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Deductibility Limits on Accrued Interests to Related Parties

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The Internal Revenue Code has long had limitations on the deductibility of certain expenses such as interest that are owed to a related party, but not yet paid. The limitations are intended to deny the tax benefit of a deduction to the person incurring the expense until the corresponding tax detriment of an income inclusion is borne by the related party. A recent case illustrates the application of these limitations in a context in which related party debt was transferred by the initial lender, who was related to the borrower claiming the interest deductions, to another person, who was not related to the borrower.

Background

Generally, a taxpayer using an accrual method of accounting may take an expense into account for Federal tax purposes in the taxable year in which all of the events have occurred to establish liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred. With respect to interest, economic performance occurs, in general, as the interest cost economically accrues. Thus, under these rules, interest expense of an accrual method taxpayer is generally taken into account by the debtor in the taxable year in which incurred, regardless of whether the interest was paid in that period.

Section 267(a)(2) of the Code changes these rules with respect to interest and other expenses owed to a related party. If, at the close of the taxable year of an accrual method taxpayer otherwise entitled to an interest expense deduction, the taxpayer and the person to whom the payment is to be made are related persons (as determined under the rules of Code section 267(b)), and if, by reason of the method of accounting of the person to whom the payment is owed, the amount thereof would not be includible in the income of the recipient until it is paid, then the deduction otherwise allowable with respect to such payment is deferred until such amount is includible in the gross income of the person to whom the payment is to be made. Thus, if the creditor uses the cash receipts and disbursements method of accounting and will accordingly not report interest income until it is actually or constructively received, the accrual method debtor cannot deduct accrued, but unpaid interest expense; rather, the debtor will deduct the interest expense when payment is made and the creditor is required to report interest income.

The relationships described in section 267(b) include members of the same family, two corporations that are members of the same "controlled group" (as defined), and an individual and a corporation where the individual owns more than 50 percent (by value) of the stock of the corporation. Certain "constructive ownership" rules set forth in section 267(c), under which (for example) one family member may be treated as owning stock actually owned by other family members, apply in determining whether there exists an ownership relationship described in section 267(b).

Ronald Moran Cadillac

The facts in *Ronald Moran Cadillac, Inc. v. United States*, No. 02-57052 (9th Cir. Oct. 12, 2004) were straightforward and not in dispute. Caesar Wackeen ("CW") owned all of the stock of Ronald Moran Cadillac, Inc. ("RMC"), the holder of a Cadillac franchise. CW was a cash-basis taxpayer and RMC was an accrual-method taxpayer.

CW made loans and advances to RMC of approximately $2.3 million in the aggregate before 1994, and the resulting indebtedness was memorialized in a consolidation note dated January 1, 1994. RMC accrued interest on the indebtedness on its records but did not pay the interest to CW. Because CW, as a cash-method taxpayer, would not be required to include such interest in his income prior to payment, Code section 267(a)(2) applied to deny to RMC a current deduction for such interest, and RMC accordingly did not claim deductions for the interest as it accrued.

On September 20, 1994, CW sold the note, including the right to collect the accrued but unpaid interest, to an unrelated person. RMC sought to deduct approximately $1 million on its 1994 tax return as the accrued but unpaid interest on the note for 1994 and prior years. The IRS determined that the

interest attributable to 1994 was deductible, but disallowed the deduction of pre-1994 interest.

RMC filed suit to contest this denial of a deduction for pre-1994 interest. Upon cross-motions for summary judgment, the district court held for the IRS on this issue (*Ronald Morgan (sic Moran) Cadillac, Inc. v. United States*, 90 AFTR2d 6719 (Central Dist. of California 2002)). On appeal by the taxpayer, the Court of Appeals for the Ninth Circuit affirmed, essentially on the District Court's reasoning as summarized below.

The courts found that a plain reading of the statute itself supported the government's position. Section 267(a) by its terms provides that, once a deduction is suspended under that provision, it will not be allowed until the amount is included in the income of the person to whom payment is to be made -- typically, when paid.

Here, the accrued interest was never included in the income of CW, because he sold the note, including the claim for accrued interest, at a loss. There was nothing in the statute to suggest that the deduction, once not allowed pursuant to section 267(a)(2), should be retroactively allowed in the later year in which the note ceased to be owned by a party related to the debtor.

Temporary Reg. section 1.267(a)-2T(b), Q&A 5, provided additional support for the government's position. Question 5 asks whether, if a deduction is deferred under section 267(a)(2) and, before the amount is includible in the income of the person to whom it is to be paid, that person and the payor cease to be related (as determined under the applicable standards of Code section 267), the deduction is allowable at the time the relationship ceases. The answer set forth in the temporary regulation is "no"; the deduction is not allowable until the amount is includible in the income of the person to whom it is to be paid, even if the section 267(b) relationship ceased to exist at an earlier time.

Q&A 5 could be interpreted to be directed exclusively to the situation where the original parties to the transaction cease to be related -- e.g., because a sole shareholder and creditor of a corporation disposes of his stock to an unrelated party, while retaining a promissory note reflecting unpaid accrued interest. In fact, the Q&A does not, by its terms, relate to a situation in which the parties remain related in the same way, but the claim to payment is transferred (as was the case in *Moran Cadillac*). However, there is no apparent reason for providing for a more favorable result in the latter case, since in neither situation has the income that would be attributable to the payment been recognized prior to or in connection with the transfer.

It was also noted in both the District Court and Court of Appeals opinions that the congressional intent underlying section 267(a)(2) was to prevent tax avoidance schemes through related parties, such as by taking advantage of different accounting methods to obtain "artificial" deductions. The courts concluded that this purpose would be undercut if the deduction for the accrued interest could be claimed upon the sale of the note at a loss, and before payment of the interest -- and RMC conceded that it had yet to pay any of such interest to either the original lender or to the buyer of the note.

The District Court opinion notes that the taxpayer claimed that the government was taking inconsistent positions by allowing the deduction of interest accrued in 1994 in that year, while disallowing a deduction for interest accrued for prior years. This distinction, though, was supported by the statute, which provides that the relationship test for the section 267(a)(2) deduction disallowance rule is to be applied on a year-by-year basis, *at the close of the taxable year* of the taxpayer that would otherwise be entitled to a deduction. Since, at the close of RMC's 1994 taxable year, RMC was not related to the then holder of the note, a deduction was allowable to RMC for the interest that accrued for 1994.

It was also noted that the application of section 267(a)(2) to a related party indebtedness need not result in a permanent disallowance of the deduction for accrued but unpaid interest. If, for example, RMC ultimately paid the full amount of the note, including the accrued interest, to the unrelated party that bought the note from CW (or to a subsequent holder of the note), and as a result of that payment the amount of the interest was includible in the gross income of the person to whom payment is made, RMC would be entitled at that time to a deduction for the accrued interest.

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