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# **DEDUCTING ACCRUED BUT UNPAID INTEREST – THE COMPTROLLER V. THE NYRA**

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## Deducting Accrued but Unpaid Interest – The Comptroller v. The NYRA

As part of its recent audit of the New York Racing Association [NYRA], the State Comptroller seriously questioned whether NYRA was authorized to deduct from federal taxation its accrued interest payment on its debt to the New York State Thoroughbred Capital Investment Fund[CIF].

In 2001, NYRA deducted \$1,748,525 for accrued interest to the CIF on its corporate tax return.<sup>1</sup> In 2000, the figure was \$1,989,006.<sup>2</sup> NYRA has not made any interest payment on its indebtedness to CIF since 1993.<sup>3</sup>

The Comptroller questioned the allowability of this deduction. While stating that the formal determination of allowability should be made by the IRS, the Comptroller stated, “It is our position that these deductions by NYRA may be inappropriate in view of the fact that the record indicates that NYRA has not made any interest payments to the Capital investment Fund since 1993, and that the Capital Investment Fund has failed in its attempts to secure a repayment agreement with NYRA.”<sup>4</sup>

NYRA in its response to the Comptroller’s draft audit stated that the Comptroller had not previously raised any concern about the possible non-deductibility of interest accruals<sup>5</sup> and argued that under the applicable law a deduction for accrued interest is allowable where it can not be said categorically that the interest would not be repaid.<sup>6</sup> NYRA also stated that it planned to repay the CIF in full,<sup>7</sup> and added that if necessary, it could sell property to repay the CIF. Finally, as a last resort, CIF holds a mortgage on the Aqueduct real property which could certainly guarantee CIF full payment of its indebtedness.<sup>8</sup>

The State Comptroller responded to NYRA’s argument by claiming that “NYRA dedicated three pages of its response to the matter without providing any evidence that ... it had any ability or intent to actually make the accrued interest payment to the CIF.”<sup>9</sup> [Comptroller’s emphasis] “When the wheat is separated from the chaff in NYRA’s response to this issue, all that is left is NYRA’s acknowledgment of its utter failure to pay any interest to the CIF since 1993.”<sup>10</sup>

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<sup>1</sup> “New York Racing Association, Inc. Audit of the Annual Franchise Fee for Calendar Years 2000 and 2001”, State Comptroller at p. 18 (2003) This report will be referred to as Comptroller’s Audit.

<sup>2</sup> Id.

<sup>3</sup> Id.

<sup>4</sup> Id.

<sup>5</sup> Id. at Appendix B-7.

<sup>6</sup> Id. at Appendix B-8.

<sup>7</sup> Id.

<sup>8</sup> Id. at B-9.

<sup>9</sup> Id. at C-5.

<sup>10</sup> Id.

Regardless of the reasons for NYRA's failure to pay CIF, the law is fairly clear. As long as the loans are fixed and unconditional, NYRA should be entitled to the deduction.

Stating the general law on the deductibility of accrued interest is simple. 26 USC §163 establishes a general rule that "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." See also 26 CFR §1.163-1(a).

The general principles of the accrual issue are also easily stated. "For accrual basis taxpayers, the interest deduction is not dependent upon payment of interest or even upon the due date for payment. Interest is ratably deductible over the period of indebtedness."<sup>11</sup> "Generally, deductions for accrued interest are proper even when at the time the deduction was claimed there was a possibility that the interest would not be paid."<sup>12</sup>

Thus, there is a general presumption that NYRA should be entitled to the interest deduction. The issue then becomes whether the improbability of interest repayment should be a factor in determining deductibility, and if it is a factor, how do establish the unlikelihood of repayment?

There are two standards in the case law, and the case law has been described as "both limited and sharply divided."<sup>13</sup> Under one standard, improbability of payment is not a factor to be considered in determining deductibility. Under the second standard, the accrued interest is deductible unless it can be demonstrated categorically that payment is extremely doubtful.

Under both standards, NYRA's accrued but unpaid interest obligation should be deductible.

Under the first standard, where improbability of payment is considered largely irrelevant, NYRA would obviously prevail since so long as the interest was accrued, the amount of the interest was deductible. This is the standard that seems to have prevailed in the federal courts.

