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Taxation—Deductions for Interest.—Knetsch v. United States

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of law will in all instances be sufficient grounds for modification of a decree based on prior law. Rather it need only be decided that such will be the Court's holding when the subsequent law specifically changes the public right which was the protected interest in the prior decree. Consequently the vitality of prior cases which rested in large part upon the reasoning of *Degenhart v. Hartford*[13] should not be considered diminished by the holding in this decision. In fact it may be that those cases which appear to espouse a contradictory rule of law can be distinguished and thereby reconciled with *Degenhart* by applying the reasoning of the Court in the instant case.[14]

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Taxation—Deductions for Interest.—*Knetsch v. United States.*[1]— In 1953 petitioner purchased a 30 year annuity bond in the face amount of $4,000,000, earning interest at 2½% annually. He made a small down payment and for the balance signed nonrecourse notes bearing 3½% interest, with the annuity pledged as the sole security. At the beginning of the year, after making advance interest payments on the notes, petitioner was allowed to borrow further sums, to the extent of the difference between the cash value of the annuity bond at the end of that year and the total amount of his indebtedness. Such loans were made at 3½% interest in 1953 and 1954. For these years petitioner claimed a deduction, under Section 23 of the 1939 Code, for interest paid, both on the principal notes and the additional loans.[2]

[13] Degenhart v. Hartford, supra note 9. (Funeral home located in an exclusively residential area was decreed an unlawful nuisance. Subsequent zoning change made funeral homes permissable in residential areas. Court, however, held that a broad change of law was not sufficient to show that the funeral home was not a nuisance.) And see cases cited supra note 9.

[14] See cases cited supra note 8.

[1] 364 U.S. 361 (1960).

[2] In effect the taxpayer has purchased a tax deduction at a cost to him of only a fraction of its value. The transaction, for the years 1953 and 1954, may be outlined as follows:

Payment by Petitioner			*Tax Deductions*
1953 Initial Payment		4,000	
1953 Prepaid Interest on Annuity		140,000	140,000
1953 Prepaid Interest on Cash Loan		3,465	3,465
1954 Prepaid Interest on Total Debt		143,465	143,465
1954 Prepaid Interest on Cash Loan		3,640	3,640
Gross Expenditures		294,570	
Less: Receipts			
1953 Cash Loan	99,000		
1943 Cash Loan	104,000	203,000	
Net Expenditure		91,570	
Total Claimed Deductions			290,570

The Commissioner of Internal Revenue disallowed the deductions and determined a deficiency for each year. The petitioner paid the deficiencies and brought an action for refund in the District Court. A judgment for the government was affirmed by the Court of Appeals. Because of a suggested conflict with a Fifth Circuit decision[3] the Supreme Court granted certiorari,[4] and affirmed. HELD: The amounts paid by petitioner were not interest on indebtedness within the meaning of Section 23 of the 1939 Internal Revenue Code (now Section 163 of the 1954 Internal Revenue Code).

The law in effect at the time of these transactions, the 1939 Internal Revenue Code, disallowed deductions for interest on indebtedness incurred or continued to purchase single premium life insurance or endowment policies.[5] With the enactment of the 1954 Code, which extended this disallowance to single premium annuities, the deduction claimed in the principal case was expressly denied.[6] Nonetheless, the issue presented in the principal case, because it is subsumed by the more general problem dealing with alleged interest payments on all types of indebtedness, merits attention. The general problem, simply stated, is whether the claimed deduction is "interest on indebtedness" within the meaning of Section 23 of the 1939 Code,[7] or Section 163 of the 1954 Code.[8]

Generally, tax statutes are drafted broadly, since Congress cannot anticipate all of the problems that may arise. Frequently, individuals, in an attempt to gain for themselves tax benefits, will go to great lengths to

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3 United States v. Bond, 258 F.2d 577 (5th Cir. 1958).

4 361 U.S. 958 (1960).

5 Internal Revenue Code of 1939, § 24:

(a) *General Rule* . . . In computing net income no deduction shall in any case be allowed in respect of . . .

(6) any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purpose of this paragraph, if substantially all the premiums on an insurance contract are paid within a period of four years from which such contract is purchased such contract shall be considered a single premium contract.

