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STOCK REDEMPTION PREMIUMS AS "ORDINARY AND NECESSARY" BUSINESS DEDUCTIONS

I. Introduction

Corporations frequently find it desirable to issue stock which can be redeemed or called at a price in excess of its original issue price.[1] Such excess amount, when paid upon redemption, is commonly called a "redemption premium." This practice of redeeming stock raises significant federal income tax questions regarding the treatment of such payments for both the shareholder and the redeeming corporation.[2] The fundamental question for the shareholder is whether the payments will be treated as dividends or as proceeds from an exchange of assets.[3] Generally, any redemption will be treated as a dividend unless it qualifies under one of the exceptions set forth under §§ 302(a), 302(b), 303, or 331 of the Internal Revenue Code.[4] These exception sections are critically important to shareholders because exchange treatment is generally more advantageous to shareholders than dividend treatment since the former means that any gain or loss will be capital gain or loss if the stock is a capital asset.[5] As regards the tax effect to the corporation—the concern of this note—the traditional federal income tax treatment of the redemption payments has been to regard them as capital expenditures.[6] Accordingly, the payments so made have been construed as nondeductible by the courts pursuant to Internal Revenue Code § 263 which disallows deductions for capital expenditures.[7]

Recently, however, an attempt was made to deduct the premium portion of a redemption payment as an "ordinary and necessary" expense under Internal Revenue Code § 162(a).[8] In *H. and G. Industries, Inc. v. Commissioner*,[9] the case which provides the basis for this note, the taxpayer argued that a redemption premium met the requirements of § 162(a) since the redemption was necessitated by an "overriding corporate business interest."[10] The Third Circuit denied the deduction and held that as a prerequisite to the deduction, the "business

1 Redeemable shares of stock can be "called" or "purchased" by the issuing corporation on the demand of the corporation or, occasionally, at the request of the shareholder. Thus, since the shares may be called upon demand of the corporation, it generally becomes necessary to set the call price higher than the market price at issuance. If this feature did not exist, a corporation would undoubtedly have considerable difficulty selling the shares at issuance. E. DONALDSON & J. PFAHL, CORPORATE FINANCE 141 (3rd ed. 1969); N. LATTIN, THE LAW OF CORPORATIONS § 135 at 512-17 (2d ed. 1971). *See also* H. HENN, LAW OF CORPORATIONS § 160, at 296-97 (2nd ed. 1970).

2 *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 9.01-9.65 (3rd ed. 1971).

3 *Id.*

4 *See* C. MCCARTHY, THE FEDERAL INCOME TAX 680 (3rd ed. 1974).

5 B. BITTKER & J. EUSTICE, *supra* note 2, at ¶ 9.20.

6 *See, e.g.,* Arthur H. DuGrenier, Inc. v. Commissioner, 58 T.C. 931 (1972).

7 INT. REV. CODE OF 1954, § 263.

8 INT. REV. CODE OF 1954, § 162(a):

> IN GENERAL—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

9 495 F.2d 653 (3rd Cir. 1974).

10 This phrase did not appear in the court's opinion; rather, it arose in a brief article by Professor Hutton of New York University School of Law on the redemption premium issue. 1 J. CORP. TAX. 346-47 (1974).

interest" which prompts the redemption must be the preservation or survival of the corporate existence.[11] Even though the court did not find it necessary to provide further reason for denial of the deduction, there are two other possible rationales for denying the deduction which the court chose not to address: (1) the payment had its "origin" in the acquisition or issuance of stock and was therefore essentially a capital expense[12] and (2) § 311 absolutely bars the deduction since it states that no gain or loss to a corporation shall be recognized with respect to its stock.[13]

This note will discuss *H. and G. Industries* and analyze other questions raised by the redemption premium problem. This discussion will enable practitioners to forecast more accurately the probable success or failure of future attempts to deduct payments attributable to a stock redemption premium.

