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Taxation -- Interest Deductions -- Sham and Business Purpose Tests

William H. Thompson

found that when the employer used the company premises and company time to make an antiunion speech to the employees, he "created a glaring imbalance in organizational communication." The Board then ruled that the employer could give such speeches but that he was under an obligation, in order to allow a proper balance to be maintained, to accede to the union's request to address the employees under similar circumstances.[36]

After *May*, the status of the law was that the NLRB was imposing an "equal time" rule on an employer only in retail department store cases and then only when the employer had in effect a broad, but privileged, no-solicitation rule. In other cases a union request for equal opportunity to address the employees has been refused where other avenues of approach have been open.[37] *Excelsior* seems to make an inroad on this practice since awarding the union a mailing list goes far toward putting it on a par with the employer.

In *General Elec. Corp.*,[38] decided the same day as *Excelsior*, the Board was asked to apply its department store rule of "equal time" to the industry in general. It refused, primarily because of its *Excelsior* ruling, saying that

> [I]n light of the increased opportunities for employees' access to communications which should flow from *Excelsior*, but with which we have, as yet, no experience, . . . we prefer to defer any reconsideration of current Board doctrine in the area of plant access until after the effects of *Excelsior* become known.[39]

After more than a year of NLRB administrative experience with the *Excelsior* rule, it appears safe to assume the rule has resulted in sufficient union accessability so that a stiffer rule is not needed at this time.[40]

GEORGE L. LITTLE, JR.

Taxation—Interest Deductions—Sham and Business Purpose Tests

The Internal Revenue Code of 1954 provides, "There shall be allowed as a deduction all interest paid or accrued within the taxable

[36] 136 N.L.R.B. at 802.

[37] NLRB v. United Steelworkers of America [Nutone, Inc.], 357 U.S. 357 (1958).

[38] 156 NLRB No. 112 (Feb. 4, 1966).

[39] *Id.* at —.

[40] See note 11 *supra* for cases in which the Board has sought to enforce its *Excelsior* rule in federal district court.

year on indebtedness."[1] Under this provision, interest is deductible without regard to whether the indebtedness is incurred in a trade or business, in connection with a profit-making activity, or in a purely personal matter.[2] The section, on its face, would allow deduction of all interest paid by any taxpayer, corporate or individual, with respect to a loan transaction between the taxpayer and lending agency.[3] Through several rationales the federal courts have imposed a "judicial amendment" on this section by which interest deductions are disallowed if the taxpayer could realize an economic gain only because of a reduction in taxes. These rationales have hinged, entirely or partially, on the courts' finding an absence of genuine indebtedness. A recent trend is to refrain from using this fiction of a lack of indebtedness and to base deductibility on the circumstances motivating the taxpayer to enter the loan arrangement.

The courts have imposed various, but somewhat analogous, tests to prohibit such deductions. One test, dating from pre-1960, involves a fiction by which the courts refuse to recognize a bona fide creditor-debtor relationship within the intent of the code. In 1960 a business purpose test was introduced to disallow an interest deduction if a transaction has no economic reality beyond a potential tax deduction, but this test has been clouded by continued insistence that genuine indebtedness is not present. A recent case[4] recognizes an actual indebtedness and applies the business purpose test without regard to the nature of the loan manipulation.

The pre-1960 test, which has continued to be applied in some circuits, may be divided into two categories. In the first the courts find a lack of indebtedness, resulting from the relationship of the parties, where there is no apparent intention that the transaction be binding on the parties. This is illustrated by *Woodward v. United States*[5] where the taxpayer made his wife a gift of insurance policies on his life. The wife later assigned the policies back to the taxpayer pursuant to a plan of placing the policies in trust for the wife and a

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[1] INT. REV. CODE of 1954, § 163(a).

[2] STANLEY & KILCULLEN, THE FEDERAL INCOME TAX § 163 (4th ed. 1961). The section also states, "Sec. 163 (Interest) states somewhat too broadly that all interest paid or accrued within the taxable year on indebtedness is deductible."

[3] Deductibility of interest paid by a taxpayer with respect to his obligation to a third party, where the original loan transaction was between the lending agency and the third party, will not be considered.

[4] Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966).