6 Internal Revenue Code of 1954, § 264:

(a) *General Rule* . . . No deduction shall be allowed for . . .

(2) any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

(b) *Contracts Treated as Single Premium Contracts* . . . For the purposes of (a) (2), a contract shall be treated as a single premium contract . . .

(1) if substantially all the premiums on the contract are paid within a period of four years from date of contract, or (2) if amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of further premiums on the contract.

7 Internal Revenue Code of 1939, § 23:

In computing net income there shall be allowed as deductions: . . .

(b) all interest paid or accrued within the taxable year on indebtedness. . . .

8 Internal Revenue Code of 1954, § 163:

(a) *General Rule* . . . There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

create allowable deductions. When this happens it is for the courts to decide between the letter and the spirit of the law. In facing this problem of tax statute interpretation the court will disregard the motives of the taxpayer, examining only the nature and results of the transaction. In *Gregory v. Helvering*[9] Mr. Justice Sutherland wrote: "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes . . . cannot be doubted. . . . But the question is, whether what was done, aside from the tax motives, was the thing that the statute intended." In viewing a specific transaction to determine "if what was done . . . was the thing the statute intended," the court will ascribe to the words of the statute their ordinary and every day meaning. In *Deputy v. Du Pont*[10] Mr. Justice Douglas recognized as the everyday meaning of "interest on indebtedness," the amount which one has contracted to pay for the use of borrowed money. In the business world "interest on indebtedness" means compensation for the use of or forbearance of money. It is assumed that Congress has used the words in this sense.

The application of the *Gregory* rule, as expanded by the *Du Pont* case, may be seen in the following example: Suppose a taxpayer were to execute and deliver to his wife a promissory note, payable on demand, with interest at 4%. The husband pays interest to his wife annually and claims deductions against gross income. He makes no principal payments and gives no security for the note. The taxpayer would not be entitled to a deduction for interest arising out of this transaction, because the entire transaction lacks economic substance.[11] The best expression of this reasoning is to be found in the dissenting opinion of Judge Learned Hand in *Gilbert v. Commissioner*:[12] "If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities it sought to impose."

The principal case fails to meet the test of the *Gregory* rule. The petitioner is paying "interest" on notes, the proceeds of which were paid to the lender for the purchase of the right to receive income 30 years hence, if the notes have been paid. Should the debt not be paid, the proceeds of the annuity will be retained by the lender to satisfy the debt, and petitioner will receive nothing. The notes have no maturity date. No payment on the principal was made, nor was there any indication that the parties ever intended payment to be made. Therefore, it seems obvious that payments by petitioner were not compensation for the use or forbearance of money. The "thing" that petitioner has done was not the "thing which the statute intended."

The rule of the *Gregory* case is the law today. As an aid in applying

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9 239 U.S. 465, 469 (1935).

10 308 U.S. 488, 497 (1940).

11 United States v. Virgin, 230 F.2d 880 (5th Cir. 1950).

12 248 F.2d 399, 411 (2d Cir. 1957).

this rule, some courts have set out certain guideposts, understanding of which is invaluable to taxpayers. In *United States v. Virgin*[13] the court stated that if the repayment of a note is so uncertain as to maturity, or if it is so risky, that it is more an advance of venture capital than a loan, there is no indebtedness within the meaning of the statute. The court in *Deputy v. DuPont*[14] held that if the transaction imposes no real liability on any one then interest arising from it is not deductible. In the principal case it might seem that the majority of the court is establishing a new guidepost. In their analysis of the case: "It is patent that there was nothing of substance to be realized by Knetsch from this transaction, beyond a tax deduction. What he was ostensibly 'lent' back was in reality only the rebate of a substantial part of the so called 'interest' payments. . . . There may well be single premium annuity arrangements . . . which create an 'indebtedness' for the purpose . . . of the code. But this one is a sham."[15] It is, possibly, with this reasoning that the dissenting Justices[16] find their difficulty. The dissent follows the reasoning of Judge Moore in his dissent in *Diggs v. Commissioner of Internal Revenue*.[17] His argument proceeds something like this: The rationale of the majority of the court is based upon the assumption that since no money was advanced to the taxpayer by the insurance company, payments that he made could not be interest on indebtedness. But in our modern commercial system money is not always advanced in the sense of delivery. A broker may purchase securities for a customer and make a loan of the purchase price with the securities as collateral. The customer usually sees neither the securities nor the money, yet this is a real transaction, clearly not a sham. The relationship between the broker and his customer is the same as that existing between the insurance company and the petitioner.

