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Taxation—Interest Deductions—Application of the "Business Purpose" Test to Section 163(a) of the Internal Revenue Code—Rothschild v. United States .

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CASE NOTES

Taxation—Interest Deductions—Application of the "Business Purpose" Test to Section 163(a) of the Internal Revenue Code—*Rothschild v. United States*.[1]—On December 6, 1955, Rothschild, a taxpayer in the 90 percent income bracket, purchased $1,500,000 of United States 2% Treasury notes, due August 15, 1956. These notes were purchased at a discount, $1,464,815, because of the fact that some of the interest coupons had been detached. To finance the transaction the taxpayer borrowed $1,500,000 from the Mellon National Bank and signed a full recourse promissory note for that amount payable to the bank. The note was to come due August 15, 1956, with interest at the rate of 5¾ percent. Two days after the taxpayer made arrangements to purchase the Treasury notes, the full cost was remitted to the broker by the Mellon National Bank and the balance of the $1,500,000 loan ($35,185) was remitted to the taxpayer. The Treasury notes were then sent to the lending bank to be held as collateral for the promissory note. Additional security could be required by the bank at any time.

On December 8, 1955, the same day that the bank paid the broker the $1,500,000, the taxpayer prepaid the interest on the promissory note with a check for $60,135 payable to the lending bank. He deducted this interest from ordinary income on his 1955 return. On August 15, 1956, at the taxpayer's request, the lending bank redeemed the notes and applied the proceeds in satisfaction of taxpayer's promissory note. On his 1956 income tax return, the taxpayer reported a capital gain of $35,185. This was the first of three substantially identical transactions, the last two involving interest deductions on the taxpayer's 1956 and 1957 returns and capital gains on his 1957 and 1958 returns.

The Commissioner of Internal Revenue disallowed the greater part of all the above interest deductions. He reasoned that the transactions had been entered into solely for the purpose of creating interest deductions for tax reasons and, in his opinion, such deductions were not allowable under Section 163(a) of the Internal Revenue Code. The taxpayer paid the assessment and filed for a refund in the United States Court of Claims. The report of the Commissioner of the Court of Claims to that court HELD: the deductions should be allowed. The transactions had substance and the indebtedness was genuine. Tax avoidance motives do not control deductibility under section 163(a).[2]

This case represents the latest in a long series of cases dealing with the use of interest deductions to secure after-tax profits.[3] This area of the tax law has produced substantial disagreement among the courts and among the legal commentators who have attempted to dispel the confusion. The *Roths-*

1 Rothschild v. United States, 7 CCH 1968 Stand. Fed. Tax Rep. ¶ 7910 (Ct. Cl. Comm'r's Rep. Dec. 18, 1967).

2 Id. at 72,523-24. Int. Rev. Code of 1954, § 163(a) provides: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." This was formerly Section 23(b) of the 1939 Code.

3 See the cases cited in 2 P-H Fed. Taxes ¶ 13,006.

child case serves as a vehicle for a re-examination of the various inconsistencies in this area of the law.

The basic situation generally involves a taxpayer buying interest-bearing notes or obligations at a discount and financing the purchase with a loan secured by the notes. The interest he owes will exceed his interest income and his expected gain on resale of the notes. No economic profit will result but there can be a tax profit for high-bracket taxpayers. The deduction for interest offsets ordinary income, while the gain on the sale can be capital gain, taxed at no more than 25 percent.

The Commissioner for the Court of Claims determined that there were two main issues in the *Rothschild* case: first, whether the transactions were economically devoid of substance, *i.e.*, involving a lack of real indebtedness, in which case the interest clearly would not be deductible; and second, whether interest paid on borrowed funds invested in a transaction involving real indebtedness, but not yielding any earnings before taxes, was deductible from ordinary income under section 163(a).[4]

The first issue concerns the "sham" test which revolves around the existence or nonexistence of a genuine indebtedness accruing to the taxpayer as a result of the transaction in question.[5] The "sham" test is concerned with whether the alleged transaction has really occurred: whether the underlying realities contradict the appearances. If a court finds a lack of real indebtedness, *i.e.*, a "hocus-pocus" paper transaction, the transaction is considered a "sham."[6] It is well settled in such cases that deductions of so-called interest payments should be denied.[7]

The trial commissioner in *Rothschild* clearly was correct in finding that the transaction there involved could not be interpreted as a "sham" transaction. The bank actually loaned the money to Rothschild. He purchased the securities and transferred them to the bank as collateral for the loan. He tendered a full recourse promissory note which gave the bank the right to call for more security. As the trial commissioner stated: "Once Rothschild entered into the transactions he was required to do all that he did do, and no step was lacking in substance or legal effect."[8] The "sham" test is simply not applicable to such a case.

