R.C. § 461(g)(1), therefore, would require taxpayers to amortize their deduction for points over the life of the loan.[104] As enacted in 1976, however, I.R.C. § 461(g)(2) is an

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100. I.R.C. § 461(g)(2) (1988). The legislative history of I.R.C. § 461(g), which disallows up-front deductions on most prepaid interest, indicates that Congress was concerned with taxpayers' use of tax shelters to defer tax on income that would otherwise be taxable in higher marginal brackets. *See* H.R. REP. NO. 658, 94th Cong., 2d Sess. 25-130 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2919-3025. Another Congressional concern was standardizing the analysis of claimed interest deductions, which had previously been done on a case-by-case basis. *Id.* at 103. The focus in these cases was whether the claimed deduction created a material distortion of income. *Id.* Although this legislative history explains Congress' rationale in enacting I.R.C. § 461(g)(1), the history does not explain the reason for the exception for prepaid points provided in I.R.C. § 461(g)(2).

Congress' reasoning for providing the favorable treatment in § 461(g)(2) may have been because "Congress perceived a lesser possibility of abuse in the case of points relating to the purchase or improvement of a taxpayer's principal residence," than the abusive use of prepaid interest in tax. Tierney, *supra* note 8, at 1102. In contrast, Congress may have sought consistency with respect to the interest deduction allowable for the acquisition of a primary residence under I.R.C. § 163(h)(2)(D). *Id.* Another theory is that Congress purposefully gave a tax break to home-buying taxpayers. *See* Lee A. Sheppard, *Seller-Paid Points Break May Go Beyond the 'Burbs*, 63 TAX NOTES 143 (1994).

101. Section 461 of the I.R.C. provides the general rules for the taxable year of deduction. Subsection 461(a) states that "[t]he amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." I.R.C. § 461(a). Subsection (g) of section 461 sets forth the rules regarding the taxable year of deduction for prepaid interest. I.R.C. § 461(g) provides as follows:

> (1) In general. If the taxable income of the taxpayer is computed under the cash receipts and disbursements method of accounting, interest paid by the taxpayer which, under regulations prescribed by the Secretary, is properly allocable to any period --
>
> (A) with respect to which the interest represents a charge for the use or forbearance of money, and
>
> (B) which is after the close of the taxable year in which paid, shall be charged to capital account and shall be treated as paid in the period to which so allocable.

Id. § 461(g). In sum, this section requires the taxpayer to allocate the amount of prepaid interest over the course of the period of the loan. *Id.* This is an exception to the basic rule of deductibility for a cash method taxpayer, which allows the taxpayer to take a deduction in the year of payment for "all interest paid . . . within the taxable year." *Id.* § 163(a).

102. *Id.* § 461(g). For example, if a taxpayer prepays $1000 interest on a 10-year loan, which interest would normally have accrued at $100 per year, the taxpayer may only deduct $100 the first year (even though the taxpayer paid $1000) and $100 every year thereafter for the next nine years. *See* Beek v. Commissioner, 80 T.C. 1024, 1029 (1983), *aff'd*, 754 F.2d 1442 (9th Cir. 1985) (stating that "Congress intended to place a cash basis taxpayer on the accrual method for purposes of deducting interest prepayments").

103. I.R.C. § 461(g)(2).

104. *See* Beek v. Commissioner, 754 F.2d 1442 (9th Cir. 1985) (denying taxpayer an interest deduction

exception to the basic rule. Section 461(g)(2) allows taxpayers to claim as a deduction prepaid interest in the form of certain points in the year in which the taxpayer paid the points.[105]

Section 461(g)(2) of the I.R.C. has remained substantially unchanged since its enactment in 1976. In 1992, however, the IRS issued Revenue Procedures 92-12 and 92-12A in order to minimize potential disputes regarding the deductibility of points paid in the acquisition of a principal residence.[106] Revenue Procedure 92-12 spelled out exactly what constituted an allowable deduction for points paid by a cash basis taxpayer.[107] Revenue Procedure 92-12A clarified and added new sections to Revenue Procedure 92-12.[108] Significantly, section 4.05 provided that "points paid by a seller in connection with the acquisition of a principal residence are outside of the scope of the deduction allowed by Revenue Procedure 92-12," thereby specifying that taxpayers were only entitled to an up-front deduction of buyer-paid points.[109]

b. The Deductibility of Seller-Paid Points - Revenue Procedure 94-27

Until the IRS issued Revenue Procedure 94-27 in April 1994, seller-paid points were not a form of allowable interest deduction under any section of the I.R.C. or any Treasury Bulletin.[110] Revenue Procedure 94-27 allows home buying taxpayers to deduct points paid by the seller in connection with the

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for prepaid interest in the year of payment on an installment loan); Wetterholm v. Commissioner, 51 T.C.M. (CCH) 988 (1986) (requiring taxpayer to amortize prepaid amounts used to finance an apartment complex over the course of the loan).

105. I.R.C. § 461(g)(2) provides that the general rule deferring deduction of prepaid interest will not apply to:

> [P]oints paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer to the extent that, under regulations prescribed by the Secretary, such payment of points is an established business practice in the area in which such indebtedness is incurred, and the amount of such payment does not exceed the amount generally charged in such area.

I.R.C. § 461(g)(2). A taxpayer, therefore, may take an immediate deduction for points paid only for the purchase or improvement of a principal residence. *Id.*

106. Rev. Proc. 92-12A, 1992-1 C.B. 664; Rev. Proc. 92-12, 1992-1 C.B. 663.

107. Revenue Procedure 92-12 states, in brief, that the following requirements must be satisfied in order for a cash basis taxpayer to deduct points during the taxable year: (1) § 3.01, the amounts must be clearly designated as points on the Uniform Settlement Statement; (2) § 3.02 , the amounts must be computed as a percentage of the amount borrowed; (3) § 3.03, the amounts paid must conform to an established business practice; (4) § 3.04, the amounts must be paid for the acquisition of a principal residence, and (5) § 3.05, the amounts must be paid directly by the taxpayer. Rev. Proc. 92-12, 1992-1 C.B. 663.

108. Rev. Proc. 92-12A, 1992-1 C.B. 664. Besides the addition of § 4.05, § 6 was added to clarify that Revenue Procedure 92-12 applied to Federal Housing Administration (FHA) and Veterans Association (VA) loan origination fees that met the requirements of the procedure. *Id.*. See *infra* note 111 and accompanying text for a discussion of § 4.05.