II. *H. and G. Industries*

Since *H. and G. Industries, Inc. v. Commissioner* is an important recent case dealing directly[14] with the redemption premium question, it is necessary to consider it in some detail at the outset. The taxpayer had entered into a stock purchase agreement with a Small Business Investment Corporation (SBIC) in order to maintain adequate working capital and to liquidate an existing loan.[15] The agreement stipulated the following provisions: (1) the SBIC was to purchase 2,000 shares of 8 percent cumulative convertible participating preferred stock at $100 par value;[16] (2) after payment of the 8 percent dividend and taxes the SBIC was to participate in income up to 12½ percent of annual net profits (to a maximum of $14,000 annually);[17] (3) the taxpayer had the option to call all (but not part) of the stock at $120 a share;[18] (4) various other restrictions involving permissible levels of current assets and net worth, mergers, compensation of officers, and dividends on common stock;[19] (5) the agreement would terminate only upon call of the preferred stock or upon conversions to common stock.[20]

After complying with the agreement for four years, the taxpayer called the preferred stock. It did so for two stated reasons: First, the large amount of

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11 495 F.2d at 657.
12 *See* text accompanying notes 59-69 *infra*.
13 INT. REV. CODE OF 1954, § 311.
14 In John Wanamaker Philadelphia v. Commissioner, 139 F.2d 644 (3rd Cir. 1943) and Pacific Southwest Realty Co. v. Commissioner, 128 F.2d 815 (9th Cir. 1942), the taxpayers attempted to deduct redemption premiums on the ground that the securities constituted debt and, therefore, were deductible pursuant to a treasury regulation which specifically allowed a bond redemption premium deduction. However, in each case the courts denied the deduction by holding the securities to be equity. Thus, the courts never addressed an argument similar to the one made by the taxpayers in *H. and G. Industries*—that assuming the securities are equity rather than debt, a redemption premium should be allowed as an "ordinary and necessary" deduction because the redemption is essential to relieve the taxpayer from the burdensome contract.
15 495 F.2d at 654.
16 *Id.*
17 *Id.*
18 *Id.*
19 *Id.*
20 *Id.* at 654-55.

dividend payments was "strangling"[21] its growth potential by reducing its working capital and; second, it could replace the redeemed stock and, thus, acquire needed capital at a lower cost by obtaining a 7 percent conventional mortgage.[22] The latter two reasons constituted the "overriding corporate business interest" which motivated the redemption, and the corporation deducted the $40,000[23] difference between the issue price and the redemption price.[24]

After the Commissioner's case against the deduction was sustained by the Tax Court,[25] H. and G. Industries made a two-part argument in the Third Circuit. First, it contended that the redemption premium was deductible as an "ordinary and necessary" business expense pursuant to Internal Revenue Code § 162(a)[26] because the payment was made to terminate a burdensome contract obligation with another party.[27] In support of its contention, the taxpayer relied on cases in which the courts have allowed an "ordinary and necessary" deduction for purchases of burdensome contracts,[28] or more significantly, purchases of stock of different corporations,[29] in order that the corporations might be relieved of a contract previously made with that corporation. The taxpayer argued for extension of these cases to allow a deduction when a company purchases its own stock to relieve itself of a burdensome contract.[30]

Second, the corporation based an argument for the deduction upon a decision in the Fifth Circuit, *Five Star Manufacturing Company v. Commissioner*.[31] The court allowed a deduction for payments by a corporation made to purchase the stock of one of its shareholders. The taxpayer's claim which the court upheld was that the purchase was "necessary" since the corporation could otherwise neither borrow money nor acquire a patent license which was essential to the corporation's business.[32] Applying *Five Star* to the redemption situation in *H. and G. Industries*, the taxpayer argued that because the court allowed a deduction for the entire purchase price of its stock when a valid reason existed, the taxpayer certainly should be permitted to deduct the redemption premium alone since a good faith business reason had motivated the redemption.

In response to this two-part argument, the government placed considerable reliance on § 311(a) of the Internal Revenue Code.[33]

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21 *Id.* at 655.
22 *Id.*
23 This amount is derived as follows:

Number of shares issued (2000) x redemption price ($120)	=	$240,000
Number of shares issued (2000) x issue price ($100)	=	200,000
Redemption premium		$ 40,000

