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NOTES

The "Business Purpose" Doctrine and Interest Deductions

Introduction

One day an American millionaire was visiting an antique shop. He was intrigued by a gleaming, golden oriental lamp, and recalling his childhood memories of Aladdin, he secretively rubbed it. Before his astonished eyes, a genie appeared, offering to grant any three wishes.

Bewildered as he was, the millionaire did not lose sight of the financial realities of life. "I have only one wish," he replied. "I wish to reduce my taxable income and to realize capital gains." The genie smiled, and so that no others might hear, whispered this plan:

"To fulfill your wish, it is necessary that you first borrow several hundreds of thousands of dollars. With this money you must purchase securities and then hold them for six months. If the interest you must pay on the loan exceeds the return you expect from the securities, do not become alarmed. Any such loss will be more than offset when you deduct the interest payment from your gross income and when you report any income from the securities as a capital gain (taxable at only twenty-five per cent). In this way it is possible to have your cake and eat it, too. One *caveat*: if the transaction is scrutinized by the Internal Revenue Service, and if, by chance, you are brought to trial, I cannot warrant your success before the courts. It is not within the power of even a genie to fathom the mysterious decision-making process utilized by these august bodies."

The genie was wise indeed to refuse to grant any such warranty, for although the millionaire would violate no section of the Internal Revenue Code, and although it is a basic tenet of the "common law" of taxation that a citizen may minimize his tax by any legal means,[1] the declared interest deduction might nevertheless be disallowed by the courts.

[1] See Gregory v. Helvering, 293 U.S. 465, 469 (1935); Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930).

The reason for the possible disallowance is based on an inevitable imperfection in the body of the Code. It is a fundamental fact of economic life that the Internal Revenue Code must, of necessity, deal with broad and general areas rather than with specific transactions. Because of this, any number of ingenious taxpayers annually attempt to lighten their tax burden by utilizing astonishing schemes which, while satisfying the literal terms of the Code, could lead to absurd tax advantages obviously contrary to congressional intent.

To offset this type of taxpayer-inventiveness, the courts in some instances have determined that a proper construction of the Code will refuse to recognize mere literal compliance with the law.[2]

Thus, although section 163 of the Code states simply that all interest paid on indebtedness[3] will be deductible, it has been argued in some cases that a payment of interest on a debt is not in itself sufficient compliance for the valid declaration of the deduction. This argument has evolved from the ambitious attempts of the courts to discourage the practice of tax avoidance, and it has serious overtones for both the taxpayer and the tax adviser in view of the many transactions which are dependent for success on interest deductions. It is the purpose of this note to discuss the history, the implications and the validity of this argument.

The Gregory Case

Whenever a court is called upon to determine if a transaction which is literally "legal" will be recognized for income tax purposes,

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[2] In one case, where a family partnership agreement existed and income was attributed to two sons who were full-time students, the Court held that income could only be distributed among "true partners." Commissioner v. Culbertson, 337 U.S. 733 (1949). In another case a corporation, under the guise of a recapitalization-reorganization, created new obligations which it transferred to stockholders in relation to their former holdings, thereby producing the same result as a distribution of cash earnings of equivalent value. The Court withheld tax immunity since the transactions were actually realized gains and were merely "cast in the form of a recapitalization-reorganization." Bazley v. Commissioner, 331 U.S. 737, 742 (1947). Again, where a construction corporation sold its heavy machinery to its chief stockholder and then leased it back, the court held the purported sale and leasing arrangement to be without substance and effect for tax purposes since the sole motive and purpose of the transaction was to form a basis for a substantial tax deduction. W. H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951).

[3] 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.

the decision will probably be influenced by the landmark Supreme Court case of *Gregory v. Helvering*.[4] In *Gregory*, a corporation wholly owned by the taxpayer transferred 1,000 shares of stock to a newly-organized corporation which thereupon issued all of its shares to the taxpayer. The new corporation was then dissolved and liquidated, the shares being distributed to the taxpayer, thus subjecting him to a lower tax liability than would have accompanied a direct transfer by dividend.[5]

Although the plan conformed literally to the Code section governing corporate reorganizations, the Supreme Court denied effect to the transactions. The Court reasoned that Congress intended the term corporation to extend only to entities "doing business"; that tax avoidance in itself was not "doing business"; and thus, that the existence of a corporation whose only purpose was to escape taxation would be denied validity for tax purposes.