109. Rev. Proc. 92-12A, 1992-1 C.B. 664.

110. Neither party to the transaction could deduct the seller-paid points prior to this new procedure. Revenue Procedure 92-12A did not allow a buyer to claim the deduction because the IRS did not consider the buyer to have "paid" the points. Rev. Proc. 92-12A, 1992-1 C.B. 664. Likewise, Revenue Rule 68-650 did not allow a seller to claim the deduction because the IRS did not consider the obligation to be the seller's "indebtedness." Rev. Rul. 68-650, 1968-2 C.B. 78.

purchase of a qualified residence.[111] Like buyer-paid points,[112] the taxpayer may deduct amounts in the taxable year of payment if the taxpayer satisfies certain requirements.[113] In justifying its change in position, the IRS explained that it viewed a seller as "having paid the amount of the seller-paid points to the buyer, who in turn is treated as having used this cash to pay the points charged by the lender."[114] The new rule is effective for points paid retroactively to encompass tax years beginning after December 31, 1990.[115]

The IRS recognizes several motivating factors behind its change in policy regarding the buyer's ability to take an up-front deduction for seller-paid points.[116] The IRS states that it changed its approach due to numerous challenges from home-buying taxpayers.[117] These taxpayers asserted that the actual substance of their transactions did not comport with the strict rules regarding who "paid" the points in a seller-paid points transaction.[118] The taxpayers, therefore, argued that these points should have been deductible under Revenue Procedure 92-12.[119]

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111. Rev. Proc. 94-27, 1994-15 I.R.B. 17. The revenue procedure allows the up-front deduction for amounts paid for the acquisition of a principal residence, but does not allow taxpayers to take an up-front deduction for points paid in the following transactions: (1) points paid for the use of principal that are in excess of the amount allowable as acquisition indebtedness; (2) points paid for the improvement of the principal residence; (3) points paid for other than the principal residence; and (4) points paid for refinancing the principal residence. *Id.* at 18.

112. I.R.C. § 461(g)(2) (1988).

113. Rev. Proc. 94-27 provides that points paid by a cash basis taxpayer are deductible in the taxable year if the following requirements are met:

> Sec. 3. APPLICATION
>
> . . .
>
> .01 *Designated on Uniform Settlement Statement.* The Uniform Settlement Statement . . . must clearly designate the amounts as points payable in connection with the loan. . . .
>
> .02 *Computed As Percentage of Amount Borrowed.* The amounts must be computed as a percentage of the stated principal amount of the indebtedness incurred by the taxpayer.
>
> .03 *Charged Under Established Business Practice.* The amounts paid must conform to an established business practice of charging points for loans for the acquisition of principal residences in the area in which the residence is located, and the amount of points paid must not exceed the amount generally charged in that area. . . .
>
> .04 *Paid for Acquisition of Principal Residence.* The amounts must be paid in connection with the acquisition of the taxpayer's principal residence, and the loan must be secured by that residence.
>
> .05 *Paid Directly by Taxpayer.* The amounts must be paid directly by the taxpayer. . . . [P]oints paid by the seller (including points charged to the seller) . . . will be treated as paid directly by the taxpayer . . . provided the taxpayer subtracts the amount of any seller-paid points from the purchase price of the residence in computing the basis of the residence.

Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18. Points paid by the seller to the lender to assist in the financing of a buyer's loan will be treated as a reduction in the buyer's purchase price and as Original Issue Discount (OID) to the lender. *See* Treas. Reg. § 1.1273-1(d) (1994); *see also id.* § 1.1273-2(g)(5), Example 3 (1994).

114. I.R.S. News Release IR-94-28 (Mar. 28, 1994).

115. Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18.

116. See also *infra* notes 154-56 and accompanying text for other theories behind the IRS's newest approach to the deductibility of seller-paid points.

117. In January 1991, banks began to report interest and points separately. Telephone Interview with James Roy, *supra* note 71. Soon thereafter, taxpayers began to challenge the non-deductibility of seller-paid points. *Id.* See *infra* note 131 regarding the new requirements for interest reporting by lending institutions.

118. Telephone Interview with James Roy, *supra* note 71.

119. *Id.*

Another stimulus for the IRS's change in position was pressure from the Veterans Administration (VA) and lending institutions. The VA pushed the IRS for a change based on perceived inequities the tax system placed upon VA borrowers.[120] Lending institutions also pressured the IRS to clarify who actually paid the points because of new reporting procedures that the IRS implemented for tax years beginning January 1, 1991.[121]

In order to deal with the intricacies of the deductibility of seller-paid points, the IRS employed the substance-over-form doctrine to fashion Revenue Procedure 94-27.[122] This new revenue procedure, based on the substance-over-form doctrine, is likely to have a great impact on previously established rules regarding interest deductibility.[123]

III. ANALYSIS

The general rule of personal interest deductions for cash basis taxpayers is that "no deduction shall be allowed . . . for personal interest paid . . . during the taxable year."[124] One important exception to this rule is that taxpayers may deduct interest paid on indebtedness incurred in the purchase or improvement of a personal residence.[125] "Points" are a form of interest that taxpayers must often pay to lenders in order to obtain financing for the purchase or improvement of a personal residence.[126] In general, taxpayers must prepay these points at the initial loan transaction.[127] The IRS allows taxpayers to deduct such prepaid points in the year of payment.[128]

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120. The VA's previous rules required that sellers pay all points on VA mortgages. *See* Sheppard, *supra* note 100. Recently, the VA changed its rules permitting points to be charged to the buyer, rather than the seller, on VA-approved mortgages. *Id.*

121. Bill Lubinger, *IRS Change on Deducting Points Aimed at Tax Cheats*, PLAIN DEALER, Apr. 10, 1994, at 1E (stating that the "Internal Revenue Service, pressured for years by banking lobbyists, finally simplified the process by allowing lenders to report buyers [as opposed to reporting the seller, who actually paid the points] only. It also let buyers deduct seller-paid points on their taxes for the first time"). See I.R.C. § 6050H (1988) for the rules that govern reporting requirements for lending institutions making home mortgage loans after January 1, 1991. Revenue Procedure 92-11 emphasized that lenders were required to report any interest received that fell under the requirements of Revenue Procedure 92-12. Rev. Proc. 92-11, 1992-1 C.B. 662. In other words, any amount "paid" by a buyer, not including amounts paid by a seller, that was not borrowed from the lender for that purpose, had to be reported. *Id.* at 663. Revenue Procedure 94-27 changed the reporting requirements for lenders receiving reportable interest. Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18. Since January 1, 1995, lending institutions have been required to report all points received from borrowers, including seller-paid points, if the borrower meets all the requirements of Revenue Procedure 94-27. *Id.*

122. *See infra* notes 146-56 and accompanying text.