24 *See* note 1 *supra*.
25 H. and G. Industries, Inc. v. Commissioner, 60 T.C. 163 (1973).
26 INT. REV. CODE OF 1954, § 162(a).
27 495 F.2d at 655.
28 *See, e.g.*, Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805 (6th Cir. 1948).
29 *See, e.g.*, Helvering v. Community Bond & Mortgage Corp., 74 F.2d 727 (2d Cir. 1935).
30 495 F.2d at 655.
31 355 F.2d 724 (5th Cir. 1966).
32 *Id.* at 727.
33 The government also argued that John Wanamaker Philadelphia v. Commissioner, 139 F.2d 644 (3rd Cir. 1943) should be controlling in denying the deduction for a stock redemption premium; however, the court in *H. and G. Industries* summarily rejected its application

> Except as provided in subsections (b), (c), and (d), no *gain* or *loss* shall be recognized to a corporation on the distribution with respect to its stock, of—
> (1) its stock (or rights to acquire its stock), or
> (2) property.[34]

This contention necessarily implies that the term "loss" as used in the statute is synonymous with the word "deduction." Thus, any payment ancillary to a stock redemption would seemingly be construed as a nondeductible expense. In support of its position, the government cited *Roberts & Porter, Inc. v. Commissioner.*[35] In *Roberts,* the Tax Court had allowed a deduction for the difference between the call price ($106) and the issue price ($100) of a convertible bond pursuant to a regulation[36] that specifically allowed a deduction for bond premiums. The court, however, denied the deduction for the remainder of the purchase price which was paid in accordance with the issuance agreement. Since the later payments were attributable to the stock into which the bonds were convertible, the court disallowed any further deduction under the authority of § 311.[37] However, the government's reliance on *Roberts* in regard to *H. and G. Industries* is curious for two reasons: (1) It is easily distinguishable from *H. and G. Industries* since in the latter case there was a *stock* redemption as opposed to a bond redemption in *Roberts;* and (2) in *Roberts* the court allowed a deduction for the redemption premium and that was exactly what *H. and G. Industries* was seeking.

Presented with these arguments, the court denied a § 162 deduction for the redemption premium paid by H. and G. Industries solely[38] by distinguishing *Five Star Manufacturing* on its facts.[39] The court held that the facts in *H. and*

to the present case. In *John Wanamaker,* the taxpayer attempted to deduct a redemption premium on the ground that the redeemed security was debt rather than equity, and hence deductible pursuant to a treasury regulation which specifically allowed a deduction for bond redemption premiums. The court, however, held that the security was equity and denied the deduction. 139 F.2d at 647-48. Although *John Wanamaker* denied a deduction for a stock redemption premium, the court in *H. and G. Industries* did not find it controlling. Its rationale was that the court in the former case did not address itself to the issue of whether a stock redemption premium was deductible under § 162(a) as a payment to be relieved of a burdensome contract; rather, it merely addressed the taxpayer's contention that it was deductible as a bond redemption premium. Thus, the taxpayer's unique argument in the stock redemption context rendered *John Wanamaker* not applicable. 495 F.2d at 656.

34 INT. REV. CODE OF 1954, § 311(a) (emphasis supplied).

35 37 T.C. 23 (1961).

36 The regulation section on which the court relied was Treas. Reg. § 1.61-12(c)(1) T.D. 6272, 1957-2 Cum. Bull. 31. This section exists now in similar form as Treas. Reg. § 163-3(c)(1) (1973).

37 37 T.C. at 27-31.

38 The court also cited in a footnote another reason which might prohibit a deduction in the future. It was noted that the cases which the taxpayers cited for the proposition that the deduction should be allowed on the basis of relieving itself of a burdensome contract are distinguishable. In the cases cited by the taxpayer the payments were merely substitutes for payments which would be deductible sometime in the future. In the present case, however, the court said that the payments (redemption premium) were made to avoid future nondeductible dividend payments. The court thus reasoned that in the cited cases the deductions were merely accelerated to an earlier date. 495 F.2d at 657. However, it is important to note two points about the court's statements: (1) the court did not rely on this reasoning to decide the case; rather it was used as a mere surmise or conjecture as to future courts' treatment of the problem; and (2) these statements were directly solely at one facet of the taxpayer's argument—relief from an onerous contract—the court did not relate this attack to other elements of the taxpayer's argument, for example, that which relied on *Five Star Manufacturing.*

39 495 F.2d at 657.