The *Gregory* rationale has not been limited to the specific field of corporate reorganization. "It has a much wider scope; it means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to avoid taxation." [6]

It should be noted that a transaction is not invalid merely because the taxpayer's *primary* motive is to avoid taxation. The application of the *Gregory* doctrine is limited to those instances where the *sole* motive, and therefore the sole function, of the transaction is tax avoidance.[7] Thus, were a man to borrow money to undertake desirable although unnecessary repairs to his business property during a high income year, the interest expense incurred could be validly deducted even though his action would be obviously motivated by tax considerations. This example indicates the dis-

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[4] 293 U.S. 465 (1935); see Holzman, *Ten Years of the Gregory Case*, 79 J. ACCOUNTANCY 215 (1945).

[5] While upon a complete liquidation only capital gains tax will arise, a corporate dividend is, in effect, subject to double taxation in that the corporation first pays a tax on its earnings, and subsequently the taxpayer is susceptible to tax on ordinary dividends. For an interesting discussion of this topic see Michaelson, *"Business Purpose" And Tax-Free Reorganization*, 61 YALE L.J. 14 (1952).

[6] Commissioner v. Transport Trad. & Term. Corp., 176 F.2d 570, 572 (2d Cir. 1949).

[7] Gregory v. Helvering, *supra* note 1, at 468. See Maysteel Prods., Inc. v. Commissioner, 287 F.2d 429, 431 (7th Cir. 1961); Herzfield, *Is Interest Deductible When Tax Saving Is Sole Motive?*, 12 J. TAXATION 336 (1960); 36 NOTRE DAME LAW. 588 (1961).

tinction between the subjective motive of the taxpayer on the one hand and the objective goal of the transaction on the other. The taxpayer wished to avoid tax—but the transaction utilized to achieve this end also fulfilled a legitimate non-tax purpose. Thus, a tax-avoidance motive alone will not vitiate a transaction. However, if both the motive and objective goal of the transaction were directed at tax avoidance, the transaction could be challenged under Hand's famous restatement of the *Gregory* rule: "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. . . ."[8]

The Livingstone Cases

The present controversy over whether the *Gregory* "business purpose" test should be applied to the area of interest deductions began with a series of cases involving the financial manipulations of one Eli Livingstone.[9] The interest deduction scheme which he invented almost invariably involved alleged borrowing of funds from a creditor. Upon examination, the courts have consistently found that the creditor, having inadequate assets, could not possibly have negotiated the loan. In reality the transactions were mere bookkeeping devices and paper proceedings.[10]

For example, in *Leslie Julian,*[11] Livingstone loaned the petitioner $80,000. The loan was unsecured, non-interest-bearing, and not evidenced by a written document. Julian then purchased through Livingstone $650,000 face value United States Treasury bonds. Livingstone sold the bonds short as "principal" and did not charge a commission on the sale. The purchase price of the bonds was $564,687.50. Julian borrowed $653,250 from Gail Finance Corporation, whose president-treasurer was a former law partner of Livingstone, to finance the purchase of the Treasury bonds. He

[8] Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (dissenting opinion). See Diamond, *Learned Hand And Federal Taxation,* 3 SYRACUSE L. REV. 81 (1951).

[9] Broome v. United States, 170 F. Supp. 613 (Ct. Cl. 1959); Egbert J. Miles, 31 T.C. 1001 (1959); Leslie Julian, 31 T.C. 998, *aff'd,* 273 F.2d 867 (2d Cir. 1959); George G. Lynch, 31 T.C. 990, *aff'd* 273 F.2d 867 (2d Cir. 1959); Eli D. Goodstein, 30 T.C. 1178 (1958), *aff'd,* 267 F.2d 127 (1st Cir. 1959).

[10] It is interesting to note that before Livingstone initiated the transactions he received a ruling letter from the Internal Revenue Service which indicated that they would be permitted. Eli D. Goodstein, *supra* note 9, at 1191.

[11] Leslie Julian, *supra* note 9.

executed a non-recourse promissory note in favor of Gail and pledged the Treasury bonds as security for the loan. At the time Gail loaned $653,250 to Julian it had only $1,381.65 cash on hand. To raise additional funds, Gail sold short to Livingstone the identical type and amount of bonds pledged to it by Julian for the same price as that paid by Julian. Gail then sent Julian a check for $88,562.50, an amount representing the difference between the purchase price of the bonds and its loan to him and he repaid Livingstone the $80,000 he had borrowed.