The real issue in *Rothschild* was whether the interest deductions should be allowed when the only purpose of the transaction from which they derived was to obtain an after-tax profit. The trial commissioner in *Rothschild*

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4 1968 Stand. Fed. Tax Rep., at 72,518.

5 See, e.g., George G. Lynch, 31 T.C. 990, aff'd 273 F. Supp. 613 (Ct. Cl. 1959); Eli D. Goodstein, 30 T.C. 1178 (1958), aff'd, 267 F.2d 127 (1st Cir. 1959). *Lynch* involved a series of transactions over a seven-day period allegedly resulting in payment of interest on loans to finance a purchase by the taxpayers of government bonds. The bonds were never physically passed between the parties involved. The lender in *Lynch* had less than $1400 cash on hand while it was loaning the taxpayer over $600,000. No loan was ever actually made and no interest was ever actually paid. As the Circuit Court stated: "When the series of transactions . . . was completed the parties were exactly where they had been at the outset. . . ." 273 F.2d at 872.

6 See cases cited note 5 supra.

7 Id. See also Broome v. United States, 170 F. Supp. 613 (Ct. Cl. 1959).

8 1968 Stand. Fed. Tax Rep., at 72,523.

found that a nontax purpose was not needed to secure an interest deduction as long as the transaction involved a real indebtedness. However, whether a transaction needs a nontax purpose, *i.e.*, a business purpose, before interest can be deducted is by no means clear and the courts continue to arrive at diverse conclusions.[9]

The "business purpose" test states that interest cannot be deducted if no economic gain could be realized from a transaction beyond a tax deduction.[10] This test grew out of the landmark Supreme Court decision of *Gregory v. Helvering*.[11] *Gregory* involved a corporate reorganization carried out solely to gain a tax benefit. The taxpayer attempted to achieve a lower tax liability by transferring shares of stock through a corporate reorganization rather than by transferring the shares by dividend. Although the reorganization plan conformed literally to the Code section governing corporate reorganizations, the Supreme Court denied effect to the transaction. The Court reasoned that when the Code "speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' . . . of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either . . . ."[12] Thus, the Court held that the existence of a corporation whose sole purpose was tax avoidance would be denied validity for tax purposes.[13]

Over the years, the *Gregory* "business purpose" test was extended, by implication, beyond the field of corporate reorganization to all tax statutes dealing with commercial or industrial transactions.[14] The test was limited to denying validity to transactions whose *sole* purpose was to avoid taxes.[15] A transaction was recognized if it had a legitimate nontax purpose even though the taxpayer's primary motive was to avoid taxes. The *Gregory* "business purpose" rule became, in the words of Learned Hand, a general test to deny recognition to a transaction for tax purposes "that does not appreciably affect [the taxpayer's] . . . beneficial interest except to reduce his tax . . . ."[16] It appears, and for the purpose of this note it will be assumed, that in the area of taxation, "business purpose" has come to mean any legitimate nontax purpose.

In the interest deduction area, the courts had difficulty in deciding cases involving real indebtedness where the sole or controlling motive behind the transaction in question was tax avoidance.[17] The three basic post-*Gregory*

9 See, e.g., Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966); Bridges v. Commissioner, 325 F.2d 180 (4th Cir. 1968); L. Lee Stanton, 34 T.C. 1 (1960).

10 See generally Summers, A Critique of the Business-Purpose Doctrine, 41 Ore. L. Rev. 38 (1961).

11 293 U.S. 465 (1935).

12 Id. at 469-70.

13 Id.

14 See Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949).

15 See Maysteel Prod., Inc. v. Commissioner, 287 F.2d 429, 431 (7th Cir. 1961). See also Herzfeld, Is Interest Deductible When Tax-Saving Is Sole Motive? 12 J. Tax. 336 (1960).

16 Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (dissenting opinion).

17 See Note, 39 St. John's L. Rev. 77 (1964).

approaches to this problem are well illustrated by three recent and factually similar cases, all involving real indebtedness. *Bridges v. Commissioner*, disregarding the existence of real indebtedness, held that as the taxpayer's transaction on its face could not make a profit except through a tax deduction, it was a "sham."[18] *Goldstein v. Commissioner* held that even though the transaction was not a "sham," interest could not be deducted when the transaction had no purpose apart from its anticipated tax consequences.[19] *Rothschild,* of course, allowed interest to be deducted whenever a genuine indebtedness was found, the motives of the taxpayer being considered irrelevant.[20]

The *Bridges* finding that a transaction is a "sham" when it lacks a "business purpose"[21] is a product of test mixing which has been strongly criticized.[22] The *Goldstein* court felt, correctly it seems, that the interest of candor was better served if the "sham" rationale was reserved for cases involving merely "hocus-pocus" paper transactions; where the taxpayer never obligated himself to make interest payments because he never subjected himself to an enforcible obligation of indebtedness.[23] As was pointed out in *Fabrecka Prod. Co. v. Commissioner:*[24] "The brightness of the motive cannot be permitted to blind our eyes to the existence of substantive events. . . . The government's charge that there was no reality to the transaction as an investment amounts only to saying that it was not entered into for what it describes as 'investment motives.' "[25]

[18] 325 F.2d 180 (4th Cir. 1963).