G. Industries did not approach the life or death situation that was present in *Five Star Manufacturing*. Accordingly, the court reasoned that H. and G. Industries would not be forced to go out of existence if it failed to redeem its stock, while in *Five Star* the purchase of its stock was essential to corporate existence.[40] The court argued that the redemption as made was no more than an astute business decision to take advantage of lower interest rates on debt financing.[41] In making this limited decision, the court left unanswered, however, the question whether § 311 was a complete bar to the deduction under *any* circumstances, including corporate life or death situations. The court, however, did acknowledge the legitimacy of § 311 as applicable to the issue at hand when it stated that to allow a deduction in all situations would completely undermine the specific prohibitions of § 311.[42]

III. Conceptual Obstacles to Allowance of the Deduction

A. *The Life or Death Requirement*

As indicated in the consideration of *H. and G. Industries,* one of the primary impediments to the deduction of a stock redemption premium is the requirement that it be necessary to preserve the life of the corporation. This principle was refined in *Jim Walter Corporation v. United States,*[43] which was decided three months after *H. and G. Industries.* There, the taxpayer corporation had purchased some of its own outstanding warrants, ostensibly because it was required to do so by its underwriters in connection with a new public offering.[44] Nevertheless, the Fifth Circuit denied the deduction for the total cost of the warrants by expressly limiting the *Five Star Manufacturing* holding to situations where the purchase is actually necessary to preserve the corporate existence.[45]

Additionally, in *Jim Walter* the court failed to be persuaded by *United States v. Smith,*[46] which the taxpayer had cited. In *Smith,* the taxpayer corporation had assumed certain liabilities of a partnership upon the purchase of its operating assets. The corporation took an ordinary and necessary business expense deduction pursuant to § 162(a) when it satisfied one of these liabilities. The Fifth Circuit, the same court which decided *Jim Walter,* held that if a corporation's primary purpose in assuming the liability was other than to acquire assets, then the deduction may be allowed.[47] Yet, the court in *Jim Walter* was unwilling to establish such a broad principle, based on *Five Star Manufacturing*

40 *Id.*
41 The taxpayer, by redeeming the stock and replacing it with debt financing (7% mortgage notes), decreased its yearly cash outlay. The reason for this is that instead of 8-12½% dividend payments each year, it was now only required to pay 7% interest on the note. Additionally, the interest paid on the note was tax deductible while the dividend payments were not.
42 495 F.2d at 658.
43 498 F.2d 631 (5th Cir. 1974).
44 The underwriters had believed that the warrants might be exercised and, since the agreement with the warrant holders required the corporation to issue high interest bonds in addition to stock there was a concern that the issuance would be impaired. *Id.* at 634.
45 *Id.* at 639.
46 418 F.2d 589 (5th Cir. 1969).
47 *Id.* at 596-97.

and *Smith*, to the effect that a deduction should be allowed for an expense of recapitalization or other reformation of capital structure whenever it serves a business purpose other than the acquisition of property.[48] Instead, it held to the rule that the deduction will be denied unless the purchase is necessary to the taxpayer's survival.[49] This position is puzzling for two reasons. First, there was no mention in either *Five Star Manufacturing* or *Smith* that in order to maintain the deduction it was necessary to demonstrate that the corporation would go out of existence but for the action so taken. However, it is not difficult to understand why the court came to such a conclusion; the facts in *Jim Walter* and *H. and G. Industries* did not match the emergency situation that existed in *Five Star*. Second, to require a corporation to have a life or death circumstance in order to avail itself of a business deduction completely undercuts past judicial interpretations of § 162(a). Specifically, the two requirements[50] of § 162(a) which the life or death requirement undermines are the "ordinary" and "necessary" requirements—typically the two most difficult to satisfy.

To illustrate the inconsistency between the life or death requirement and the judicial interpretations of ordinary and necessary, it is necessary to consider the judicial definitions accorded these two words. First, in order for an expense to be considered "ordinary" it must be normal, usual, or customary in the type of business involved.[51] Also, it has been held that the expense need not be habitual or normal in the sense that the same taxpayer must make them on any regular basis.[52] Additionally, the deduction is not barred if it is unique or nonrecurring,[53] nor is it barred if the payment is voluntary.[54] Certainly, a corporate stock redemption in order to save future expenses and to prevent future decreases in working capital should be considered as an expense which is normal, usual, or customary. Undoubtedly, other corporations, under conditions similar to those facing H. and G. Industries, would pay a premium on a stock redemption in order to replace the equity capital with debt that provides substantially lower fixed[55] yearly payments. Then, too, the courts have held that "necessary," as used in § 162(a), means "helpful and appropriate" in maintaining a business.[56] Furthermore, contrary to the interpretation of *Jim Walter* and the *H. and G. Industries* courts, the expense need not be indispensable or absolutely essential[57] to qualify under § 162(a). Thus, to be granted a § 162(a) business deduction,

48 498 F.2d at 638-39.