123. *See infra* notes 157-220 and accompanying text.

124. I.R.C. § 163(h)(1) (1988).

125. *Id.* § 163(h)(2)(D).

126. See *supra* note 8 for the definition of "points."

127. 6 JACOB MERTENS, JR., MERTENS LAW OF FEDERAL INCOME TAXATION § 26.117 (1995).

128. I.R.C. § 461(g)(2) (1988). This special concession directly contradicts the general rule that prepaid interest is deductible, but must be amortized over the period in which the interest is chargeable. *Id.* § 461(g)(1) (1988).

Until recently, the IRS's position on points deductibility was that only points paid by a buyer were deductible by that buyer.[129] On April 11, 1994, the IRS published Revenue Procedure 94-27,[130] which allows a buyer to take an immediate deduction for points paid by a seller in a primary residence purchase transaction. The IRS justifies its position by focusing on the apparent "substance" of the transaction, rather than the "form."[131] Revenue Procedure 94-27 does not require the taxpayer to actually "pay" the amount claimed as an interest deduction[132] or that the points be incurred on the taxpayer's own "indebtedness."[133]

A. The "Substance" of the Seller-Paid Points Transaction

In the announcement accompanying Revenue Procedure 94-27, the IRS states that "points paid by the seller of the property should be viewed as an adjustment to the purchase price of the home."[134] In other words, the IRS is presupposing that all taxpayers engaging in a home purchase transaction adjust the price of the property to reflect the amount paid as points by the seller. This approach—looking beyond the "form" of the transaction, and applying a presupposed "substance" in order to benefit taxpayers—does not comport with the IRS's usual treatment of taxpayers and the substance-over-form doctrine.[135]

The IRS's rationale dictates the following "substantive" hypothetical for each home purchase transaction involving seller-paid points.[136] The buyer requests that the seller pay all or a portion of the buyer's points incurred in mortgaging the new home. The seller agrees to pay the points, but raises the price of the home to compensate for the amount paid as points. Alternatively, the seller, in anticipation of being asked to pay all or some of a prospective buyer's points, increases the initial asking price of the home to compensate for a potential future points payment.[137]

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129. Rev. Rul. 67-297, 1967-2 C.B. 87.

130. Rev. Proc. 94-27, 1994-15 I.R.B. 17.

131. *See infra* notes 146-56 and accompanying text.

132. Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18. See also *infra* notes 165-208 and accompanying text for a discussion of the "paid" requirement of interest deductibility and its applicability to the deductibility of seller-paid points under Revenue Procedure 94-27.

133. *See* Rev. Proc. 94-27, 1994-15 I.R.B. 17. See also *infra* notes 209-20 and accompanying text for a discussion of the "indebtedness" requirement of interest deductibility and its applicability to the deductibility of seller-paid points under Revenue Procedure 94-27.

134. I.R.S. News Release IR-94-28 (Mar. 28, 1994).

135. See *supra* notes 63-75 and accompanying text for a discussion of the generally unfavorable treatment the courts and the IRS grant taxpayers attempting to employ the substance-over-form doctrine in their favor. *See also* Paul E. Klein, *Purchasers of Principal Residences Permitted to Deduct Seller-Paid Points*, 22 J. REAL EST. TAX'N 88, 89 (Fall 1994) (stating that the IRS's new approach to the deductibility of seller-paid points "is in sharp contrast to the theoretical, impractical, and frequently incomprehensible, approach oftentimes taken by the Service to commercial transactions that are normal and nontax motivated, but which are forced to run the gauntlet of IRS regulations run amok").

136. *See* IRS News Release IR-94-28 (Mar. 28, 1994).

137. *See id.*

Whether this scenario is realistic for all home-purchase transactions, the IRS gives the benefit of the doubt to all home-buying taxpayers. The generic substance that the IRS prescribes for all home-purchase transactions assumes that all taxpayers act in a financially responsible manner.[138] Implicit in this assumption is that all home-selling taxpayers are educated regarding proper pricing strategies, and the market is such that home-selling taxpayers can increase the asking price of the home to cover the cost of the points paid.[139]

Reality suggests that some sellers may agree to pay points without raising the price of the home accordingly.[140] The condition of the housing market combined with a seller's desperate need to sell may induce a seller to pay points for a buyer without adjusting the price of the property, thereby actually accepting a lower price for the home.[141] While this scenario may not technically fall within the generic "price raising" hypothetical suggested by the IRS,[142] the theory may be the same. A seller who, in effect, accepts a lower selling price due to the payment of points, may actually be conceding that the actual worth of his home was lower than the original asking price.

Another reason for the IRS's concession on the deductibility of seller-paid points may be administrative convenience. If the IRS did not allow all buyers to deduct seller-paid points, the IRS would have to delve into a factual determination of each transaction to ascertain whether the buyer did, in fact, economically absorb payment of the points.[143] Alternatively, perhaps the Government, through the IRS, is simply "pandering to suburban voters."[144] Whatever the reason for the implied substance of home purchase transactions, home buying taxpayers can be assured that, regardless of the actual events

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138. *See* United States v. Bender, 218 F.2d 869, 871 (7th Cir. 1955) (stating that there is a presumption that taxpayers act in their own financial best interest).

139. Obviously, not all taxpayers act in the most financially responsible manner. Assuming the home price was adjusted accordingly, "a well-advised buyer would never have consented to seller 'payment' of points before Rev. Proc. 94-27 became effective," because seller-paid points were not deductible. Sheppard, *supra* note 100, at 144. Instead, buyers would have offered a lower price for the home and insisted on paying the points themselves, since buyer-paid points were deductible. Nevertheless, sellers paid a median of $2,500 worth of points for buyers purchasing homes in 1993. *See* Kathy Kristof, *A Few Points About Points: IRS Ruling on Upfront Costs Could Change the Way Homes are Sold and Financed*, CHI. TRIB., Apr. 5, 1994, at C9. Some taxpayers, however, may not have had a choice regarding who paid the points due to lending policies that required the seller to pay the points. See *supra* note 120 stating that the VA previously required that sellers pay all points on VA mortgages.

140. "[I]n difficult markets, the seller often 'pays' the points -- in essence *accepting a lower purchase price* by virtue of turning a portion of the price over to the lender." Sheppard, *supra* note 100, at 144 (emphasis added).