[19] 364 F.2d 734 (2d Cir. 1966). See L. Lee Stanton, 34 T.C. 1, 14 (1960) (dissenting opinion), and Knetsch v. United States, 364 U.S. 361 (1960). The latter case involved the borrowing of money from an insurance company to buy annuity bonds and the deducting of interest paid on the loans. The bonds only returned 2½% income while the loans called for payment of 3½% interest. The Supreme Court denied the deduction both on the ground that the transaction did not affect the taxpayer's beneficial interest except to reduce his tax, id. at 365-66, and on the ground that the transaction was a sham, id. at 366-67. The three dissenters disagreed with the finding of a "sham" transaction and took the position that as long as the transaction was not "hocus-pocus," the interest deduction should be allowed. Id. at 370-71. The dual standard announced by the majority left future courts unsure as to whether *Knetsch* stood for the requirement of a business purpose when real indebtedness was present or whether, feeling there was no real indebtedness, the Court had simply defined "sham" in terms of lack of business purpose. See generally Blum, Knetsch v. United States: A Pronouncement on Tax Avoidance, 40 Taxes 296 (1962).

[20] 7 CCH 1968 Stand. Fed. Tax Rep. ¶ 7910. See L. Lee Stanton, 34 T.C. 1 (1960). This case involved a transaction similar to the one in *Rothschild*. The majority disregarded the tax-savings motive and allowed the deduction because there was a real indebtedness. See Doukas, Though Tax-Saving Is Only Motive, Interest Is Deductible, IRS Concedes, 14 J. Tax. 292 (1961).

[21] 325 F.2d at 184-85.

[22] See Fuller, Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation, 37 Tul. L. Rev. 355 (1963); Note, 46 Cornell L.Q. 649 (1961); Note, 45 N.C.L. Rev. 792 (1967).

[23] 364 F.2d at 738. The court stated: "Different considerations govern decision as to whether interest payments are deductible by a taxpayer who borrows money from an independent lending institution, executes a promissory note with recourse and purchases Treasury obligations that are then in fact pledged with the lender as security for the loan for a significant period of time . . . ." Id.

[24] 294 F.2d 876 (1st Cir. 1961).

[25] Id. at 878.

Goldstein, despite its observation that the "sham" test should not be used in cases of real indebtedness, held that no deductible interest resulted from a transaction which had no purpose apart from its tax consequences.[26] While the court did not refer to this nontax purpose as a "business purpose," and, in fact, rejected the application of that test, the requirement it did impose appears to be no more than the "business purpose" test as it has come to be interpreted, with a new name.

In *Goldstein,* the taxpayer, without any real expectation of profit, bought U.S. Treasury 1½ percent notes to secure a loan payable at 4 percent per annum. There was no question as to the reality of the indebtedness, as the loans were obtained from independent banks which could request additional collateral. The court denied the deduction, however, after divining the congressional purpose underlying the interest deduction provision. The court first determined that Section 163(a) of the Internal Revenue Code, in permitting the deduction of "all interest paid or accrued within the taxable year on indebtedness," precluded any requirement that deductible interest serve a business purpose, that it be ordinary or necessary, or even that it be reasonable.[27] But then the court found, underlying this section, a congressional policy to encourage what the court referred to as a "purposive activity" to be financed through borrowing. In light of this, the court concluded that interest was deductible

> when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he borrowed to gain an interest deduction rather than to finance the activity in some other way. In other words, the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction.[28]

It is submitted that there is no valid distinction between the "business purpose" test and *Goldstein*'s "purposive activity" test.[29] The *Goldstein* court defines "purposive activity" in the same terms Judge Hand used to describe "business purpose", *i.e.*, in terms of the legitimate nontax substance of the transaction. Furthermore, the court quoted the often repeated statement in *Gregory* that "the question for determination is whether what was done apart from tax motive, was the thing which the statute intended."[30] It appears to have fallen back on the view expressed in *Gregory,* that Con-

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26 364 F.2d at 741-42.

27 Id. at 741.

28 Id.

29 It must be remembered that the "business purpose" test has been expanded to deny deductions to a taxpayer in any transaction "that does not appreciably affect his beneficial interests except to reduce his tax." Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (dissenting opinion by L. Hand, J.); Knetsch v. United States, 364 U.S. at 361-66; Blum, supra note 19, at 303-05.