Appropriate entries were made on the books of Gail and Livingstone to reflect the above outlined transactions. Since Gail owed Livingstone $564,687.50 on behalf of Julian, and since Livingstone owed Gail a like amount due to the short sale to Livingstone, the liabilities cancelled each other. No Treasury bonds were physically transferred between petitioner, Livingstone and Gail.[12]

More important than the result in the *Livingstone* cases (the disallowance of the deduction for interest paid on the loan) was the judicial rationale utilized in reaching that result. The Tax Court has refused the deduction on three interdependent grounds:

(1) *No Real Loan*—section 163 allows "as a deduction all interest paid or accrued within the taxable year on indebtedness." The Court has defined interest as "the amount one has contracted to pay for the use of borrowed money."[13] Since in the Livingstone transactions the creditor could not lend (the resources of Gail, for example, were only slightly over one thousand dollars at the time of the loan), it was obvious that the debtor could not actually borrow. Since the money was not borrowed there was no indebtedness, and, therefore, no interest could be validly deducted.[14]

(2) *No Business Purpose*—the Court adapted the *Gregory* doctrine to the Livingstone transactions, holding that an interest deduction will be allowed only if the transaction is undertaken in furtherance of a legitimate, non-tax economic purpose. Thus, in cases where the decision might have rested upon the absence of a real loan, the Court nevertheless illustrated the applicability of

[12] For similar transactions see George G. Lynch, *supra* note 9; Eli D. Goodstein, *supra* note 9.

[13] Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1931); see Autenreith v. Commissioner, 115 F.2d 856 (3d Cir. 1940).

[14] *E.g.,* Broome v. United States, *supra* note 9; Eli D. Goodstein, *supra* note 9.

the more theoretical "business purpose" doctrine as an alternative ground for judgment.[15]

(3) *No Real Transaction*—in general, when the transaction was, in reality, something different from what it appeared to be, the Court disallowed the interest deduction on the ground that the proceedings were a "sham" for tax purposes.[16] This label has been very unsatisfactory and confusing in practice since the courts have tended to describe a multiplicity of transactions as "shams" when other, more precise grounds for disallowance were available.[17] Careful examination of these "sham" transactions reveals that they could have fallen within either the "no real loan" or the "no business purpose" categories.

On appeal the Tax Court determinations in the *Livingstone* cases have been upheld unanimously. The appellate courts have justified their results on the two basic grounds of *no real loan* and *no real transaction*—but have been reluctant to extend the *Gregory* "business purpose" principle into the interest deduction area. For example, it does not appear that the first and second circuits have disallowed an interest deduction in a Livingstone transaction on the basis of "business purpose."[18]

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[15] In George G. Lynch, *supra* note 9, at 996, the court disallowed the interest deduction under the *Gregory* rule, and then continued: "Respondent's determination may be sustained on yet another basis"—indicating that the previously considered *Gregory* rule was indeed itself a "basis." *Accord,* Egbert J. Miles, *supra* note 9, at 1008: "if petitioner did purchase the bonds and incur an indebtedness he did so but for one reason, to realize a tax deduction. When examined in this posture, the interest allegedly paid is not within the intendment of section 23(b) and is not deductible by petitioner."

[16] George G. Lynch, *supra* note 9, at 996.

[17] See Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance,* 40 TAXES 296, 311 n.73 (1962). The author describes four situations in which the transactions have been declared "shams":

(1) where "the taxpayer did not establish the jural relationship he purported to create";

(2) where if "the business-purpose test is applicable, a particular entity performs no business function apart from the tax-reduction plan of which it is an element";

(3) where "intermediate steps in a series of moves serve no function other than to provide formal compliance with the requirements for obtaining an advantageous tax position"; and

(4) where "a transaction, which involves binding legal relationships of more than transitory duration, lacks commercial substance or economic reality in the sense that the arrangement would not have been embarked upon were it not for the profit expected to materialize from the presumed tax consequences."

[18] Doukas, *Tests For Deductibility of Interest Payments: Is Business Purpose Necessary?,* N.Y.U. 17TH INST. ON FED. TAX 1259, 1267 (1961).