141. *See id.*

142. *See supra* notes 148-49 and accompanying text.

143. *See* Barber v. Commissioner, 64 T.C. 314, 320 (1975) (stating that one of the goals of tax law is to prevent administrative burdens and inconvenience).

144. Sheppard, *supra* note 100, at 143; see also *supra* notes 126-29 and accompanying text for the stimuli behind the changes incorporated in Revenue Procedure 94-27. *But see* Klein, *supra* note 135, at 89 (surmising that this "curious" new approach by the IRS may have come about "because IRS officials purchase principal residences for themselves and their families, [and] they understand the nontax motivation behind these 'real world' transactions").

surrounding the negotiations with the seller, the IRS will assume the buyer economically absorbed the seller-paid points through a higher sales price and will allow the buyer to deduct the seller-paid points in the taxable year of payment.

B. The Requirements of Interest Deductibility

For an amount to be deductible as interest paid, a taxpayer must satisfy the requirements of I.R.C. § 163. A taxpayer must prove that he or she "paid" the amount claimed as deductible interest and that the amount claimed was incurred on the taxpayer's own "indebtedness" to satisfy the requirements of I.R.C. § 163.[145] Cash method taxpayers generally deduct interest paid on the acquisition of a qualified personal residence in the year in which the interest is paid.[146] Points are allowable interest deductions.[147] Although prepaid interest is generally not deductible in the year of payment,[148] cash basis taxpayers who prepay points may be able to deduct the points amount in the year paid, as opposed to amortizing the amount over the life of the loan.[149] Taxpayers must read I.R.C. § 163 in conjunction with I.R.C. § 461(g) to decide whether a current deduction is allowable for the total amount of points paid.[150]

1. "Paid"

The question of whether a taxpayer "paid" interest seems self-evident when viewing the facts of a given transaction. Presumably, if a taxpayer remitted cash or an equivalent to a lender, the IRS would deem the taxpayer to

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145. Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1932). Section 162 of the I.R.C. sets forth similar requirements for the deductibility of ordinary and necessary business expenses. I.R.C. § 162 (1988 & Supp. V 1993); *see also* Heidt v. Commissioner, 274 F.2d 25 (7th Cir. 1959). The *Heidt* court denied the taxpayer a deduction for expenses that the taxpayer incurred when driving his personal automobile for company business. *Heidt*, 274 F.2d at 28. Although the taxpayer did not seek reimbursement from his employer, the court deemed the expenses were not really the taxpayer's since the employer had a policy of reimbursing employees for such expenses. *Id.* This application of the concept that the expense must be the taxpayer's and that the taxpayer must actually pay the expense is similar to the requirement of actual payment on the taxpayer's own indebtedness for interest to be deductible under I.R.C. § 163.

146. I.R.C. § 163(h)(2)(D) (1988). *But see id.* § 461(g)(1) (stating that amounts that are "prepaid" are not deductible in the year of payment, but must be allocated over the term of the loan).

147. *Id.* § 163(h)(2)(D) (identifying qualified residence interest as deductible); Rev. Proc. 94-27, 1994-15 C.B. 17 (identifying points paid in the acquisition of a primary residence as deductible). See *supra* notes 94-99 and accompanying text for a discussion of qualified residence interest. See *supra* notes 119-35 and accompanying text for a discussion of the background of Revenue Procedure 94-27.

148. I.R.C. § 461(g)(1) (1988).

149. See *supra* note 114 for restrictions on deductibility of points.

150. Baird v. Commissioner, 68 T.C. 115, 131 (1977). When Congress enacted I.R.C. § 461(g), Congress did not intend to change the existing definition of interest. H.R. REP. NO. 658, 94th Cong., 2d Sess. 100 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2995. A claimed deduction must still meet the requirements of deductible interest in order to be deductible under I.R.C. § 461(g). See *supra* notes 110-16 and accompanying text for a discussion of I.R.C. § 461(g).

have paid the assessed interest. While this is generally true,[151] the IRS does not always view transactions in such a simplistic manner. Rather than examine the form of a given situation, the IRS or the courts may restructure a transaction to determine whether a taxpayer actually "paid" the amount claimed by that taxpayer as deductible interest.[152]

An analogous tax case may be helpful in illustrating the restructuring technique that the IRS or the courts may use to ascertain the true substance of a transaction.[153] In *Old Colony Trust Co. v. Commissioner*,[154] the IRS challenged the fact that the taxpayer did not claim an amount paid by his employer as income received.[155] The taxpayer never actually received the monies because the employer remitted the payment directly to the IRS to pay the taxpayer's income taxes.[156] In analyzing whether the taxpayer was substantively in "receipt" of the amount paid to the IRS by the employer, the Court restructured the facts of the transaction.[157] The Court viewed the transaction as if the employer gave the amount paid for taxes to the employee taxpayer and then the employee remitted the payment to the Government. In other words, it was as if the taxpayer was in "receipt."[158]

The IRS constructed a similar analysis in explaining Revenue Procedure 94-27. The IRS stated that it views a transaction involving the payment of points by a seller as if the seller gave the amount to the buyer and then the buyer remitted the payment to the lender. In other words, it is as if the buyer "paid" the lender.[159] The IRS's benevolence in recreating this transaction in the taxpayer's favor is unusual because it does not coincide with the generally disparate treatment the IRS accords taxpayers in recreating the actual substance of transactions.[160]

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151. "A cash-basis taxpayer 'pays' interest only when he pays cash or its equivalent to his lender." Wilkerson v. Commissioner, 655 F.2d 980, 982 (9th Cir. 1981); *see also* Don E. Williams, Co. v. Commissioner, 429 U.S. 569 (1977) (holding that the payment required to entitle a cash-basis taxpayer to a deduction is the payment of cash or its equivalent).

152. Rev. Proc. 94-27, 1994-15 C.B. 17. See *supra* notes 24-75 and accompanying text for a more detailed discussion of the courts' and the IRS's use of the substance-over-form doctrine to ascertain the true nature of a transaction.

153. The IRS codified the use of this technique in I.R.C. § 7872(a). This section treats loans with below-market interest rates as if the foregone interest was "transferred from the lender to the borrower, and . . . retransferred by the borrower to the lender as interest." I.R.C. § 7872(a)(1)(A)(B) (1988).

154. 279 U.S. 716 (1929). Although the Supreme Court analyzed the concept of "receipt," as opposed to "paid," the Court's method in *Old Colony Trust Co.* is helpful in understanding the method that may be used to restructure a given transaction. *Id.* See *supra* notes 33-38 and accompanying text for a detailed description of *Old Colony Trust Co.*

155. *See Old Colony*, 279 U.S. at 720.