49 *Id.*

50 In addition to "ordinary" and "necessary," the courts have fashioned two additional requirements to a § 162(a) deduction: "proximately related to the taxpayer's business," 4A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 25.09, at 54-55 (J. Malone ed. 1972); "reasonable in amount," Commissioner v. Lincoln Electric Co., 176 F.2d 815 (6th Cir. 1949).

51 International Trading Co. v. Commissioner, 275 F.2d 578 (7th Cir. 1960).

52 Welch v. Helvering, 290 U.S. 111, 114 (1933).

53 *Id.*

54 Pepper v. Commissioner, 36 T.C. 886, 895 (1961).

55 In *H. and G. Industries*, even though there was no requirement that the corporation pay dividends on the redeemed preferred stock, the dividends were practically "fixed" since they were cumulative dividends and, if the corporation failed to pay them, it would reduce significantly its ability to sell stock in the future.

56 Welch v. Helvering, 290 U.S. 111, 113 (1933).

57 Slaymaker Lock Co. v. Commissioner, 18 T.C. 1001, 1008 (1952).

it is not required that the taxpayer make the expense in order to survive; rather, it is enough that the transaction is beneficial to the business.[58]

B. *The Origin Test*

Another obstacle which a taxpayer must contend with, in attempting to deduct redemption premiums, is the "origin" test created by the Supreme Court in *United States v. Gilmore.*[59] The test states that in looking at questions involving deductibility of an expense, the focus should be on the origin of the expense and not on "the potential consequences upon the fortunes of the taxpayer."[60] In *Gilmore,* the Court was faced with the question of whether a husband could deduct legal fees incurred in a divorce proceeding. Although divorces are generally personal in nature and thus nondeductible activities, the taxpayer contended that the fees should be deductible since the proceeding involved the applicability of the community property laws to certain business assets.[61] The Court, over the dissents of Justices Black and Douglas,[62] resolved a conflict among the circuit courts by disallowing the deduction because the expense did not have a business origin. Accordingly, the fees were considered nondeductible personal expenses since they had not originated from business activity. The fact that the fees were incurred to protect income-producing assets was rendered nugatory by the Court because this was regarded as merely a "consequence" of the original purpose for incurring the expense.[63]

Although the origin test was not used to deny the redemption premium deduction in *H. and G. Industries,* there is an indication that it may be used in the future since the court in *Jim Walter* placed considerable emphasis on it. The taxpayer there attempted to use the test to obtain a deduction for the cost of the warrants by contending that the warrants had "originated" with the issue of stock rather than the issue of bonds.[64] Thus, the taxpayer contended the issuance was initiated for the deductible business purpose of saving interest.[65] The court failed to be persuaded by this argument and applied the *Gilmore* rationale, though in a different manner. It held that the payment to repurchase the warrants was required by the underwriters in connection with a public offering and was thus a recapitalization expense.[66] The purchase of the warrants, having been characterized as a recapitalization expense by the court, was then held nondeductible pursuant to existing precedents.[67] There is a flaw, however, in the court's application of *Gilmore* to the issue presented in *Jim Walter.* The Supreme Court in the former case was concerned with the deductibility of the expense from the perspective of whether its origin was business or personal in

58 Commissioner v. Pacific Mills, 207 F.2d 177 (1st Cir. 1953), *aff'g* 17 T.C. 705 (1951).
59 372 U.S. 39 (1963).
60 *Id.* at 49.
61 *Id.* at 40.
62 *Id.* at 52.
63 *Id.* at 51-52.
64 498 F.2d at 635.
65 *Id.*
66 *Id.* at 638.
67 United States v. Hilton Hotels, 397 U.S. 580 (1970); Woodward v. Commissioner, 397 U.S. 572 (1970); Estate of Meade v. Commissioner, 489 F.2d 161 (5th Cir. 1974).

nature, rather than with whether such expenditures were capital in nature or ordinary business expenses:

> [W]e resolve the conflict among the lower courts on the question before us in favor of the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of *whether the expense was "business" or "personal"* and hence whether it is deductible or not. . . .[68]

Thus, the Fifth Circuit's application of the *Gilmore* test to questions involving capital origins is a clear extension of the test to areas not contemplated in the Supreme Court decision.

