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IS INTEREST ON TAXES DEDUCTIBLE?

— by Neil E. Harl*

For months, the debate has raged over the question of whether interest on federal income taxes attributable to a business is deductible for federal income tax purposes.¹ Much of the debate has focused on a North Dakota farm case² although the Tax Court in early 1996 decided a case on the issue.³

Background

Before enactment of a different statutory provision in 1986, interest on tax deficiencies attributable to business income was deductible as an ordinary and necessary business expense.⁴ However, in the Tax Reform Act of 1986, Congress acted to prohibit a deduction for personal interest (except on a phase-out basis).⁵ The statute prohibiting a deduction for personal interest⁶ contained several exceptions, one of which was for "interest paid or accrued on indebtedness properly allocable to a trade or business...."⁷ The conference committee report⁸ and the General Explanation of the Tax Reform Act of 1986⁹ (the "Blue Book") both took the position that personal interest included interest on tax deficiencies with the Blue Book stating specifically that interest on taxes is considered personal interest even though the taxes may have arisen in a trade or business.¹⁰

The temporary Regulations, issued in late 1987,¹¹ provided that —

"...personal interest includes interest...paid on underpayments of individual Federal, State or local income taxes and on indebtedness used to pay such taxes...regardless of the source of the income generating the tax liability...."¹²

At that point, it appeared that interest on unpaid taxes would not be deductible even if attributable to business income.

Miller I

In the first case to consider the issue, *Miller v. United States*,¹³ the U.S. District Court held the temporary regulation invalid and allowed a deduction for \$367,332 in interest expense on the taxpayers' state and federal income

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tax returns.¹⁴ The deficiency was related to their Schedule F. The court granted the government a 90 day continuance to complete discovery on the issue of whether the claimed interest deduction was "ordinary and necessary."¹⁵

Miller II

After the discovery under the granted continuance, the government took the position that the claimed interest deduction was not an ordinary and necessary business expense.¹⁶ The second round of hearings produced more facts about the nature of the transaction that produced the deficiency. The taxpayers had established a fiscal year farm corporation to market grain produced by the taxpayers. The income from the grain sold after the end of the corporation's taxable year was treated as "loans" with the income deferred until the following year.¹⁷ The taxpayers, by the government's view, had failed to report approximately \$1.5 million of income on their 1982 and 1983 returns. The court agreed that the deferral scheme was improper, stated that the tax deficiencies were based "on a clearly erroneous decision" by the taxpayers to underreport their income and held that the interest failed the test of being an "ordinary and necessary" business expense.¹⁸

That decision, Miller II, was appealed to the Eighth Circuit Court of Appeals. The Eighth Circuit agreed that the claimed deduction failed the "ordinary and necessary" test but held that the temporary regulation represented "a permissible construction" of the statute and was, therefore, valid.¹⁹

The Tax Court decision

Although the Tax Court had decided cases on the issue,²⁰ not until the 1996 decision of *Redlark v. Commissioner*²¹ did the Tax Court address the question of validity of the temporary regulation. The *Redlark* case²² involved adjustments from the correction of errors in shifting an unincorporated business from an accrual basis to the cash basis of accounting.²³

The Tax Court held that the temporary regulation classifying all interest on back taxes as non-deductible personal interest²⁴ constituted "an impermissible reading of the statute" and, therefore, was invalid.²⁵ The Tax Court went on to state that the interest involved in *Redlark*²⁶ was interest "on indebtedness properly allocable to a trade or business" and was deductible. The court acknowledged that

"there will be situations where a Federal income tax deficiency will not be as narrowly focused" and that interest paid on a tax deficiency may not be an ordinary and necessary business expense.²⁷ The court specifically noted that Miller I and Miller II involved just such a situation.²⁸

The Tax Court was badly divided in *Redlark*.²⁹ Eight judges agreed with the majority opinion, six dissented and several wrote concurring opinions.

In conclusion

At the moment, for taxpayers in the Eighth Circuit Court of Appeals area, the regulation has been declared valid.³⁰ Outside the Eighth Circuit, the Tax Court view prevails that the temporary regulation is invalid but that the interest must be an ordinary and necessary business expense to be deductible.³¹

But *Redlark*³² may be appealed. In any event, the last word has probably not been written on this issue.