156. *Id.*

157. *Id.* at 729.

158. *Id.* "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Id.*

159. I.R.S. News Release IR-94-28 (Mar. 28, 1994). "The seller is treated as having paid the amount of the seller-paid points to the buyer, who in turn is treated as having used this cash to pay the points charged by the lender." *Id.*

160. Since the taxpayer chooses the form of the transaction, courts and the IRS generally do not allow

The IRS spells out its concession concerning the deductibility of seller-paid points in the fifth requirement of Revenue Procedure 94-27.[161] This requirement provides that "if the taxpayer provides, from funds that have not been borrowed for this purpose as part of the overall transaction, an amount at least equal to the amount required to be applied as points at the closing," the amount is considered to have been paid directly by the taxpayer.[162] In order to satisfy the fifth requirement, a taxpayer may only take an immediate deduction for prepaid interest in the form of points if the points were "[p]aid [d]irectly by [the] [t]axpayer."[163] Revenue Procedure 94-27 provides that seller-paid points are considered to be "paid" by the buyer, as are any buyer-paid points that "have not been borrowed for this purpose."[164] An examination of the IRS's handling of previous cases concerning borrowing of funds to pay points sheds some light on the IRS's decision to consider seller-paid points as points "paid" by the buyer.

a. The IRS's Treatment of Interest "Paid" with Funds Borrowed from a Third Party

If a taxpayer borrows, as part of the loan transaction, the amount to cover the points, the IRS admonishes that the points are not be considered "paid" and therefore not deductible in the year of the loan transaction.[165] In contrast, courts have generally allowed taxpayers to deduct, in the year allowable, payments made with borrowed funds.[166] "[T]he general rule is that when a deductible payment is made with borrowed money, the deduction is not postponed until the years in which the borrowed money is repaid," but is deductible in the year in which the I.R.C. would otherwise allow the deduction.[167]

The following hypothetical illustrates the deductibility of payments made with borrowed funds. Assume a taxpayer purchased a primary residence for $100,000 and financed the entire sum.[168] The lender charged two points for the

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the taxpayer to claim a different substance in order to receive more favorable tax treatment. *See supra* notes 63-75 and accompanying text.

161. Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18. See *supra* note 116 for the five requirements that a taxpayer must satisfy before the IRS will allow a deduction for points.

162. Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18.

163. *Id.*

164. *Id.*

165. "[P]oints paid by the seller . . . will be treated as paid directly by the taxpayer from funds that have not been borrowed for this purpose" as part of the overall transaction. *Id.*

166. *See, e.g.*, Bramer v. United States, 259 F.2d 717, 721 (3d Cir. 1958) (stating that a cash basis taxpayer's losses are deductible only when the taxpayer satisfies the obligation, and an obligation paid with funds borrowed from a third party fulfills this requirement); McAdams v. Commissioner, 15 T.C. 231, 235 (1950), *aff'd*, 198 F.2d 54 (5th Cir. 1952) (allowing a deduction in the year the taxpayer paid the obligation, as opposed to the year in which the funds borrowed for such purpose were repaid to the third party lender).

167. Granan v. Commissioner, 55 T.C. 753, 755 (1971).

168. Some loans, such as loans obtained through the VA or some conventional loans to low and

mortgage, or $2,000. Assume the taxpayer did not have cash to pay the points. The taxpayer could borrow the $2,000 from any third party, and the IRS would consider the amount to have been "paid" by the taxpayer.[169] The taxpayer could deduct the points amount in the year of payment rather than in the year in which the taxpayer repaid the borrowed money.[170]

The third party from whom the taxpayer borrows the points amount could be a lending institution other than the institution financing the home mortgage. If the buyer pays the points with funds borrowed from another lending institution, the IRS considers the points "paid" at the time of closing. These "paid" amounts, which the taxpayer actually borrowed from a financial institution, would be deductible in the year of payment according to the I.R.C., the new revenue procedure, and case law regarding the deductibility of payments made with borrowed funds.[171]

b. The IRS's Treatment of Interest "Paid" with Funds Borrowed from the Lending Institution

The IRS's admonition that some points are not considered "paid" and therefore not deductible in the year of the loan transaction[172] applies to amounts borrowed from the lending institution involved in the home mortgage transaction.[173] Typically, a transaction in which the taxpayer borrows points from the lender is structured so that the lender actually increases the amount of the loan to cover the amount the taxpayer needs for payment of the points. The points amount is considered to be "withheld from [the] loan proceeds," and the loan is referred to as a "discounted loan."[174] The IRS and the courts agree that points paid in connection with discounted loans are not deductible in the year of the loan transaction because the taxpayer is not considered to have "paid" the points up front.[175]

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moderate income home buyers obtained under the Community Reinvestment Act, do not require the taxpayer to remit cash as a down payment. Telephone Interview with Timothy A. Kimerling, Assistant Vice President, Community Development and Lending, Bank One, Dayton, NA (Jan. 3, 1995).

169. I.R.C. § 461(g)(2) (1988).

170. Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18; *see also Granan*, 55 T.C. at 755.

171. I.R.C. § 461(g)(2); Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18; *see also supra* notes 180-82 and accompanying text.

172. Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18.

173. The legislative history of I.R.C. § 461(g) clarifies that Congress intended that a taxpayer should not be able to deduct the entire interest paid in a discount loan in the year in which the taxpayer received the loan. H.R. REP. NO. 658, 94th Cong., 2d Sess. 101 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2996.