As previously indicated, this test has not been used to deny the deduction for redemption premiums; however, its expansion to other situations[69] makes it reasonable to assume that in the future taxpayers attempting to use the deduction will be confronted with the test. Conceivably, it may be the government's most potent weapon in combating the deduction since the *Jim Walter* rationale can now be used to deny the deduction. Undoubtedly, if the issue arose again, the Internal Revenue Service would argue that even though there was an overriding corporate business interest in redeeming the stock, it would not be deductible because the expense originated in the issuance or acquisition of equity capital and was thus a nondeductible capital expense.

C. *Section 311*

As noted previously, a major element of the government's argument in *H. and G. Industries* was that § 311 constituted a complete bar to an ordinary and necessary deduction for a redemption premium. Section 311 prohibits, with certain exceptions, the recognition of gains and losses on distributions with respect to stock. At first glance it appears that the government's position in *H. and G. Industries* is unassailable. However, the validity of its argument is suspect for two reasons. First, there is a flaw in the contention that § 311 constitutes an absolute bar to an ordinary and necessary deduction because the statute only forbids the recognition of losses not deductions. This phraseology employed by Congress is significant since the Code makes a clear distinction between the concepts of a loss and deduction. Second, the legislative history of § 311 raises doubt as to whether the enactment was intended to deny an ordinary and necessary deduction; rather, it seems that it was intended to bar corporations from recognizing gains and losses, whether capital or otherwise, on the exchange of its assets.

As regards the first reason stated above, the presence of the term *"loss"* in

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68 372 U.S. at 49 (emphasis supplied).

69 *See* United States v. Hilton Hotels, 397 U.S. 580 (1970) (appraisals for mergers); Woodward v. Commissioner, 397 U.S. 572 (1970) (appraisal, attorney's, and accountant's fees for mergers); Jim Walter Corporation v. United States, 498 F.2d 631 (5th Cir. 1974) (warrant purchases); Estate of Meade v. Commissioner, 489 F.2d 161 (5th Cir. 1974) (legal fees for antitrust claim).

§ 311 is an indication that Congress did not intend to deny an ordinary and necessary deduction. In support of this conclusion consider the part of the Internal Revenue Code's Income Tax Subtitle entitled "Itemized Deductions for Individuals and Corporations."[70] This part consists of sections which allow, disallow, or limit certain types or categories of deductions. Included therein are § 162[71] and § 165.[72] These provisions deal respectively with "Trade or Business Expenses" (ordinary and necessary expenses) and "Losses." Additionally, the part treats other expenses such as: interest,[73] taxes,[74] depreciation,[75] and charitable contributions.[76] Clearly, then, losses as used in § 165 and ordinary and necessary expenses as used in § 162 are mere categories or types of deductions which may either be prohibited or allowed. Thus, based on the treatment of deductions under this construction of the statute, it is evident that the government's interpretation of § 311 in *H. and G. Industries* was inaccurate because § 311 prohibits only a specific type of deduction, a loss deduction pursuant to § 165. Furthermore, the enactments should not be construed as barring the recognition of all deductions because if Congress had intended this in § 311, undoubtedly it would have used the more generic term deduction rather than using a mere category of a deduction—loss.

Moreover, there are indications in the Code that Congress, in using the phrase "gain or loss," intended to prohibit the recognition of gains and losses on the sale or exchange of assets rather than to prohibit ordinary and necessary deductions. To illustrate this finding it is necessary to consider the only Code sections dealing exclusively with the phrase "gain or loss"; i.e., Subchapters O[77] and P[78] of the Income Tax Subtitle of the Code. These subchapters treat "Gain or Loss on Disposition of Property" and "Capital Gains and Losses," respectively. Included in these provisions are sections which specify the determination of the amount and recognition of gain or loss,[79] the treatment of wash sales of stock and securities,[80] capital gain and loss treatment,[81] and general and special rules for determining capital gains and losses.[82] Although these sections encompass different income tax concepts, there is an element common to all: Each pertains to the recognition of gains or losses *on the sale or exchange of assets,* while none pertain to the ordinary and necessary expense deduction of § 162. Hence, since it appears that the term "gain or loss" is used in the Code to deal with the resultant tax effect of a sale or exchange of assets, the term undoubtedly has a more specific meaning than that which the government attached to it in *H. and G. Industries.* This view was raised by the attorney for H. and G. Industries during the oral argument of the