FOOTNOTES

- ¹ I.R.C. § 163(h)(2)(A). See Temp. Treas. Reg. § 1.163-9T(b)(2)(i)(A). See generally 4 Harl, *Agricultural Law* § 28.05[3] (1995); Harl, *Agricultural Law Manual* § 4.03[12] (1995).
- ² Miller v. United States, 65 F.3d 687 (8th Cir. 1995), *aff'g*, 95-1 U.S. Tax Cas. (CCH) ¶ 50,068 (D. N.D. 1994) (Miller II). An earlier decision involving the same controversy (Miller I) was decided in 1993. Miller v. United States, 841 F. Supp. 305 (D. N.D. 1993).
- ³ Redlark v. Comm'r, 106 T.C. No. 2 (1996).
- ⁴ I.R.C. § 62(a)(1).
- ⁵ Pub. L. 99-514, Sec. 511(b), 100 Stat. 2085, 2246, adding I.R.C. § 163(h).
- ⁶ I.R.C. § 163(h)(1).
- ⁷ I.R.C. § 163(h)(2)(A).
- ⁸ H. Conf. Rep. 99-841 at II-154 (1986).

- ⁹ Staff of Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986 at 266 (1987).
- ¹⁰ *Id.*
- ¹¹ 52 Fed. Reg. 48409 (Dec. 22, 1987), adding Temp. Treas. Reg. § 1.163-9T.
- ¹² Temp. Treas. Reg. § 1.163-9T(b)(2)(i)(A).
- ¹³ 841 F. Supp. 305 (D. N.D. 1993).
- ¹⁴ *Id.*
- ¹⁵ I.R.C. §§ 62(a), 162.
- ¹⁶ Miller v. United States, 95-1 U.S. Tax Cas. (CCH) ¶ 50,068 (D. N.D. 1994).
- ¹⁷ *Id.*
- ¹⁸ *Id.*
- ¹⁹ Miller v. United States, 65 F.3d 687 (8th Cir. 1995).
- ²⁰ Tippin v. Comm'r, 104 T.C. 518, 529 (1995) (taxpayer did not show relationship between interest expense and any business); Rose v. Comm'r, T.C. Memo. 1995-75 (taxpayer failed to show tax attributable to trade or business or investment activity); Crouch v. Comm'r, T.C. Memo. 1995-289 (deduction disallowed for portion of tax attributable to business because of failure of proof and interest was for previous year). See Sheerazi v. Comm'r, T.C. Memo. 1994-245 (personal interest).
- ²¹ 106 T.C. No. 2 (1996).
- ²² *Id.*
- ²³ *Id.*
- ²⁴ Temp. Treas. Reg. § 1.163-9T(b)(2)(i).
- ²⁵ 106 T.C. No. 2 (1996).
- ²⁶ *Id.*
- ²⁷ *Id.*
- ²⁸ *Id.*
- ²⁹ *Id.*
- ³⁰ Miller v. United States, 65 F.3d 687 (8th Cir. 1995).
- ³¹ Redlark v. Comm'r, 106 T.C. No. 2 (1996).
- ³² *Id.*

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

HORSES. The plaintiff was injured when the plaintiff's car struck a horse on a highway. The horse belonged to the defendant and had escaped after a parked truck rolled down a slope and crashed through the fence holding the horse. The evidence demonstrated that, except for the breach in the fence caused by the truck, the fence was in good repair and sufficient to prevent the horse from escaping. Although the jury found for the plaintiff, the trial court entered judgment for the defendant notwithstanding the verdict because the evidence showed that the fence was in good repair. The appellate court affirmed, agreeing that no evidence was presented that the defendant or any agent, employee or resident of the defendant was responsible for the breach in the fence. The evidence showed that the truck was parked on a slope in gear and with its parking brake engaged. After the accident, the truck was out of gear and the parking brake

was off. **Butcher v. White's Iowa Institute**, 541 N.W.2d 262 (Iowa Ct. App. 1995).

BANKRUPTCY

GENERAL-ALM § 13.03.*

AVOIDABLE TRANSFERS. The debtor was a corporation which operated a feedlot. The corporation was wholly-owned by the defendant who was also the president and principal employee of the debtor. The defendant was convicted of a check kiting scheme using the debtor's funds. The trustee sought to recover prepetition payments made to creditors during the check kiting as fraudulent transfers. The trustee argued that the defendant's guilty plea in the check kiting case was prima facie evidence that the payments to creditors were made with intent to defraud creditors. The court held that the guilty plea was prima facie evidence of intent to defraud only as to the two banks used in the check