Taxation--Interest Deduction--Transaction Must Be Economically Purposive to Qualify for Interest Deduction (Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966))

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Another unresolved issue implicit in the holding of the instant case concerns the standard to be applied in determining who is sufficiently indigent to warrant this immunity from imprisonment. In *Saffore*, the defendant was apparently completely without funds and property. The Court, presented with such a clear case of indigency, was not required to devise any more explicit standard than the word "indigent." In closer cases, where varying degrees of poverty are presented to the courts, some more specific test will have to be developed. Certainly, this definition of indigency will have to be reconciled with the "indigency" that gives a criminal defendant the right to state-provided counsel. Even persons with a limited amount of money, who are deemed sufficiently solvent to afford competent counsel, but who exhaust their financial resources to secure one, appear to be entitled to the immunity from imprisonment for failure to pay fines under the holding of the instant case.

As an immediate consequence of the instant case, the attention of the criminal courts will be refocused on the proper purpose of any confinement they impose in attempting to enforce a fine. Imprisonment in lieu of payment can only be justified when the criminal can afford to pay the fine. This procedure was designed to punish those with ample means by exacting of them a legislatively determined sacrifice in money proportionate to the seriousness of their crime. Knowingly transforming this monetary obligation into an unavoidable additional incarceration cannot be justified. Clearly the Court was correct in determining that the criminal must be capable of paying the fine before he can be imprisoned for his "refusal" to pay it.

**TAXATION — INTEREST DEDUCTION — TRANSACTION MUST BE ECONOMICALLY PURSUITIVE TO QUALIFY FOR INTEREST DEDUCTION.** — Petitioner, a sweepstakes winner, attempted to reduce her tax liability by creating a large prepaid interest deduction. Borrowing almost one million dollars, she purchased treasury notes which, in turn, were pledged to secure the loans. The Court of Appeals for the Second Circuit *held* that, even though the transaction was not a sham, the interest deduction was not allowable under Section 163 of the Internal Revenue Code of 1954 since the sole purpose of petitioner's acts was tax avoidance. *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966).

With certain exceptions, Section 163 of the Internal Revenue Code provides that the deduction of interest must be supported by (1) an indebtedness, (2) interest on the indebtedness, and (3)
the payment or accrual of the interest within the taxable year.\textsuperscript{1} The development of this section has been left almost entirely to the courts since the pertinent Treasury Regulations do not provide an interpretive guide. The courts have generally held that as long as there is a genuine indebtedness, the interest deduction is allowable.\textsuperscript{2} This is true regardless of the nature of the expense or the purpose for which the proceeds of the indebtedness are utilized. Such indebtedness, furthermore, need not serve a business purpose, or even be reasonable.\textsuperscript{3} Due to the broad language of section 163, many taxpayers have attempted to use the interest deduction as a method of avoiding or decreasing their tax liabilities.\textsuperscript{4} The courts have opposed such attempts and have generally disallowed the interest deduction\textsuperscript{5} by placing elaborate interpretive limitations upon the simple language of section 163.

For purposes of analysis, these tax avoidance “schemes” may be categorized as either “annuity” or “treasury note” plans. In the former cases, the taxpayer purchases annuities from an insurance company, paying only a nominal cash sum and giving nonrecourse notes secured by the annuity for the balance. The taxpayer then prepays a substantial amount of the interest on the indebtedness. The interest prepayment significantly raises the excess or loan value of the annuity which taxpayer immediately borrows from the insurance company, again prepaying the interest on this indebtedness. These “borrowings” and “interest” prepayments are repeated each year until the annuity is surrendered to the insurance company as a set off to the cash value of the annuity against the principal amount of the loan thereby cancelling the annuity contract. Thus, the prepayments of interest accelerate the loan value of the annuity but the concurrent borrowing of this accelerated loan value allows taxpayer to recoup almost all the purported interest prepayments.\textsuperscript{6}

\textsuperscript{1} INT. REV. CODE OF 1954, § 163(a). \textit{But see} INT. REV. CODE OF 1954, §§ 264, 265(2), respectively disallowing certain amounts paid in connection with insurance, endowment and annuity contracts or tax-exempt income.

\textsuperscript{2} MERTENS, FEDERAL INCOME TAXATION ¶ 26.01 (1960 ed.).

\textsuperscript{3} Ibid.

\textsuperscript{4} In the typical case, a taxpayer will become liable on a large indebtedness, the proceeds of which are put into high-grade investments such as bonds, annuities, or government notes. The taxpayer then uses the securities purchased as collateral for the indebtedness and prepays the interest. Since the rate of return on the collateral is less than the interest on the indebtedness, the taxpayer shows a pre-tax economic loss. However, after deducting from his income the prepaid interest, he has a post-tax economic gain. See 19 VAND. L. REV. 194 n.1 (1966).