174. Wilkerson v. Commissioner, 655 F.2d 980, 982 (9th Cir. 1981).

175. Fox v. Commissioner, 57 T.C.M. (CCH) 383 (1989) (denying the taxpayer an immediate deduction for prepaid finance charges that were withheld by the lender from a home mortgage loan); Schubel v. Commissioner, 77 T.C. 701, 704 (1981) (stating that "since petitioners received, or had available, only the face amount of the loan less the 'prepaid finance charges,' those 'prepaid finance charges' were not 'paid' during [the year of the loan transaction]"); Roemer v. Commissioner, 69 T.C. 440 (1977) (disallowing a taxpayer an up-front deduction of interest withheld from loan proceeds that were obtained to purchase an apartment complex); Cathcart v. Commissioner, 36 T.C.M. (CCH) 1321 (1977) (not allowing taxpayers to

To illustrate this point, assume a taxpayer purchased a primary residence for $100,000 and financed the entire amount. Assume the lender charged two points for the mortgage, or $2,000. If the taxpayer did not have the cash to cover the amount charged for the points, the taxpayer could request that the lending institution increase the loan amount from $100,000 to $102,000.[176] Thus, the taxpayer borrows $100,000 for principal and $2,000 for points. In this scenario, the taxpayer borrowed the points amount from the lender. The points amount, therefore, would not be immediately deductible as prepaid interest charges.[177]

The IRS's stance that all points are immediately deductible, with the exception of points that have been borrowed as a part of the overall transaction, seems to leave room for an informed taxpayer to maneuver around the exception. For example, a taxpayer could request the same $102,000 loan from the lender and temporarily borrow $2,000 from a third party.[178] At the loan transaction, the taxpayer could remit the $2,000 cash at the beginning of the transaction and receive the same amount back at the end of the transaction in the form of loan proceeds of $102,000 rather than $100,000.[179] The buyer could then use $100,000 to pay the seller and $2,000 to repay the third party. According to the Revenue Procedure 94-27, the IRS would consider the points to be paid directly by the taxpayer and, therefore, immediately deductible.[180]

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deduct the points amount in the year they received the mortgage proceeds since the points were withheld from the mortgage).

176. The amount of the loan would actually have to be $102,041 to net a principal payment of $100,000 (2% of $102,041 = $2,040 leaving a principal balance of approximately $100,000), but the rounded-down figure of $102,000 will be used for simplicity.

177. I.R.C. § 461(g)(2) (1988). Note that the points will still be deductible over the course of the loan under I.R.C. § 163 and I.R.C. § 461(g)(1), although they will not be immediately deductible as prepaid interest charges under I.R.C. § 163 or I.R.C. § 461(g)(2). Klein, *supra* note 135, at 88 (identifying that "[m]erely because the loan transaction is *not* covered by the safe harbor rules of the revenue procedure does not mean the points are not deductible"). The simplistic example presented does not illustrate the confusion that may exist if the taxpayer pays costs in addition to points at the time of closing. For example, consider the situation in which a lender required a taxpayer to pay both $2,000 for points and $2,000 for closing costs. If the taxpayer borrowed the same $102,000 for the $100,000 residence and pays $2,000 cash, is the $2,000 cash considered to have been paid towards the points or the closing costs? The IRS attempted to clarify this question in Revenue Procedure 94-27 by stating, "[t]he amount provided may include down payments, escrow deposits, earnest money applied at the closing, and other funds actually paid over by the taxpayer at the closing." Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18. Accordingly, in this scenario, the taxpayer may claim the $2,000 cash towards the payment of points for tax purposes. *Id.* In sum, if the taxpayer's cash down payment, or other amounts paid at closing, "amounts to as much or more than the cost of the points, [the taxpayer] can deduct the points in the year [the taxpayer] buy[s] the home." Kristof, *supra* note 139, at C9. The problem of non-deductibility of lender-financed points thus would only surface when the taxpayer did not pay an amount equal to or greater than the points amount at the time of closing. *Id.*

178. The taxpayer's ability to borrow $102,000 for a $100,000 home may be limited, depending on the appraisal value of the home. BERNARD J. WINGER & RALPH R. FRASCA, PERSONAL FINANCE 296 (John D. Stout & Dwayne Martin eds., 2d ed. 1989). Lending institutions will typically not loan amounts over and above the appraised value of the home. *Id.*

179. This restructured loan transaction would not be considered a "discount loan" because the points were not "withheld" from the loan proceeds. Schubel v. Commissioner, 77 T.C. 701, 704 (1981).

180. The amount would be immediately deductible because the amount was not "borrowed [from the lender] for this purpose as a part of the overall transaction." Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18.

Based on this illustration, the IRS's different treatment of amounts "paid" by the buyer, with regard to borrowed funds, is not justified.[181]

c. Viewing Buyers' "Payment" of Seller-Paid Points in the Context of "Borrowed Funds"

Perhaps the deductibility of seller-paid points can be linked to the IRS's general acceptance of amounts borrowed from third parties as being "paid" by the borrower.[182] A home-buying transaction could be seen as if the buyer borrowed the funds from the seller with which to "pay" the points. After borrowing the points amount, the buyer would then return the same amount to the seller by way of the principal borrowed to pay the higher purchase price.[183]

This same theme, however, does not explain the IRS's refusal to allow amounts borrowed from the lending institution to qualify as immediately deductible interest payments. The IRS could easily view the transaction as if the taxpayer borrowed the amount from the lender, and then the buyer immediately remitted the same amount back to the lender in the first year of interest payments on the mortgage.[184]

d. Extending the Immediate Deductibility of Points to Encompass Points "Borrowed" from the Lending Institution

Since the IRS has extended the concept of "paid" far enough to cover points that were actually paid by the seller, it is only logical that the IRS should take the next step and extend the "paid" concept to encompass the immediate deductibility of points borrowed from the lender. Although the points borrowed from the lender are not technically "paid" by the buyer at the time of closing, these lender-borrowed points are no less "paid" than the points that the seller actually paid or that the buyer borrowed from a third party.

Extending the deductibility allowance to points borrowed from the lender would provide numerous benefits. First, this extension would standardize the IRS's treatment of the up-front deductibility of points paid in the acquisition

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181. Also consider the hypothetical presented in the text accompanying *supra* notes 183-85. A taxpayer could borrow the points amount from any lending institution, other than the lender involved in that transaction, and the amount paid for points would be immediately deductible.

182. *See supra* notes 180-86 and accompanying text.

183. This is assuming that the seller did, in fact, raise the purchase price to compensate for payment of the seller-paid points. See *supra* notes 146-47 and accompanying text for a discussion of the assumption that sellers raise purchase prices in an amount equal to the amount of seller-paid points. See also *supra* notes 151-53 and accompanying text for an indication that, although this may not be a realistic assumption, a price-lowering transaction would still fall within the concept of the new revenue procedure.