In *Goodstein v. Commissioner*,[19] the court recognized that one ground for the Tax Court disallowance was based on the *Gregory* principle. The court affirmed however, on the alternative ground—that there was no indebtedness and, therefore, there could be no payment of interest.[20]

In *Lynch v. Commissioner* and *Julian v. Commissioner*,[21] the court again considered the government's argument that the interest deductions were invalidated by the *Gregory* doctrine, yet stated, "we are not required to and do not rest our decision here on the principle of Gregory v. Helvering." [22] Finding that the financial proceedings "did not in fact produce the legal transactions which they simulated," [23] and that "no money was used or forborne," [24] the court upheld the disallowance of the deduction.

The court of appeals in *Diggs v. Commissioner*,[25] declared that to interpret *Gregory* to preclude tax relief with respect to any transaction entered into for tax avoidance alone is a "mistaken oversimplification."[26]

The Stanton Case

While in the *Livingstone* cases the evidence was clear that no real or enforceable loan had been granted, the case of *L. Lee Stanton*[27] presented a new and challenging factual situation.

Stanton purchased substantial amounts of short-term government notes and commercial paper at a discount, and financed the purchases by actually borrowing money from several banks, giving his promissory note in the full amounts as security for the loans. It was found that he anticipated a loss before taxes on one of the transactions in question.

Examining the proceedings, the Tax Court found a *real loan* ("the lenders actually advanced the money borrowed for Lee's use"[28]) and in addition a *real transaction* ("he was required to do

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[19] 267 F.2d 127 (1st Cir. 1959).
[20] *Id.* at 131.
[21] 273 F.2d 867 (2d Cir. 1959) (these cases were decided together).
[22] *Id.* at 871.
[23] *Ibid.*
[24] *Id.* at 871-72.
[25] 281 F.2d 326 (2d Cir. 1960).
[26] *Id.* at 329.
[27] 34 T.C. 1 (1960). See Doukas, *Though Tax-Saving Is Only Motive, Interest Is Deductible IRS Concedes,* 14 J. TAXATION 292 (1961); 74 HARV. L. REV. 783 (1961).
[28] L. Lee Stanton, 34 T.C. 1, 8 (1960).

all that he did do, and no step which he took was lacking in substance or legal effect"[29]). Thus, the question of whether a "business purpose" was necessary before an interest deduction would be allowed was presented before the court for consideration. It was answered in the negative.

It was decided that Stanton might validly deduct the interest which he paid; that the deduction was in no way dependent on the use to which the loan was put; and that the "business purpose" doctrine had no standing as binding precedent in the Tax Court. In the judgment of the court, all previous deduction cases were actually decided on the basic ground of *no real loan*—as a result, any "business purpose" language in these decisions was never necessary for determination of whether the deduction would be allowed, and consequently was merely dicta.[30]

It would appear that the court, in fact, did not effectively distinguish these "business purpose" decisions. As already indicated, the Tax Court has, in some cases, applied the *Gregory* doctrine, as an *alternative ground* for judgment.[31] The Supreme Court has held that where there are such alternative bases for a decision, neither can be considered dicta.[32]

The *Stanton* dissents espoused the principle that the presence of a real debt did not, in itself, give recognizable economic reality to the transaction. It was, they determined, only evidence that the formalities were more rigorously observed. Since the scheme was set up essentially for tax avoidance, they refused to grant recognition to the transaction for tax purposes.

An Internal Revenue Service appeal of the *Stanton* decision was attempted but subsequently withdrawn, apparently indicating that the service might acquiesce in the Tax Court determination and would allow interest deductions once the reality of the debt was established. The deduction controversy might thus have ended[33] were it not for the fact that subsequent to the *Stanton* decision, the United States Supreme Court rendered a decision in the interest deduction area.

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[29] *Ibid.*

[30] *Id.* at 10.

[31] See note 15 *supra.*

[32] Woods v. Interstate Realty Co., 337 U.S. 535, 537 (1949).

[33] The *Stanton* decision was followed in several subsequent cases, *e.g.*, Fabreeka Prods. Co., 34 T.C. 290, 300 (1960); Jack L. Sherman, 34 T.C. 303 (1960); Sadie S. Friedman, 34 T.C. 456 (1960). Although the end result of the schemes involved in these cases (a deduction for the amortization of bond premiums) was disallowed, it was held that since the taxpayers were granted real loans to finance the transactions, they might properly deduct the interest so incurred. See 61 MICH. L. REV. 199 (1962).