In *Knetsch v. United States*, the United States Supreme Court disallowed the interest deduction on such loans from insurance companies. The Court inquired into whether or not the transaction created an "indebtedness" within the meaning of section 163. Clearly disregarded, as immaterial, was the trial court's determination that the taxpayer's "'only motive in purchasing these . . . bonds was to attempt to secure an interest deduction.'" The Court stated that a taxpayer has the right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by any means the law permits. Motive is immaterial because "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute had intended." In examining "what was done" here, the Court saw the form of an annuity contract that would yield substantial payments at maturity. However, this form "was a fiction" since taxpayer's borrowings kept the cash value, on which the annuity payments depend, negligible. Therefore, the taxpayer's transactions "did not appreciably affect his beneficial interest except to reduce his tax . . . ." What the taxpayer "was ostensibly 'lent' back was, in reality, only the rebate of a substantial part of the so-called 'interest' payments." The Court concluded that the transactions did not create an indebtedness but were a sham.

Notably, the Court did not state that "indebtedness," to fall within the section, must carry a qualification as to the purpose for which the obligation is incurred. The case, however, has been said to stand for the principle that, in annuity cases, the transaction must have commercial substance or a business purpose to support the tax deduction.

However, in *John Loughran*, the taxpayer borrowed from a bank the purchase price of annuities which he then pledged as security with the bank. The taxpayer paid interest on this loan and borrowed from the bank amounts equal to the excess loan value of the annuities over his indebtedness. Although the taxpayer had no right to annuity benefits because he borrowed the full amount of the loan value and could derive no pre-tax gain from such an undertaking, the tax court allowed the interest deduction.

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7 364 U.S. 361 (1960).
8 Id. at 365. (Emphasis added.)
11 Ibid. (Emphasis added.)
12 Ibid.
13 Ibid.
15 19 T.C.M. 1193 (1960).
The court distinguished this case from prior annuity cases where the insurance company itself was the lender. In *Loughran* the lender was an independent bank and, therefore, there was a genuine indebtedness. The distinction is between a three-party transaction and a two-party transaction.

The courts have consistently analyzed the net effect of the two-party transactions, such as in *Knetsch*, and, if there is no economic benefit to the taxpayer, they have refused to find a genuine indebtedness.

Unlike the simplicity of the factual patterns in the annuity cases, the treasury note cases have presented highly sophisticated transactions for judicial scrutiny. Notable among the cases involving the purchase of treasury notes was *Eli D. Goodstein*. There, the taxpayer purchased ten million dollars worth of treasury notes by paying fifteen thousand dollars in cash to his broker and borrowing the remainder. He then gave his note to the lending institution and pledged the treasury notes as security. The taxpayer paid the lending institution the periodic interest charges on his outstanding promissory note, which amount he immediately received back in the form of a loan for which the taxpayer again gave a note. The tax court disallowed the deduction for interest on taxpayer's promissory note. Relying on the "form versus substance" doctrine utilized in *Knetsch*, the court held that the total transaction was devoid of substance and should be ignored for tax purposes.

The court found, *inter alia*, that: (1) taxpayer's transactions were collusive shams arranged by taxpayer's broker; (2) the treasury notes were purchased and sold in almost one transaction wherein no actual money passed on behalf of taxpayer; (3) the lending institution had no actual money to lend; (4) taxpayer never had either actual ownership or possession of the treasury notes; and (5) the lending institution never actually held the treasury notes as collateral. In the court's view, the whole matter of "interest" was merely an empty bookkeeping device to create the illusion of interest on a purported indebtedness.

Significantly, the "form versus substance" rationale followed by the *Goodstein* court subsequently induced courts, scrutinizing mere variations of the tax-saving device utilized by Goodstein, to strongly indicate that an interest deduction, in treasury note cases, requires a business purpose or profit motive. It should be

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16 30 T.C. 1178 (1958), aff'd, 267 F.2d 127 (1st Cir. 1959).
17 Id. at 1190.
18 Id. at 1187-89.
19 Id. at 1188.
noted, however, that both the Court of Appeals for the First Circuit and the Court of Appeals for the Second Circuit did not require that there be a business purpose in order for there to be an interest deduction in cases where treasury notes were involved.

The next significant development in this area was the landmark case of L. Lee Stanton. In Stanton, the taxpayer purchased treasury notes on the open market with funds borrowed from independent banks. He gave the banks his personal recourse notes and pledged the treasury notes as collateral. Factually, Stanton was similar to numerous other tax avoidance schemes which were disallowed by the courts. As in previous cases, the taxpayer had little hope of a profit except in terms of a tax saving. There was, however, one important distinction, i.e., in Stanton there was a genuine indebtedness involved. The Commissioner attacked the deduction on the grounds that the taxpayer's sole purpose was tax avoidance and the transaction had neither a business purpose nor a profit motive. The tax court, in allowing the deduction, stated that "Congress has repeatedly considered and ultimately rejected limitations somewhat comparable to the one now urged by the Commissioner." The court concluded that, since Congress had failed to act, the tax court lacked authority to require that a transaction be entered into for profit rather than for personal or non-business purposes, or merely to obtain tax benefits, in order that an interest deduction be allowed.