The primary case is Zimmerman Steel v. Commissioner, 130 F. 2d 1011 (8th. Cir 1942). In Zimmerman, the Tax Court denied deductibility of a accrued interest on the grounds that there was no reasonable expectation of payment of interest. The 8th Circuit reversed. The court stated:

But where interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it, but must go into bankruptcy as this taxpayer was obliged to do, can not of itself justify denial of deduction in computing the taxpayer's net income. It is true that if a man's gains at the

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<sup>11</sup> 3A Rabkin and Johnson, Federal Income Gift and Estate Taxation, §37.14 (2003)

<sup>12</sup> Mertens, Law of Federal Income Taxation, §12A:114

<sup>13</sup> Southern Mail Transportation Inc. v. Commissioner, T.C. Memo 1992-252.

end of the year consist of bad debts he can have no net income to tax. But neither does he have such net income if the interest on what he owes amounts to more than his gains.<sup>14</sup>

Over the years, most of the federal courts have followed the Zimmerman rationale.<sup>15</sup> The Fifth Circuit followed Zimmerman in Fahs v. Martin, 224 F. 2d 387 (5th Cir. 1955). The Fahs court concluded that the Internal Revenue Code “does not preclude the deduction of interest on interest, not even if the latter is unlikely to be paid.”<sup>16</sup> While Fahs has been questioned over the years, it remains the law in the Fifth Circuit. <sup>17</sup> In fact, “the Eighth Circuit, the Eleventh Circuit, and the Court of Federal Claims ... follow the rule we adopted in Fahs. See Keebey's Inc. v. Paschal, 188 F.2d 113, 115-16 (8th Cir. 1951); Zimmerman Steel Co. v. Commissioner, 130 F.2d 1011, 1012 (8th Cir. 1942); Sartin v. United States, 5 Cl. Ct. 172, 176 (1984) (citing Fahs rule with approval).<sup>18</sup>

In the recent case of In re Dow Corning Corp., 270 B.R. 393 (2000), the court found that the Internal Revenue Code did not identify solvency as a condition for deducting an interest obligation.<sup>19</sup> “Thus the imposition of some kind of solvency requirement in connection with IRC § 163 cannot be justified as reflecting the manifest will of Congress.”<sup>20</sup> The Court agreed with the rationale of Fahs and Zimmerman that inability to pay interest did not affect the deductibility of accrued interest. Thus, the federal courts basically have found that the unlikelihood that interest payments will be made does not affect the deductibility of accrued interest.<sup>21</sup> Under the federal court decisions, NYRA should clearly be entitled to deduct its unpaid but accrued interest obligations under the federal tax code.

There is however a second line of cases which does factor the unlikelihood of repayment into the issue of whether a taxpayer can deduct accrued but unpaid interest. This stems from the fact that the Tax Court has never acceded to the decision of the 8th Circuit in Zimmerman Steel.<sup>22</sup> In Pearlman v. Commissioner, the Tax Court wrote, “With all due deference to the Circuit Court of Appeals for the Eighth Circuit, we adhere to the view expressed in Zimmerman Steel Co., 45 B. T. A. 1041, notwithstanding the reversal in Zimmerman Steel Co. v. Commissioner, 130 Fed. (2d) 1011.”<sup>23</sup> Thus, the Tax Court has

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<sup>14</sup> Zimmerman Steel at 1012.

<sup>15</sup> See the cases listed in Southeastern Mail, supra.

<sup>16</sup> Fahs at 393.

<sup>17</sup> See Kellogg v. United States (In re West Tex. Mktg. Corp.), 54 F.3d 1194 (5<sup>th</sup> Cir. 1995)

<sup>18</sup> Id. Dissenting Opinion at 1206, note 12.

<sup>19</sup> of In re Dow Corning Corp., 270 B.R. 393, 406 (2001)

<sup>20</sup> Id.

<sup>21</sup> The few court cases that are not in total agreement with the Zimmerman and Fahs rationale can be distinguished. See the discussion of In re Continental Vending Mach. Corp., [77-1 U.S. Tax Cas. (CCH) P 9,121, at 86,093 (E.D.N.Y. 1976)], in the dissenting opinion in Kellogg, note 16 supra at pp. 1203 – 1204. Pearlman v. Commissioner Of Internal Revenue, 153 F.2d 560 (3<sup>rd</sup> Cir 1946) affirmed a ruling of the Tax Court which imposed an improbability of payment issue to deny an accrued interest deduction. The court decision, however, affirmed the Tax Court without deciding the improbability of payment issue.

<sup>22</sup> See note 14, supra.

<sup>23</sup> Pearlman v. Commissioner, 4 T.C. 34, 54 (1944), aff’d on other grounds 153 F.2d 560 (3<sup>rd</sup> Cir. 1946).

been left with the Zimmerman Steel rationale that “since there was no reasonable expectation of such obligation being discharged in the normal course of business,”<sup>24</sup> there was no deduction for the accrued but unpaid interest.