[5] 208 F.2d 893 (8th Cir. 1953).

son. The taxpayer executed demand notes, equal to the cash value of the policies, payable to his wife and claimed deductions for the interest purportedly paid. In disallowing the deductions, the court found that there was no indebtedness and that the money paid was still the taxpayer's. It labeled the arrangement as camouflage and as acts of benevolence.[6]

The second category involves transactions, both arm's length and collusive, that are treated as shams, therefore failing to create indebtedness within the intent of the statutory deduction. In *Jockmus v. United States*[7] the taxpayer procured 1,000,000 dollars face amount United States Treasury Notes for a purchase price of 973,750 dollars. In plan, the taxpayer bought the notes from a securities corporation that purchased them from the original seller and delivered them to a finance and loan corporation (Corporate). Corporate loaned taxpayer the purchase price secured by the treasury notes. Meanwhile, Corporate directed a brokerage firm to make a short sale of 1,000,000 dollars in treasury notes which was accomplished by sale to the original seller. In actuality, the original seller delivered the notes to an exchange bank and then accepted redelivery of the same notes. All of the other transactions, except the taxpayer's promissory note to Corporate, were book entries only, and no money changed hands. Taxpayer borrowed 30,000 dollars from another finance and loan corporation (Court) and prepaid Corporate 41,384 dollars interest on the purchase price loan. The brokerage firm contrived the scheme, created Corporate as a loaning agency "front" with very limited capital, and controlled Court.

The court disallowed the interest deduction after finding a lack of a bona fide creditor-debtor relationship[8] as evidenced by Corporate's failure to advance funds or to obtain possession of the notes as security and by the intricate manipulations completely cancelling each other. Rather than a loan arrangement, the resulting obligation was labeled a contractual right to future delivery of the securities upon payment of an agreed price which was the amount of the purported loan.

[6] *Cf.*, Foresun, Inc. v. Commissioner, 348 F.2d 1006 (6th Cir. 1965).

[7] 335 F.2d 23 (2d Cir. 1964).

[8] See, *e.g.*, Dooley v. Commissioner, 332 F.2d 463 (7th Cir. 1964); Gheen v. Commissioner, 331 F.2d 470 (6th Cir. 1964); Lewis v. Commissioner, 328 F.2d 634 (7th Cir. 1964), *cert. denied*, 379 U.S. 821 (1964); Nichols v. Commissioner, 314 F.2d 337 (5th Cir. 1963); Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959).

Taxpayer in *Jockmus* contended this transaction should be allowed since it was an arm's length transaction with the arrangements made by the brokerage firm, rather than by the taxpayer.[9] The court refused to distinguish the case from *Lynch v. Commissioner*[10] where interest deductions were disallowed in a similar plan but where the prearranged collusive scheme was known to and directed by the taxpayer.[11]

The case law in this area was expanded when the business purpose test, as applied to interest deductions, was advanced in *Knetsch v. United States*.[12] During 1953 the taxpayer purchased ten, thirty-year, 400,000-dollar face amount, single premium annuity bonds, bearing interest at two and one-half per cent annually, for an initial outlay of 4,000 dollars. The remaining purchase obligation was met by taxpayer "borrowing" 4,000,000 dollars from the insurance company, executing three and one-half per cent notes secured by the annuity bonds, and prepaying interest of 140,000 dollars. The annuity contract enabled the taxpayer to keep the cash or loan value reduced to 1,000 dollars by borrowing against each year's incremental increase at the beginning of the year in which the increase was to be realized. Five days after the initial purchase, the taxpayer borrowed 99,000 dollars of the first year's scheduled increase with a further prepayment of interest. Similar borrowing in 1954 and

[9] *Accord,* MacRae v. Commissioner, 294 F.2d 56 (9th Cir. 1961), where the court disallowed the deductions in an "arm's length transaction" and also stated that the payments made were in reality consideration for tax deductions, not for loans, hence, were not deductible as interest under the code. *Contra,* L. Lee Stanton, 34 T.C. 1 (1960).

[10] 273 F.2d 867 (2d Cir. 1959).

[11] The court relied on the often cited phrase, "Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers." 335 F.2d at 28.

[12] 364 U.S. 361 (1960). The district court rendered judgment for the United States by disallowing the deduction and the court of appeals affirmed. 272 F.2d 200 (9th Cir. 1959). The Supreme Court granted certiorari due to a suggested conflict with United States v. Bond, 258 F.2d 577 (5th Cir. 1958), where deductions were upheld upon a finding that the transaction appeared, in form, to be what the statute intended, i.e., interest paid on indebtedness, and despite the realities of the transaction.