Knetsch v. United States

In *Knetsch v. United States*[34] the taxpayer purchased thirty-year maturity, deferred annuity savings bonds with a face value of $4,000,000. The purchase price was $4,004,000. Knetsch paid $4,000 to the insurance company and signed $4,000,000 of non-recourse annuity loan notes for the balance, secured by the annuity bonds. The $140,000 interest on the loan was prepaid. The cash or loan value of the bonds at the end of one year would be $4,100,000; however, under the terms of the contract, Knetsch was permitted to borrow any excess of this amount above his indebtedness. He thus borrowed $99,000 of the $100,000 excess above his indebtedness, and once again paid advance interest of $3,465 on this second loan. The cycle was continued for three years after which he surrendered the bonds and the indebtedness was cancelled. Knetsch deducted the interest payments from his gross income.

In holding that Knetsch's interest deduction should not be allowed, the opinion seemed to employ all three theories of disallowance previously discussed. Looking at "what was done" in the transaction, the Court found that nothing of substance beyond a tax deduction could be gained by Knetsch and that therefore the payment of interest was a "sham."[35] Utilizing the *Gregory* rationale, the Court determined that Congress intended that "indebtedness" be incurred only in pursuance of a legitimate non-tax advantage, and not in pursuance of a plan solely aimed at tax avoidance. Since Knetsch's transaction could not affect his "beneficial interest" except to reduce his tax, it could not give rise to an "indebtedness" within the statutory intendment, and, therefore, he could pay no interest.[36]

Although this particular type of transaction has been prohibited by statute since 1954, the *Knetsch* decision is of vital importance since it represents Supreme Court policy in the entire interest deduction area.[37] The Court, unlike *Stanton,* maintains that no part

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[34] 364 U.S. 361 (1960).

[35] *Id.* at 366. The courts often view a transaction as a whole, overlooking intermediate steps if they do not affect the transaction except to complete its literal compliance with statutory demands. See Rice, *Judicial Techniques in Combating Tax Avoidance,* 51 MICH. L. REV. 1021 (1953).

[36] *Id.* at 365-66.

[37] INT. REV. CODE OF 1954 provides that "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." See generally O'Connor, *Knetsch Means Interest Deduction Is Allowable Only If Loan Has Real Business Purpose,* 14 J. TAXATION 160 (1961); Note, 46 CORNELL L.Q. 649 (1961).

of a transaction will be recognized for tax purposes unless it is directed at an objective goal beyond mere tax avoidance. Under this interpretation, the taxpayer (who always has the burden of proof to sustain the deduction)[38] would have to indicate to the satisfaction of the court that something other than a tax benefit was to be gained from any transaction under which he wishes to declare an interest deduction.

Obviously, the Court is not saying that there was no indebtedness because there was no enforceable payment of money or because there was no real loan as in the *Livingstone* cases. In those decisions, there was no indebtedness because the loans were mere paper proceedings. However, since the insurance company actually only loaned to Knetsch a partial rebate of what he had already paid or secured, it would seem that the Court might have disallowed the interest deduction on the requirement advocated by the *Livingstone* cases, viz., there was no real loan. In fact, the Court referred to the portion of Knetsch's payments that was not refunded to him as a "fee for providing the facade of loans."[39] The applicability of this theory was not developed as the Court relied heavily on the *Gregory* rationale in its decision.

The "business purpose" test, as applied in *Knetsch,* was followed in *Bridges v. Commissioner.*[40] There, in two transactions wholly arranged and handled by a broker, Bridges bought $1,000,000 of United States Treasury notes. In each case the broker arranged for a bank loan to Bridges, evidenced by a promissory note and secured by the Treasury notes. Bridges prepaid the interest on the loans and deducted it from his gross income. It was clear that he had no hope of profit before taxes and did not expect the excess of what would be received upon the maturity of the Treasury notes to exceed or even equal the amount of prepaid interest on the loans.

In denying the deduction, the court found that petitioner could receive no benefit from the transaction except through a tax deduction, and stated that interest is deductible "if there is, under the realities of the terms of the transaction, some reasonable hope of the transaction appreciably affecting the taxpayer's beneficial interest other than by tax reduction. . . ."[41]

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[38] Weyl-Zuckerman & Co., 23 T.C. 841, 847 (1955), *aff'd,* 232 F.2d 214 (9th Cir. 1956).

[39] Knetsch v. United States, 364 U.S. 361, 366 (1960).

[40] 325 F.2d 180 (3d Cir. 1963).