184. The IRS usually would account for this in the context of interest payment on the first year of the home mortgage. Most home mortgage loans accrue a majority of the chargeable interest in the early years of the loan. WINGER & FRASCA, *supra* note 178, at 305. The IRS could view a portion of the large interest payment paid during the first year of a mortgage as the interest paid for the points.

of a primary residence.[185] Second, the extension would ease the accounting burden on taxpayers who would otherwise be required to amortize the amount of lender-financed points over the course of the loan. This accounting burden may be even more unwarranted than may appear. The IRS now allows any amount provided at closing that is at least equal to the points amount to be treated as a cash payment of points, thereby greatly reducing the amount of lender-borrowed points the taxpayer must amortize.[186] The extension also would reduce the burden on lending institutions to track the portion of the points the taxpayer paid and the portion the lending institution paid.[187]

Finally, allowing buyers an up-front deduction of points borrowed from the lender would not frustrate Congressional intent. As the legislative history for I.R.C. § 461(g) indicates, Congress disallowed the immediate deduction of almost all prepaid interest to discourage the creation of tax shelters and material distortion of income.[188] Allowing taxpayers to immediately deduct all amounts paid as points would not raise tax shelter concerns. It seems highly unlikely that a taxpayer would purchase a primary residence in order to use the typically minimal points amount as a tax shelter for the given year. Further, although a deduction for lender-financed points may slightly distort income for the given year,[189] the minimal amount could generally be viewed as returned to the lender via interest paid on the first year's mortgage payments.[190]

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185. All qualified points, except points borrowed from the lender, are now deductible if the buyer meets the requirements of Revenue Procedure 94-27. *See* Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18.

186. *See* Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18. For example, suppose the taxpayer incurs points indebtedness of $5,000, along with various other closing costs. The taxpayer brings $4,500 cash to the closing to be applied to a down-payment. The lending institution would then provide a discount loan to the buyer, which included the points amount the buyer did not pay at closing. According to Revenue Procedure 94-27, the IRS would view the $4,500 paid at closing (even though actually used as a down payment) as an amount paid for points. Therefore, the taxpayer could deduct $4,500 in the year of the loan transaction under I.R.C. § 461(g)(2) but would be required to amortize $500 over the course of the loan according to I.R.C. § 461(g)(1). Amortizing $500 over the course of a typical 30-year home mortgage would require the taxpayer to deduct approximately $17 per year over the course of the loan.

187. *See* IRS News Release IR-94-28 (Mar. 28, 1994) (emphasizing the "additional reporting requirement[s]" that lenders have in reporting points payments to the IRS via information returns under Rev. Proc. 94-27). See also *supra* note 121 for a discussion of lending institutions' reporting requirements under I.R.C. § 6050H (1988 & Supp. V 1993).

188. *See supra* note 100.

189. Given the liberal viewpoint the IRS now takes regarding the amount presented at closing that may be considered a cash payment of points, the remaining lender-financed points amount is likely to be very minimal in most home mortgage situations.

190. See *supra* note 184 noting that in most situations, due to the disproportionate amount of interest charged in the first years of a home mortgage, the IRS could view the lender-borrowed points as paid in the context of the first year's interest payments. This would assume that the buyer purchased the home early enough in the year to have accumulated sufficient interest charges to cover the amount of points.

The IRS's concern with material distortion of income is a valid one. Cash-method taxpayers could arrange their affairs in such a manner as to prepay certain expenditures to take an immediate deduction for payments, but not include the income from the transaction until a later year. *See* I.R.C. § 446(a), (b) (1988) (stating that a taxpayer should compute his taxable income "under the method of accounting . . . which the taxpayer regularly computes his income . . . [unless] the method used does not clearly reflect income"); Thor Power Tool Co. v. Commissioner, 563 F.2d 861, 869 (7th Cir. 1977) (finding that the taxpayer's treatment of his inventory did not clearly reflect his income); Artnell Co. v. Commissioner, 400 F.2d 981, 986 (7th Cir.

The legislative history for I.R.C. § 461(g) does not provide a reason for the IRS's exception to its "no up-front deductions for prepaid interest" rule with respect to prepaid points on principal residences.[191] Since the apparent purpose of Revenue Procedure 94-27 was to provide a tax break to home-buying taxpayers, this exception to the exception, which disallows an immediate deduction for only those points that were borrowed from the lender, seems to be unwarranted. The benefits provided by an all-encompassing rule of up-front deductibility for prepaid points outweigh the minimal concerns the IRS may have regarding the "paid" requirement[192] and the distortion of income consideration.[193]

2. "Indebtedness"

In order for an amount to be deductible as interest paid, a taxpayer must not only "pay" the amount, but the amount also must be incurred on the taxpayer's own "indebtedness."[194] Courts are generally strict in their application of the requirement that deductible interest must be incurred on a legal obligation of the claiming taxpayer.[195] Accordingly, prior to the release of Revenue Procedure 94-27, seller paid points were viewed as being "paid with respect to a debt which [was] not that of the taxpayer" and therefore were not deductible.[196] In issuing Revenue Procedure 94-27, however, the IRS permitted a blanket deduction of points paid by the seller if the taxpayer satisfies the revenue procedure's requirements.[197] Noticeably absent from these requirements is the necessity that the seller-paid points be incurred on a legal obligation of the buyer.[198]

1968) (remanding the case for a determination of whether the White Sox's claimed deductions for prepayment of services clearly reflected its income). In the present proposal regarding the deductibility of prepaid points borrowed from the lending institution, material distortion of income would be negligible, if any. The IRS controls this aspect by requiring that the "amount of points paid . . . not exceed the amount generally charged in that area." Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18.

191. *See supra* note 100.

192. *See supra* note 188 and accompanying text.

193. *See supra* notes 189-90 and accompanying text.

194. I.R.C. § 163 (1988 & Supp. V 1993). "It has long been established that for interest to be deductible under section 163(a), the interest must be on the taxpayer's own indebtedness and not on the indebtedness of another. The interest must be paid . . . on a valid obligation of the taxpayer claiming the deduction." Tolzman v. Commissioner, 43 T.C.M. (CCH) 1, 6 (1981) (citation omitted).

195. *See* Colston v. Burnet, 59 F.2d 867 (D.C. Cir. 1932) (not allowing the taxpayer to deduct interest payments that were made by him to pay off tax debts of his spouse); Secunda v. Commissioner, 36 T.C.M. (CCH) 763 (1977) (not allowing taxpayers to deduct interest paid on the debts of their children); Rushing v. Commissioner, 58 T.C. 996, 1000 (1972) (stating that under I.R.C. § 163, taxpayers should be denied an interest deduction where the "liability is secondary or indirect"); *cf.* Amundson v. Commissioner, 60 T.C.M. (CCH) 39 (1990) (allowing a taxpayer to deduct interest that was in form paid on the debt of another, because the substance of the transaction indicated that the taxpayer had a legal obligation to make the payment).

