31 T.C. 46 (1958)

A cash-basis taxpayer cannot deduct interest paid on estimated tax deficiencies if the underlying tax liability has not been formally assessed by the IRS, even if the taxpayer remits funds to the IRS to cover the estimated liability.

Summary

Fred Arheit, a cash-basis taxpayer, sent a check to the IRS in 1952 to cover estimated tax deficiencies and interest for prior years. The IRS credited the payment to a suspense account. The IRS had not yet assessed the tax deficiencies or issued a 30-day letter at the time of payment. Later, in 1955, after a 30-day letter was issued and the deficiencies and interest were formally assessed, the IRS applied the funds in the suspense account to the assessed liability. Arheit sought to deduct the interest portion of the 1952 payment on his 1952 tax return. The Tax Court held that the interest was not deductible in 1952 because the payment was a mere deposit to a suspense account and not a payment of interest on an existing tax liability.

Facts

- Fred Arheit and his wife filed joint tax returns, with Arheit using the cash method of accounting.
- In 1952, the IRS had not issued a 30-day letter or a notice of deficiency for the years 1945-1950.
- The IRS agents informed Arheit that they recommended deficiencies for those years due to fraud. Arheit did not agree with some proposed deficiencies and the fraud penalties.
- Arheit, wanting to stop interest accrual, sent a check for $66,639.70 to the IRS, covering estimated deficiencies and interest through April 7, 1952. The check was credited to a suspense account.
- In 1955, after a grand jury declined to indict Arheit on criminal tax evasion charges, the IRS issued a 30-day letter. Arheit then executed waivers and consents (Forms 870) agreeing to the deficiencies and fraud penalties, and the funds in the suspense account were applied to the assessed liability.
- Arheit sought to deduct the interest portion of the 1952 payment on his 1952 tax return, which the IRS disallowed.

Procedural History

The IRS disallowed Arheit’s deduction for interest paid in 1952. The Tax Court reviewed the IRS’s determination. The Tax Court decided in favor of the Commissioner, denying the deduction.

Issue(s)

Whether a cash-basis taxpayer can deduct interest paid to the IRS in a year where the underlying tax liability has not been formally assessed, but the payment is made

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to stop the accrual of interest.

Holding

No, because the payment was credited to a suspense account and did not represent a payment of interest on an existing assessed tax liability in 1952.

Court's Reasoning

- The court relied on the Supreme Court's decision in *Rosenman v. United States*, 323 U.S. 658 (1945), which held that a remittance to the IRS credited to a suspense account does not constitute a payment of tax. Money in a suspense account is considered a deposit, similar to a cash bond, until liability is determined and assessed.
- The court distinguished the case from situations where there is an existing indebtedness that is satisfied by a payment. Here, the tax liability was disputed in 1952, and the IRS had not yet made a formal determination of the deficiencies or assessed the taxes. Therefore, there was no existing indebtedness to be discharged by Arheit's payment.
- The Court noted that the use of the suspense account meant the IRS could refund the money if the ultimate assessment was lower than the deposited amount, which is inconsistent with a completed payment.
- The court rejected Arheit's argument that he had admitted liability through the tender, because the IRS had not accepted that offer and a mere offer does not establish liability.

Practical Implications

- Taxpayers cannot deduct interest payments on estimated tax liabilities before the IRS has made a formal assessment.
- Payments made to a suspense account are not deductible until the underlying tax liability is established, and the payment is applied to that liability.
- This case emphasizes the importance of formal assessment for triggering a deduction under the cash method for interest paid to the IRS.
- The ruling is a reminder that even when a taxpayer makes a payment to stop the accrual of interest, the timing of the deduction is governed by whether the tax liability has been definitively established.
- Attorneys should advise their clients to await formal assessment of taxes before claiming deductions for interest paid.

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