It is submitted that the analogy drawn disregards a number of important considerations. In the hypothetical case presented, the customer has changed his financial interests as a result of the transaction. He stands to make a profit, or suffer a loss, depending upon conditions in the security market. Also, it is to be noted that there is actual liability on the customer as a result of the transaction. The parties anticipate that the purchase price of the securities will be paid. If payment is not made, and the collateral is sold, the customer remains personally liable for any deficiency.

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[13] Supra note 11. Taxpayer borrowed money from his wife at 8% interest, the loan to be repaid only if the family financial position was such that in taxpayer's opinion no hardship would accrue.

[14] 308 U.S. 488 (1940). The taxpayer borrowed shares of stock to cover short sales made for the purpose of passing ownership of the corporation to management, under a contract which obliged him to pay dividends received to the lender as well as the lender's income tax on the dividends. Such payments were not allowable interest deductions.

[15] Supra note 1, at 135.

[16] Justices Douglas, Whittaker and Stewart dissented.

[17] 281 F.2d 326, 330 (2d Cir. 1960). Taxpayer purchased an annuity, borrowed from a bank to prepay the premiums, and then borrowed the cash surrender value from the insurer to pay the bank. No deductions were allowed for interest paid.

Clearly, none of these elements of economic substance are to be found in the principal case.

The alarm of the minority, generated by the majority's designation of the "sham test" was unnecessary, for it is doubtful that a new "guidepost" was actually being created. Before the court can characterize any transaction as a sham, the individual components of the arrangement must be separately examined. They must be measured against the already existing guideposts of personal liability, definitions of maturity, and substantial economic substance. It is only when the separate parts fail to meet the mark that the whole is designated a "sham" and interest incident to the transaction is disallowed as a deduction from gross income.

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Taxation—Depreciation Deduction—Useful Life—Salvage Value.— ***Massey Motors, Inc. v. United States; Commissioner of Internal Revenue v. Evans.***[1]—In each of these companion cases the Court applied Section 23(1) of the Internal Revenue Code of 1939 to establish the correct depreciation equation[2] for computing the depreciation allowance in given tax years in respect to automobiles employed in rental and complementary uses. In the *Massey* case taxpayer owned an automobile agency which leased out new model cars and employed current models for company use. Using the straight-line method in computing his yearly depreciation allowance for the cars, taxpayer claimed a useful life of 4 years and a salvage value of zero. These cars would be resold within 15 months and if the resale price was greater than the remaining undepreciated cost, taxpayer would claim a capital gain. In the *Evans* case, taxpayer computed depreciation with respect to the automobiles rented to a U-Drive agency on the same basis as did taxpayer Massey. In both cases the Commissioner of Internal Revenue took issue with the depreciation allowances on the theory that the useful life of the automobiles should equal their useful life in the taxpayer's business rather than their physical life, and that upon disposition the salvage value should equal their resale value rather than their junk value. Taxpayer Massey succeeded in his claim for a tax refund in the United States District Court,[3] but the decision was reversed by the Court of Appeals for the Fifth Circuit.[4] The Commissioner's ruling that taxpayer Evans had a tax deficiency was supported by the Tax Court,[5] but the decision was reversed by the Court of Appeals for the Ninth Circuit.[6]

The Supreme Court in a 5-4 decision HELD: The business taxpayer

1 364 U.S. 92 (1960).

2 $\frac{\text{(Total cost)} - \text{(Salvage value)}}{\text{(Years of estimated life)}} = \text{Yearly depreciation allowance.}$

3 156 F. Supp. 516 (S.D. Fla. 1959).

4 264 F.2d 552 (5th Cir. 1959).

5 16 C.C.H. Tax Ct. Mem. 639 (1957).

6 264 F.2d 502 (9th Cir. 1959).