70 INT. REV. CODE OF 1954, §§ 161-88.
71 INT. REV. CODE OF 1954, § 162.
72 INT. REV. CODE OF 1954, § 165.
73 INT. REV. CODE OF 1954, § 163.
74 INT. REV. CODE OF 1954, § 164.
75 INT. REV. CODE OF 1954, § 167.
76 INT. REV. CODE OF 1954, § 170.
77 INT. REV. CODE OF 1954, §§ 1001-1111.
78 INT. REV. CODE OF 1954, §§ 1201-53.
79 INT. REV. CODE OF 1954, §§ 1001-02.
80 INT. REV. CODE OF 1954, § 1091.
81 INT. REV. CODE OF 1954, §§ 1201-12.
82 INT. REV. CODE OF 1954, §§ 1221-53.

case before the Third Circuit;[83] it was his belief that the court was persuaded by his argument.[84] Although the court did not directly address this issue in its opinion, his belief was apparently accurate because the court did recognize that if a life or death situation existed, § 311 might not constitute a complete bar to an ordinary and necessary deduction for a redemption premium.[85]

Further indicia appear in § 311's legislative history that the intention of Congress was to prohibit the recognition of gains and losses on *sales or exchanges of assets* rather than to deny the application of § 162 on corporate stock redemptions. The statute, according to the Senate Committee Report on § 311,[86] was passed to incorporate the Supreme Court's holding in *General Utilities & Operating Co. v. Helvering*.[87] This case involved a corporate distribution of appreciated property which was made in order to avoid tax on the capital gain that would have resulted if the corporation had sold the property. Although the government argued that the sale should have been attributed to the corporation rather than the distributee-shareholders, the Court allowed the transaction to remain untouched.[88] After the decision, *General Utilities* had always been cited for the rule that no gain or loss should be recognized on the distribution of a corporation with respect to its stock.[89] In 1954, Congress codified the *General Utilities* holding by enacting § 311. Thus, clearly, codifying *General Utilities* and in employing the term "gain or loss" rather than "deduction," Congress intended that § 311 was to apply to deny a gain or loss on the sale or exchange of property[90]—a far different focus than the prevention of an ordinary and necessary expense deduction.

IV. Conclusion

Future attempts to deduct a redemption premium pursuant to § 162(a)

83 Conversation with Mr. Martin D. Cohen, attorney for H. and G. Industries and member of the New Jersey Bar, Dec. 27, 1974 (transcript on file at *Notre Dame Lawyer* office).

84 *Id.*

85 "[W]e therefore do not reach the question of whether a § 162 deduction limited to more *oppressive corporate circumstances* than those presented by the instant case would be consistent with § 311." 495 F.2d at 658. (Emphasis added.)

86 S. Rep. No. 1622, 83d Cong., 2d Sess. 247 (1954).

87 296 U.S. 200 (1935). Although the Senate Committee Report did not specify this case by name, most commentators believed that this is the one that the committee was referring to. *See* note 89 *infra*.

88 296 U.S. at 206-07. The Court did not decide this point directly but merely reversed the lower court's holding which had attributed the sale to the corporation. The Court did not decide the issue involving attributing the transaction to the corporation rather than the shareholders because of a procedural mistake by the government. *Id.*

89 *See, e.g.*, J. Chommie, The Law of Federal Income Taxation 576 (2d ed. 1973); Mintz & Plumb, *Dividends in Kind—The Thunderbolts and the New Look*, 10 Tax Law Rev. 41, 44-45 (1954).