A sidelight to the Knetsch affair is the taxpayer's later attempt to deduct his out-of-pocket costs, under INT. REV. CODE OF 1954, § 165(c)(2), as a loss sustained in a transaction entered into for profit or, alternatively, under INT. REV. CODE OF 1954 § 212 as an ordinary and necessary expense incurred in the management and maintenance of property held for the production of income. The deduction was disallowed on both grounds in Knetsch v. United States, 172 Ct. Cl. 378, 348 F.2d 932 (1965).

1955 maintained the cash and loan value at 1,000 dollars. In 1956 he terminated the contract, surrendered the bonds, obtained cancellation of his indebtedness, and received the 1,000 dollars cash surrender value. For taxable years 1953 and 1954, the only taxable years involved, the taxpayer paid 290,570 dollars as interest, received 203,000 dollars in loans, and attempted to realize a tax savings of 233,297 dollars by deduction of interest.

The Supreme Court applied a business purpose test by which an interest deduction is disallowed if no economic gain is realized, or could be realized, beyond a tax deduction. The Court stated that the tax reduction motive or intent is immaterial and that the determinative question is "whether what was done, apart from the tax motive, was the thing which the statute intended."[13] This statutory intent as to indebtedness was found to be lacking since the taxpayer did not appreciably affect his beneficial interest except to reduce taxes.

While *Knetsch* added another rule to the Commissioner's repertory for disallowing interest deductions, its inherent value was weakened by the Court's further finding of no genuine indebtedness and, particularly, by its labeling the transaction as a sham. It has been suggested that a finding of sham is not compatible with a business purpose test.[14] The reasoning is that an indebtedness is not recognized in sham transactions, while a business purpose test should be applicable irrespective of a valid creditor-debtor relationship.

The uncertainty ensuing from the dual standard articulated in *Knetsch* is illustrated by *Bridges v. Commissioner*.[15] The taxpayer purchased 500,000 dollars face amount treasury notes for 486,875 dollars. A bank loaned 500,000 dollars on his promissory note, secured by the treasury notes, and the taxpayer prepaid interest of 19,687 dollars. A brokerage firm obtained the notes, arranged the financing, and forwarded the notes to the bank. The bank sold the notes at maturity and cancelled the indebtedness. Taxpayer's only involvement was signing the promissory notes. He claimed the interest as a deduction in 1956, when his adjusted gross income was

[13] 364 U.S. at 365. The Court adopted the business purpose test invoked to disallow capital gains treatment for securities distributed in a corporate liquidation in Gregory v. Helvering, 293 U.S. 465 (1935).

[14] 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).

[15] 325 F.2d 180 (4th Cir. 1963).

95,582 dollars, and reported 13,125 dollars as a long-term capital gain in 1957.

The court, relying on *Knetsch,* discussed the absence of a beneficial gain other than a tax deduction but seemed to support its disallowance of the deductions by finding that no genuine indebtedness existed and that the transaction was a sham. The court pointed to the taxpayer's outlay of more funds than he could possibly receive by an acceleration in value of the securities and emphasized that he never had uncontrolled use of the additional money, of the securities, or of the interest on the securities.

The potential of the business purpose test, divorced from the sham aspects, began to emerge in *Minchin v. Commissioner.*[16] The taxpayer prepaid interest on the purchase price loan for two ten-year, 200,000 dollar, single premium annuity contracts, the sole security for the loan. The annuity contracts provided for reduced interest on the loans after the sixth year and for deferment of the loan repayment until just prior to maturity of the annuities. The court relied on *Knetsch* and the business purpose test to disallow the interest deduction.[17] Due to the shorter deferred period and reduced interest payments after the sixth year, the court expressed doubt about the lack of genuine indebtedness aspects and did not call the transaction a sham. It adopted the view that such a net actual loss places the burden of showing the economic reality of the transaction on the taxpayer.

The business purpose test reached full bloom, unfettered by a sham stigma, in *Goldstein v. Commissioner*[18] where the taxpayer won a 1958 Irish Sweepstakes of 140,000 dollars. Apart from the sweepstakes proceeds, taxpayer and her husband had an income of 904 dollars for 1958. She borrowed 945,000 dollars in December 1958, purchased 1,000,000 dollars face amount Treasury Notes, pledged the notes as collateral for the loan, and prepaid interest of 81,396 dollars. The Tax Court,[19] following *Knetsch,* found as an

[16] 335 F.2d 30 (2d Cir. 1964). The *Knetsch* and *Minchin* litigation should be unnecessary today due to INT. REV. CODE OF 1954 § 264(a)(2) which disallows deduction of "any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract." This provision is only applicable to annuity contracts purchased after March 1, 1954.