[41] *Id.* at 184. One problem raised by the requirement of a "reasonable hope" is that of determining for whom the hope must be reasonable. Is this the "reasonable man" standard of the negligence area, or does the court

This decision is a clear indication that the "business purpose" doctrine, although briefly interred by the *Stanton* decision, has been revived in the interest deduction area.[42] It remains to be determined if the revivification was fortunate.[43]

Criticism of Extension

There are several reasons why the *Gregory* "business purpose" doctrine should not be extended to the interest area.

Section 163 places no express limitation on the deduction and since other sections of the Code do expressly require a business purpose before recognition will be granted the transaction,[44] it may be argued that if Congress wished interest deductions to be allowed only if the debt were incurred in furtherance of an independent economic goal, it would have expressed this intent. In fact, an opportunity to express any such desire was granted Congress in 1924 when the Senate offered an amendment to the 1924 Revenue Act which would allow a deduction on "all interest paid or accrued within the taxable year on indebtedness, *except on indebtedness incurred or continued for the purpose of evading the payment of taxes. . . .*"[45] Senator Reed explained the purpose of his amend-

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really mean "any hope" of benefit? Another problem will arise if this reasonable hope test is consistently utilized to determine the validity of various interest deductions. If the taxpayer invests the loaned money in preferred stocks or other slightly fluctuating securities, the court must evaluate changing market conditions and other financial variables ex post facto to decide if a profit might "reasonably" have been expected. It is a difficult question of fact in view of the inevitable plea of the taxpayer that he honestly expected his "beneficial interests" would be affected by the transaction.

[42] Before the *Stanton* decision, insurance transactions similar to that utilized in *Knetsch* were denied validity for tax purposes under the *Gregory* rule. Carl E. Weller, 31 T.C. 33 (1958), *aff'd*, 270 F.2d 294 (3d Cir. 1959), *cert. denied*, 364 U.S. 908 (1960); W. Stuart Emmons, 31 T.C. 26 (1958), *aff'd*, 270 F.2d 294 (3d Cir. 1959), *cert. denied*, 364 U.S. 908 (1960). *Contra*, United States v. Bond, 258 F.2d 577 (5th Cir. 1958); see 35 NOTRE DAME LAW. 155 (1959).

Subsequent to the *Stanton* decision, the Tax Court allowed an interest deduction in a three party variant of the *Knetsch* scheme. In this case, the taxpayer borrowed from a bank rather than from the insurance company directly. The court sustained the transaction, *finding a real loan*. John Loughran, 19 CCH Tax Ct. Mem. 1193 (1960). See *Supreme Court Deciding Knetsch Narrowly, Leaves Question of 3-Way Loans Unanswered*, 14 J. TAXATION 5 (1961).

[43] See generally Summers, *A Critique of the Business Purpose Doctrine*, 41 ORE. L. REV. 38 (1961).

[44] See, *e.g.*, INT. REV. CODE OF 1954, §§ 229, 1551.

[45] SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1961 728 (1938). (Emphasis added.)

ment on the floor of the Senate: "The clause I have undertaken to insert . . . denies an exemption on account of interest paid of any kind if the indebtedness was not incurred in good faith for the purpose of carrying on a business, but was part of a plan or a device to evade taxation."[46] The amendment was stricken,[47] indicating that Congress did not wish to limit the interest deduction by a "business purpose" doctrine.

Moreover, although the *Gregory* decision has not been limited to the area of corporate reorganization, its extension has been only to such transactions as are considered "commercial or industrial."[48] Since all loans are not made in connection with "commercial or industrial" purposes, it is argued that the extension of the doctrine into the interest area is unwarranted. Furthermore, it would appear that a rule which theoretically allows a taxpayer to freely deduct interest on money which he borrows but does not use, and which forces that same person to prove a reasonable expectation that his "beneficial interests" would be "appreciably affected" if that money is utilized, is illogical. Under the *Gregory* rule, for example, one taxpayer who borrows money and carefully hides it under his bed, may freely deduct the interest paid, while another taxpayer must carry the burden of proving the validity of his deduction merely because he invested the money he borrowed.

