***Schubel v. Commissioner, 77 T. C. 709 (1981)***

Prepaid finance charges withheld from loan proceeds by the lender are not considered "paid" for tax deduction purposes under Section 461(g)(2).

**Summary**

In Schubel v. Commissioner, the petitioners sought to deduct prepaid finance charges withheld by Pan American Bank during the refinancing of their home. The Tax Court held that these charges were not deductible in the year they were withheld because they were not "paid" by the petitioners. The decision hinged on the interpretation of Section 461(g)(2), which allows a deduction for points paid in connection with a home purchase or improvement, but only if the points are actually paid. The court emphasized that the legislative intent did not extend this deduction to points withheld from loan proceeds, aligning with prior case law on discounted loans.

**Facts**

Roger A. Schubel and Shirley D. Schubel, cash basis taxpayers, refinanced their home in 1977, obtaining a $55,000 loan from Pan American Bank. The bank withheld $1,893. 39 as prepaid finance charges, including an origination fee, a loan discount fee, and interest on the new loan. The petitioners used the remaining proceeds to pay off existing debts, including a previous mortgage and a personal loan. They sought to deduct the withheld charges as points under Section 461(g)(2).

**Procedural History**

The case was submitted to the United States Tax Court on a fully stipulated record. The petitioners contested a $602 deficiency in their 1977 federal income tax, initially assessed by the Commissioner of Internal Revenue. The sole issue before the court was the deductibility of the prepaid finance charges withheld by the lender.

**Issue(s)**

1. Whether amounts withheld as "prepaid finance charges" from a mortgage loan are deductible in the year the petitioners received the balance of the mortgage loan proceeds under Section 461(g)(2).

**Holding**

1. No, because the prepaid finance charges were not "paid" by the petitioners within the meaning of Section 461(g)(2), as they were withheld by the lender from the loan proceeds.

**Court's Reasoning**

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The court applied Section 461(g)(2), which provides an exception to the general rule of Section 461(g)(1) for points paid in connection with a home purchase or improvement. The court found that the legislative history and existing case law on discounted loans indicated that Congress did not intend for withheld charges to be deductible. The court cited Rubnitz v. Commissioner, emphasizing that a cash basis taxpayer must actually pay the interest to claim a deduction. The court also noted that the legislative history explicitly stated that the new rule did not change the treatment of discount loans, further supporting the conclusion that withheld points do not qualify for immediate deduction. The court's interpretation focused on the literal meaning of "paid" and the economic substance of the transaction, concluding that the petitioners did not "pay" the withheld charges in 1977.

**Practical Implications**

This decision clarifies that prepaid finance charges withheld by lenders from loan proceeds are not immediately deductible for cash basis taxpayers, even when related to home refinancing. Practitioners must advise clients that only amounts actually disbursed to the borrower and subsequently paid to the lender qualify as deductible points under Section 461(g)(2). This ruling impacts how mortgage brokers and lenders structure loans and how taxpayers plan their tax deductions, particularly in the context of home refinancing. Subsequent cases have followed this precedent, reinforcing the principle that the form of the transaction (withholding vs. payment) determines the timing of deductions for prepaid finance charges.

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