[17] *Accord,* Kaye v. Commissioner, 287 F.2d 40 (9th Cir. 1961).

[18] 364 F.2d 734 (2d Cir. 1966).

[19] Kapel Goldstein, 44 T.C. 284 (1965). For a student note on the Tax Court decision, see 19 VAND. L. REV. 194 (1965).

ultimate fact that the taxpayer's purpose was not to derive an economic gain but solely to secure a large interest deduction as an offset to the sweepstakes proceeds, and held the transaction to be a sham.

The court of appeals rejected the sham or bona fide creditor-debtor rationale by pointing out that an *actual* loan arrangement existed which was indistinguishable from any other legitimate loan transaction. It found a transaction that had no substance, utility, or purpose beyond the tax deduction and stated that a deduction should not be allowed "when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction."[20] The court, further, appeared to adopt the dissenting view of *Gilbert v. Commissioner*[21] where Judge Learned Hand expressed his dislike of labeling transactions as "no substantial economic reality," "sham," or "dependent on the substance of the transaction" to bring them within the intent of the tax statutes and proposed a test that would turn on the taxpayer's motives at the time of entering the transaction.[22]

Application of the *Goldstein* view would result in disallowance of any interest deduction, irrespective of the type of loan manipulations, where it objectively appears that the taxpayer had no anticipation of an economic gain other than a tax benefit. By recognizing that an actual indebtedness exists, this view considers the realities of a loan obligation between creditor and debtor, which the previous tests glossed over, and avoids the fiction that no such genuine situation is present. It is still open for the taxpayer to obtain his deduction by showing that he entered the transaction as a purposive activity, to be financed through borrowing, with a reasonable expectation of economic gains.

In approximately seven years since its introduction into the interest deduction area, the business purpose test has evolved from an initial association with the sham considerations to a complete separation of these approaches and rejection of the sham test. The other

[20] Goldstein v. Commissioner, 364 F.2d 734, 741 (2d Cir. 1966).

[21] 248 F.2d 399, 410 (2d Cir. 1957) (L. Hand, J., dissenting). The majority disallowed deduction of a bad debt claim.

[22] *Id.* at 412 where Judge Hand stated, "When the petitioners decided to make their advances in the form of debts, rather than of capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise."

federal courts should adopt the independent application of this test[23] which enables a more realistic evaluation of the taxpayer's motives and the statutory intent in determining the deductibility of interest.

WILLIAM H. THOMPSON

Torts—Medical Malpractice—Rejection of "But for" Test

In *Hicks* v. *United States*[1] a navy doctor failed to test for bowel obstruction in a patient who complained of severe abdominal pains. The patient, treated only for a "bug," died some eight hours later, suffering from a strangulation of the intestine. On the basis of expert testimony, the doctor was found to have been negligent in failing to diagnose the obstruction. There was also testimony that if a correct diagnosis had been made, an immediate operation would have saved the patient's life. Testimony apparently was not given to indicate whether an immediate operation could have been performed or to indicate what dangers such an operation would have involved, if any.[2] On the basis of this testimony the Court of Appeals for the Fourth Circuit held that the trial judge was compelled to find negligence and "cause in fact" and to award a verdict to the plaintiff. The evidence of cause in fact is probably sufficient to meet the orthodox tests, but the court apparently rejected the usual test of cause in fact, saying that

> When a defendant's negligent action or inaction has effectively terminated a person's chance of survival, it does not lie in the defendant's mouth to raise conjectures as to the measure of the chances that he has put beyond the possibility of realization. If there was any substantial possibility of survival and the defendant has destroyed it, he is answerable.[3]

[23] The close family relationship will continue to pose a problem if it appears the taxpayer was "borrowing" his own money. In this situation the realities of a loan obligation may not be present.

[1] 368 F.2d 626 (4th Cir. 1966).

[2] The patient suffered from diabetes as well as from an "abnormal congenital peritoneal hiatus with internal herniation. . . ." *Id.* at 629. It seems doubtful that a layman could estimate the likelihood or non-likelihood of the patient's survival under these conditions, especially without knowing whether qualified personnel were on hand to operate. Compare George v. City of New York, 253 N.Y.S.2d 550 (Sup. Ct. 1964) where a barium enema penetrated the bowel wall; an operation was immediately performed, but the patient died. Nevertheless, the testimony in *Hicks* that an operation would probably have been successful is no doubt sufficient evidence of cause.

[3] 368 F.2d at 632.