30 Gregory v. Helvering, 293 U.S. 465, 469 (1934).

gress did not intend a purely formal compliance with the language in avoiding a tax.[31] The court, however, has offered no explanation as to how it concluded that Congress intended the statute to be read in a manner other than it was written.

The trial commissioner in *Rothschild* determined that the congressional intent in section 163(a) was to allow deductions on all real indebtedness regardless of the purpose or motive behind the transaction.[32] He found that this congressional intent, in combination with the fact that tax considerations are an essential element in almost every financial transaction, led to the inescapable conclusion that the motives of the taxpayer should not be controlling as to the deductibility of his interest payments.[33]

The history of section 163(a) certainly supports the conclusion in *Rothschild*.[34] Section 163(a) places no express limitation on the deduction of interest while other sections of the Code expressly require a business purpose before a transaction will be recognized for tax purposes.[35] For example, section 269(a) denies recognition, for tax purposes, to corporate acquisitions whose "principal purpose . . . is evasion or avoidance of Federal income tax . . . ." Also, the provisions of section 341 dealing with "collapsible corporations" are aimed directly at the use of a business-in-appearance-but-not-in-purpose device for avoiding taxes.[36] The specific inclusion of versions of the business purpose doctrine in other sections of the Code is evidence in support of the conclusion that had Congress wished interest deductions to be allowed only if a debt were incurred to promote a business purpose, it would have clearly expressed such a desire.

The legislative history of Section 163(a) of the 1954 Code and its predecessor, Section 23(b) of the 1939 Code, show that Congress repeatedly considered and ultimately rejected limitations on the interest deduction.[37] In 1924, Congress rejected an amendment which would have prohibited deductions for interest paid ". . . on indebtedness incurred or continued for the purpose of evading the payment of taxes. . . ."[38] Restrictions of the same type were again rejected in 1926.[39] Thus, it seems clear that Congress intended section 163(a) to allow deductions of interest paid on real indebtedness regardless of the taxpayer's motive or purpose. The trial commissioner in *Rothschild* relied on this clear congressional intent to allow the deductions to Rothschild.

This congressional policy toward interest deductions seems so clear that courts should have had no trouble in applying section 163(a). The problems arose, however, from an underlying judicial displeasure with the fact that high income taxpayers were able to get a tax break only because they were in a high tax bracket. This result seemed to offend the traditional notions of

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31 Id.
32 1968 Stand. Fed. Tax Rep. at 72,523-24.
33 Id.
34 Id. at 72,523-25.
35 § 163(a).
36 See Int. Rev. Code of 1954, § 341(a) & (b).
37 Infra notes 38-39. See also L. Lee Stanton, 34 T.C. 1, 7-8 (1960).
38 See H. Conference Rep. No. 844, 68th Cong., 1st Sess., at 18 (1924).
39 See H. Conference Rep. No. 356, 69th Cong., 1st Sess., at 34 (1926).

fairness under the tax law. Since the terms of section 163(a) offered no assistance, many courts tried to rationalize a decision based on their concept of the public policy involved. Therefore, the confusion is caused by courts that equate their concept of public policy with congressional intent.

A few commentators have suggested that the vagueness of the courts in the interest area may have its purpose.[40] As one commentator stated: "The major premises under which tax avoidance is frustrated in some cases and allowed in others are simply too ephemeral to be articulated. And if such articulation were possible, it would only serve to challenge further the ingenuity of the taxpayer."[41] In other words, vagueness may make tax manipulators wary and less likely to take a chance.

As has been stated, there appears no reason for disallowance of an interest deduction except the absence of genuine indebtedness. Such doctrines as the "business purpose" test or the "beneficial interest" test are mere judicial contrivances to allow courts to reach a finding which they feel to be justified, not a finding compelled by the statute. Such doctrines hamper the growth of a consistent and useful body of case law in the interest deduction area. As one court held:

> [U]nless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple. The limitation which the government asks us to read into the statute, even if appealing in the particular instance, might readily . . . "create difficulties and uncertainties more objectionable in their results than any seeming inequities which would be eliminated or prevented." Granting the government's proposition that these taxpayers have found a hole in the dike, we believe it calls for the application of the Congressional thumb, not the court's.[42]

The application of the "business purpose" doctrine has been remarkably inconsistent. Only by analysis of the transaction and by determination of the genuineness of the indebtedness can the courts build a consistent body of law in the interest deduction area. They do not serve this purpose by reading into the statute a vague policy which only obscures the issue of the reality of the debt.

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[40] Blum, supra note 19, at 312.

[41] Rice, Judicial Techniques in Combating Tax Avoidance, 51 Mich. L. Rev. 1021, 1051 (1953).

[42] Fabreeka Prod. Co. v. Commissioner, 294 F.2d 876, 878 (1st Cir. 1961).