The court distinguished the prior treasury note cases relied upon by the Commissioner on the ground that in those cases there was no true indebtedness "but merely collusive shams to create a supposed appearance of indebtedness on which supposed interest was paid." The court also distinguished the annuity cases in which the taxpayers had purchased annuity contracts and borrowed money from banks to prepay premiums and then [borrowed the full loan

21 Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959), affirming 30 T.C. 1178 (1958). The court of appeals affirmed on the alternative theory relied upon by the tax court. Since taxpayer was on a cash basis, the giving of a promissory note did not satisfy the statutory requirement of payment.
22 Lynch v. Commissioner, 273 F.2d 867 (2d Cir.), affirming 31 T.C. 998 (1959). The court affirmed on the sham theory, i.e., no true indebtedness existed.
23 Doukas, supra note 20, at 293.
24 Id. at 7.
25 Ibid.
26 Supra note 24, at 10.
value of the annuity and] ... then used a part of this money to pay off the loans at the banks. *The interest on the bank loans was not in controversy.* The taxpayers were disallowed claimed deductions for 'interest' on the amounts they allegedly borrowed from the insurance companies, since no money was in effect loaned to them by the insurance companies.\(^2\)

Subsequent tax court cases have followed *Stanton* in focusing on the "genuine indebtedness" theory.\(^3\) It seems clear that *Stanton* stands for the principle that in order for there to be an interest deduction for commercial transactions there is no need that there be a business purpose or profit motive as long as there is a genuine indebtedness.\(^4\)

In the instant case, the taxpayer, as in *Stanton*, purchased treasury notes on the open market by borrowing from independent banks by pledging the treasury notes as collateral and giving her recourse note for the purchase price. Taxpayer then prepaid substantial interest charges on her note and claimed them as a deduction. The Court of Appeals, while affirming the tax court's disallowance of the deduction, rejected the determination that the transaction did not create a genuine indebtedness. Several factors compelled the Court to reach this conclusion. First, the lending institutions were independent financial institutions. Second, the loan transactions did not return the parties, within a few days, to the position from which they started. Third, the banks retained significant control over the future of the loan arrangements. For example, the banks could, with thirty-days notice, demand that the collateral be increased or that the loan be liquidated entirely. Fourth, the notes signed by taxpayer were with recourse, rendering the taxpayer personally liable, if necessary, for deficiency of collateral.\(^5\) Even though there was a genuine indebtedness, the Court disallowed the deduction because the taxpayer's sole motive was tax avoidance. The Court pointed out that the transaction was economically unsound and unprofitable. Congressional intent, the Court opined, was to encourage purposive activities financed through borrowing. A deduction is allowable even though the taxpayer's motives are mixed. There is, however, no requirement that the deductible interest serve a business purpose, that it be ordinary and necessary or even that it be reasonable. But some substance, beyond a mere deduction, is required.\(^6\) Therefore, the Court held that section 163

\(^{29}\) *Supra* note 24, at 10-11.


\(^{31}\) See Doukas, *supra* note 20, at 294.


\(^{33}\) *Id.* at 741.
"does not permit a deduction for interest paid or accrued . . . that can not with reason be said to have purpose, substance or utility apart from their anticipated tax consequences." 

Since the Court of Appeals conceded the genuineness of the indebtedness, the instant case is in opposition to Stanton and Loughran where the tax court interpreted section 163 literally. While the prime consideration continues to be the existence of indebtedness, once it is established, the court will enlarge its inquiry to determine whether the taxpayer's motive is solely tax avoidance.

In reaching its holding, the Court relied on three prior annuity cases. While each of these three cases contains strong indications that a legitimate purpose is required, they involved a two-party annuity arrangement. As such they do not appear to be sound precedent for the holding in the instant case in which three parties were involved. In three-party transactions, the loan arrangement, being completely independent, the courts have been able to find a genuine indebtedness. Once it is established that a taxpayer has changed his position by incurring an actual debt and has actually received the funds, it is clear that the interest payment is in substance what it appears to be in form, i.e., the cost of the use of money. Judicial consideration of the transaction should end at this point since section 163 merely requires a genuine indebtedness. Clearly, a court should not engraft upon a statute a prohibition which was not specified by Congress. Since section 163 does not place any restrictions on the purpose of the indebtedness, it is quite possible that the Supreme Court might take a different view of the transaction in the instant case than did the second circuit. The case of Commissioner v. Brown squarely stands for the sound judicial policy that the courts should not accomplish by decision what Congress has failed to accomplish by legislation. It would appear that the Court in the instant case has violated this policy.

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34 Id. at 740.
35 See Barnett v. Commissioner, 364 F.2d 742 (2d Cir. 1966); Ippolito v. Commissioner, 364 F.2d 744 (2d Cir. 1966).