90 When Congress enacted § 311(d), in 1969, it presented another indication that § 311 was intended to address uses or abuses of sales or exchanges of assets as compared with uses or abuses of deductions. This subsection states that when appreciated property is distributed to redeem stock, gain must be recognized on the difference between the fair market value of the stock and the adjusted basis of the property distributed. The Senate Committee Report of this amendment to § 311 indicates that Congress was concerned with the practice of certain insurance companies of distributing appreciated stock to shareholders in exchange for their own stock. S. Rep. No. 552, 91st Cong., 1st Sess. 279 (1969). Note that this scheme was similar to that in *General Utilities* and its effect was basically the same—gains were attributable to the shareholders, with the result that capital gains tax was avoided at the corporate level.

will encounter intense opposition from the Internal Revenue Service and the courts. Specifically, since the IRS will possess the conceptual weapons discussed above,[91] a taxpayer corporation will have considerable difficulty in sustaining its burden of proof on the allowance of the deduction. Yet, this burden may not be insurmountable. Indeed, of the three obstacles to the deduction which were analyzed, the origin test is the only one which a perceptive court should employ to deny the deduction; the remaining two obstacles, however, are imperfect rationales for disallowing the deduction.

Even though the life or death requirement is poorly reasoned, the courts will probably continue to use it to deny the deduction. As previously indicated, requiring corporations to have a life or death situation facing them as a prerequisite to deduction of a redemption premium when another valid business reason already exists is contrary to the ordinary and necessary requirements of § 162(a).[92] A better approach would allow a corporation to deduct the premium if it redeems to conserve working capital, or if it redeems to relieve itself from a burdensome contract obligation. This approach should not be attacked on the ground that it fails to meet the requirements of § 162(a) since it is an expense which satisfies the judicial interpretation of "ordinary and necessary."[93] The courts, however, as evidenced by the recent decision in *Jim Walter Corporation,* are apparently placing increasing stress on the life or death requirement thus making it a continued hindrance to corporations which attempt to deduct redemption premiums.

Although the government's position on § 311 contains flaws, it does retain some validity to the redemption premium question. As examined above, there is considerable doubt whether it was the intention of Congress, in enacting § 311, to deny a § 162(a) deduction; yet, there is commentary[94] that the section should properly apply to deny a loss deduction when depreciated property is used to redeem the stock. To illustrate the correct application of § 311 to the problem, assume a corporation needed to redeem a share of stock which was issued at $100 and which is callable at $120. Assume further that the redemption payments to the shareholder consist of property which is currently worth $120 (the redemption price) but which has an adjusted basis of $130.[95] If § 311 did not apply, the corporation might have a $10 loss deduction.[96] Section 311, however, should properly be applied to deny the $10 deduction; but it should not apply to deny the $20 ordinary and necessary deduction for the amount

91 See text accompanying notes 43-90 *supra.*
92 *Id.*
93 *Id.*
94 Hutton, *Business Expense Deduction for Premium Paid upon Redemption,* 1 J. CORP. TAX. 346-47 (1974).
95 Note that if the asset which was distributed had an adjusted basis of less than $120, § 311(d) would require that the corporation recognize a gain on the difference between the asset's fair market value and its adjusted basis.
96 The $10 loss is derived as follows:

Redemption price	$120
Fair market value	130
	$(10)

attributable to the premium.[97] This treatment comports with the proper purpose of the statute since § 311 is used to deny a loss deduction on the exchange of an asset, rather than to deny a § 162(a) ordinary and necessary expense deduction.

Notwithstanding the flaws in the arguments against the deduction for stock redemption premium payments, it is believed that most attempts to deduct it pursuant to § 162(a) will fail. The transaction will be attacked on the ground that it had its origin in a capital undertaking[98] and is therefore nondeductible in accordance with § 263.[99] A successful attempt at deductibility, however, may be realized if the corporation needs to purchase or redeem due to a life or death situation or similar circumstances. *Jim Walter Corporation v. United States,* one of the most important recent decisions which have employed the origin test to disallow deductions due to capital origins, has apparently carved out an exception to this general rule. This opinion can only be interpreted as holding that a life or death situation somehow negates the effects of the origin test. Thus to suggest to a corporate client that it deduct a redemption premium in other than life or death situations would be precarious in light of the existing judicial trends.

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97 The $20 redemption premium is the difference between the call price ($120) and the issue price ($100).

98 A capital undertaking in that the payment arose as a result of the issuance or acquisition of stock.

99 INT. REV. CODE OF 1954, § 263.