While it is recognized that borrowed money can, in fact, become part and parcel of a "commercial or industrial" transaction, and, at the same time be without a "business purpose," nevertheless, a close examination of the original *Gregory* case indicates that disallowance of the interest deduction is unprecedented and unrealistic. The Supreme Court decision in the *Gregory* case was based on a construction of the nature of a bona fide corporation. Whereas a corporation may not be a corporation for tax purposes if it does not transact business, it does not necessarily follow that, similarly, interest is not interest because of the use to which the capital is put. To apply the *Gregory* rationale to disallow an interest deduction, the court must contend that although this interest

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[46] 65 Cong. Rec. 8255-56 (1918) (remarks of Senator Reed). In discussing another amendment, which would disallow interest paid on the purchase of tax-exempt government bonds, and which was enacted into law, Senator Reed reasoned that the amendment would "exempt interest paid for the purpose of carrying these tax-exempt securities; but if it is interest paid on *any other character of indebtedness than that, the deduction is to be allowed.*" *Ibid.* (Emphasis added.)

[47] H.R. Rep. No. 844, 68th Cong., 1st Sess. 18 (1924).

[48] Commissioner v. Transport Trad. & Term. Corp., 176 F.2d 570, 572 (2d Cir. 1949).

is actually the amount paid on borrowed money (the Supreme Court's own definition of interest)[49] it will not be within the statutory meaning of interest because the debt was not genuine, since it was not incurred for any beneficial economic purpose. The analogy is defective in that the *Gregory* Court had only to determine the intrinsic definition of a corporation—it was obvious that a corporation whose purpose was not to do business was not within the statutory concept. But to disallow an interest deduction, a court must look beyond the usual interpretation of interest to the substance of the whole transaction of which incurring the debt was only a part. To do this is to go one step beyond the *Gregory* reasoning and, as a result, to attach a tenuous construction to the express and unqualified congressional grant of deduction. Moreover, any such construction completely ignores the common experience of businessmen that money actually paid on a debt, incurred for whatever reason is, in fact, interest.[50]

Conclusion

It is submitted that the only valid ground for disallowance of an interest deduction is the absence of an enforceable and real loan and that any extension of the doctrine of the *Gregory* case into this area is unwarranted. It follows that the *Stanton* case was decided correctly on the merits and that "business purpose" language in *Knetsch* and other decisions must be considered as immaterial if dicta, and incorrect if not.

Although the courts may wish to disallow certain transactions which create favorable tax consequences for a taxpayer by his skillful, but merely literal, compliance with the Code, this disallowance must be based on sound legislative or judicial policy. An interest deduction cannot be disallowed by an allusion to a presumed congressional intent or by a general statement that the Code cannot be supposed to "provide an escape from the liabilities it sought to impose."[51]

The legislature has specifically granted the right to deduct interest paid on indebtedness. As such, it falls within its exclusive domain to alter or disallow the availability of deductions in this area. As the Code now exists, the courts must grant an interest

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[49] Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1931).
[50] See Knetsch v. United States, 364 U.S. 361, 371 (1960) (dissenting opinion).
[51] Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957).

deduction if there is a real debt. Before the "business purpose" doctrine can be extended to the interest sphere, Congress must promulgate concrete guidelines for adherence for both the taxpayer and the Government.

COPYRIGHT AS COLLATERAL IN A SECURED TRANSACTION †

Introduction

The present Copyright Act[1] is an anachronism. The advent of modern means of diversified communications has greatly increased the economic importance of the copyright, for the copyright owner is no longer limited to the sale of reprinted copies as the only commercially feasible means of realizing economic gain. However, if the various media of communication are to be fully exploited by the copyright owner, the copyright and its divisible parts must be accessible to the modern vehicles of commercial transferability.

In modern commercial practice, businesses have become completely reliant on financing, since the size and complex form of contemporary business have rendered the cash system commercially infeasible. Financing is a system by which a financier advances the necessary capital to a business in exchange for a security interest in its assets. It has become the mainstay of modern business procedure. In order to protect both the financier and the debtor, an extensive but burdensome legal system of secured financing has developed. This system has been recently refined and co-ordinated by the Uniform Commercial Code (hereinafter referred to as the Code) which has been adopted by a majority of the states.

The amount of capital that a creditor is willing to advance to a business will depend on the reliability of the business and the value of the assets given as collateral. Those businesses which own copyrights or a divisible part of copyrights constitute a substantial portion of the business community. The ability of these businesses to effectively offer a copyright to a creditor as security for his loan will depend on the stability of this asset. Stability depends upon the answers to the following questions: (1) are the statutory rights which inure to a copyright adequate to enable feasible

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[1] 17 U.S.C. (1952).