196. MERTENS, *supra* note 127, § 26.117.

197. See *supra* note 113 for the five requirements that a taxpayer must satisfy in order to deduct seller-paid points.

198. *See supra* note 113.

To illustrate the extent to which the IRS has strayed from its previous "indebtedness" requirement, consider the following scenario.[199] Suppose the buyer purchases a newly-built home directly from the builder. Assume the builder/seller previously contracted with a lending institution to finance all homes built by the seller. In order to secure a low interest rate that would be attractive to potential buyers, the builder/seller contractually agreed to pay the lender one point for every home mortgage the lender serviced for the builder. When a buyer purchases a home from the builder/seller, the builder/seller pays the one point to the lender at the buyer's closing. Indeed, the seller-paid point in this hypothetical is paid on a legal obligation of the seller, rather than the buyer. Nevertheless, under Revenue Procedure 94-27, the seller-paid point would undoubtedly be deductible by the buyer.[200]

The IRS has strayed a long way from the Supreme Court's definition of interest as "the amount which one has contracted to pay for use of borrowed money."[201] Because Revenue Procedure 94-27 does not make an exception for the deductibility of seller-paid points that are the seller's liability, buyers may deduct all seller-paid points regardless of who is liable.[202] The only explanation for the omission of such an exception is the IRS's desire to avoid the administrative burden of determining who was liable for the points in each seller-paid points transaction.[203] Administrative inconvenience hardly seems an ample justification for straying from the stringent indebtedness requirement that the courts and the IRS have imposed on taxpayers for years.[204] Without the stringent indebtedness requirement, the IRS is no longer in concert with the harsh personal interest deductibility requirements of I.R.C. § 163.[205]

C. A Tax Planning Tip

All individuals purchasing primary residences should be aware of the additional benefit that Revenue Procedure 94-27 provides. The main thrust of this new revenue procedure is to permit buyers to take an up-front deduction of seller-paid points.[206] In allowing immediate deductibility of seller-paid

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199. *See* Sheppard, *supra* note 100, at 145.

200. *See id.*; Rev. Proc. 94-27, 1994-15 I.R.B. 17. This result would not have occurred prior to Revenue Procedure 94-27. Under former procedures, no seller-paid points were deductible. Rev. Proc. 92-12, 1992-1 C.B. 663. Therefore, regardless of who was legally obligated to pay the seller-paid point, the buyer would not have been allowed to take the deduction. *Id.*

201. Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1932).

202. Revenue Procedure 94-27 allows buyers to deduct "points paid by the seller (including points charged to the seller) in connection with the loan to the taxpayer . . . ." Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18.

203. *See* Sheppard, *supra* note 100, at 145.

204. *See supra* notes 194-96 and accompanying text.

205. *See supra* notes 72-75 and accompanying text.

206. Rev. Proc. 94-27, 1994-15 I.R.B. 17.

points, Revenue Procedure 94-27 provides an additional benefit to home-buying taxpayers.

According to the new revenue procedure, points "paid directly by the taxpayer" are immediately deductible.[207] The IRS will consider the points to have been "paid directly by the taxpayer" if "the taxpayer provides . . . an amount at least equal to the amount required to be applied as points at the closing."[208] The procedure further explains that "[t]he amount provided may include down payments, escrow deposits, earnest money applied at the closing, and other funds actually paid over by the taxpayer at the closing."[209] Therefore, as long as a buyer pays cash at the closing of the home mortgage transaction in an amount at least equal to the amount the lender charges for points, the taxpayer will be allowed an up-front deduction for points.

For example, assume a taxpayer purchases a $200,000 home and has $20,000 cash to apply towards a down payment. If the lender charges three points, the taxpayer will be obligated to pay $6,000 to the lending institution as an up-front interest charge. The loan transaction will be structured such that the taxpayer actually takes out a $186,000 loan. At closing, the seller will receive $180,000 in principal from the lender, and $20,000 from the buyer. The additional $6,000 borrowed from the lending institution is the amount "borrowed" from the lender to cover the buyer's points obligation.

According to the new procedure, although the points amount in this example was technically not "paid directly by the buyer," and although the points amount was technically "borrowed for this purpose as part of the overall transaction,"[210] the amount would still be immediately deductible.[211] In fact, the IRS will allow taxpayers to take an immediate deduction for almost all points paid, regardless of whether the points were borrowed from the lending institution as a part of the loan transaction. The only stipulation is that the taxpayer pay cash at the closing at least equal to the amount the lending institution is charging for points.[212] Tax advisers, therefore, should ensure that their clients take all up-front "points" deductions allowable under Revenue Procedure 94-27.

207. *Id.* at 18.

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.* The IRS would likely view this transaction as if the taxpayer used $6,000 cash to pay the points and only applied $14,000 as a down payment, thereby needing to borrow $186,000 of principal to pay for a $200,000 home.

212. Rev. Proc. 94-27, 1994-15 I.R.B. 17, 18. Perhaps many tax planners have been treating amounts paid as points in this manner notwithstanding the concession in Revenue Procedure 94-27. *See* Kristof, *supra* note 139, at C9 ("[s]ome savvy tax accountants say they had been advising their clients to [claim all cash amounts as amounts paid for points] since 1992, when the IRS had 'clarified' previous law and tax court rulings, indicating that full first-year deductions were allowable under these circumstances").

IV. CONCLUSION

Revenue Procedure 94-27 broadens all aspects of the concept of interest deductibility under I.R.C. § 163 and I.R.C. § 461(g)(2). The basic "paid" requirement of interest deductibility is only supplied through a factual rearrangement of the home selling transaction. Relying on a generic seller-paid points transaction, the IRS treats the amount of points paid by the seller as interest "paid" by the buyer. If the IRS is willing to make this conceptual leap, it seems only logical that the IRS should take the next step and treat points borrowed from the lender as if they were also "paid" by the buyer. This concession would produce enormous benefits. The concession would provide consistent tax treatment for all taxpayers deducting amounts paid for points, and it would reduce accounting burdens on both taxpayers and lenders. Although the Government would incur costs in the form of current deductibility of certain payments that would normally be amortized, the costs would undoubtedly be outweighed by the benefits.

Furthermore, the basic "indebtedness" requirement of interest deductibility is missing in Revenue Procedure 94-27. The procedure does not require that the buyer be liable for the seller-paid points in order to satisfy the requirements for up-front deductibility. Unless the IRS is prepared to change its historically accepted definition of interest deductibility, it is imperative that the IRS clarify Revenue Procedure 94-27 to encompass the requirement of buyer "indebtedness."

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