Since Zimmerman and Pearlman, the Tax Court has maintained its position that there is no deduction for accrued but unpaid interest where the likelihood of payment of the interest obligation was extremely doubtful.<sup>25</sup> The definitive formulation of that standard was issued in D.J. Jorden v. Commissioner. In that case, the court stated:

“In such circumstances, we do not feel that it could have been categorically stated at that at the time these deductions were claimed that the interest would not be paid even though the course of the conduct of the parties indicated that the likelihood of payment of any part of the disallowed portion was extremely doubtful.”<sup>26</sup>

The Jorden “categorical unlikelihood” language was reiterated in Cohen v. Commissioner<sup>27</sup> and in Taube v. Commissioner.<sup>28</sup> The issue thus becomes what standards the Internal Revenue Service and the Tax Court would apply to determine whether there was a categorical unlikelihood of paying interest.

For the past half century, the Tax Court has not disallowed any accrued interest deductions. “Cases decided in this Court since Brainard have generally fallen short of finding that the interest accruals involved would never be paid.”<sup>29</sup>

Under the standards applied under the “categorical unlikelihood” standard it is apparent that it would not be categorically unlikely that NYRA will not pay interest on its debt to the CIF. In Southeastern Mail, the deduction was allowed even though the taxpayer discontinued business four days before its fiscal year ended. The fact that there had been an “active operating business”<sup>30</sup> up until that time was enough to make the deduction allowable. In Cohen and Jorden, the fact that the taxpayer had been paying some principal and interest on the loan sufficed to qualify for the deduction. In Taube, the prospect of potential future revenue qualified the taxpayer for the deduction.

The Internal Revenue Service in R.R. 70-367 allowed a railroad corporation, which was in bankruptcy and was about to reorganize its debt, to maintain its deduction for accrued interest. The doubt as to payment of the interest did not postpone its accrual.

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<sup>24</sup> Zimmerman Steel Co. V. Commissioner, 45 B.T.A. 1041, 1047 (1941)

<sup>25</sup> See Brainard v. Commissioner, 7 T.C. 1180 (1946) remanded by 1947 U.S. App. LEXIS 3892 (7th Cir. 1947); D.J. Jorden v. Commissioner, 11 T.C. 914, 925 (1948); Cohen v. Commissioner, 21 T.C. 855 (1954); Taube v. Commissioner, 88 T.C. 464 (1987); Southeastern Mail, supra at note 13.

<sup>26</sup> Jorden supra at note 26 at 925.

<sup>27</sup> 21 T.C. 855 at 857.

<sup>28</sup> 88 T.C. 464 at 490.

<sup>29</sup> Southeastern Mail supra

<sup>30</sup> Id.

Finally, in *Dow Corning Corp.*, the court speculated that solvency might be an appropriate measure for determining likelihood of repaying interest.<sup>31</sup>

Applying these standards to NYRA, you have a taxpayer that is in active operation, is not even in bankruptcy, that is repaying some principal, is solvent in that the value of its racetrack properties far exceeds its debt, and certainly has prospects for future revenue.<sup>32</sup> NYRA's only negative is its failure to pay interest on its indebtedness since 1993. The balance of these factors certainly favors NYRA, and it is certainly appropriate for NYRA to deduct its accrued but unpaid interest to the CIF on its federal corporate tax return.

There is one significant caveat, here. While NYRA certainly acknowledges the existence of this debt to the CIF and its duty to repay the loan in its response to the Comptroller,<sup>33</sup> it also asserts briefly that it is repaying CIF in accordance with its statutory obligation.<sup>34</sup> Here, NYRA may be arguing that its sole duty under law is to repay CIF if and only when NYRA's profits are in excess of \$2 million. The difficulty here is that if NYRA's obligation is to pay CIF only when NYRA reaches a particular level of profitability, then you may not have a fixed and unconditional obligation to pay interest. You don't have a definite indebtedness. If payment of interest is contingent on NYRA's profitability, then NYRA may be facing the line of cases that denies the deductibility of accrued interest when the debt is only conditional.<sup>35</sup>

Given NYRA's general recognition of its indebtedness to the CIF, I would still believe that NYRA has a definite and fixed obligation to the CIF. If, however, NYRA's repayment of principal and interest to the CIF is, in fact, contingent upon NYRA maintaining a fairly high level of profitability, then the debt may be conditional. If the debt is conditional, then NYRA may not receive a deduction for accrued, but unpaid, interest.

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<sup>31</sup> 293 B.R. at 407.

<sup>32</sup> You have potential growth from the operation of video lotteries, legislative changes that might improve NYRA's fiscal health, and the overall potential for growth in the sport of horse racing.

<sup>33</sup> Audit at B-8.

<sup>34</sup> *Id.* at B-9.

<sup>35</sup> See *Burlington Rock Island Railroad Company v. United States*, 321 F. 2d 817 (5<sup>th</sup> Cir. 1963), cert denied 377 US 942 (1964); *Gounares Bros. & Co. v. United States*, 292 F. 2d 79 (5<sup>th</sup> Cir. 1961). Cf. *In re Ford*, 967 F. 2d 1047, 1051 (5<sup>th</sup> Cir. 1992)