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Taxation-Federal Income Tax- Taxpayer's Dividend to Shareholders Allowable As Amortizable Bond Premium Deduction

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TAXATION—FEDERAL INCOME TAX—TAXPAYER'S DIVIDEND TO SHAREHOLDERS ALLOWABLE AS AMORTIZABLE BOND PREMIUM DEDUCTION—In an effort to make an amount distributed to its shareholders tax deductible, taxpayer bought utility bonds which were selling at a large premium and which were callable on thirty days' notice. Taxpayer borrowed an amount equal to the lowest call price, mortgaged the bonds to secure the loan, and paid cash equal to the difference, *i.e.*, the premium in this case. After holding the bonds for thirty days, taxpayer declared a dividend of the bonds and distributed them to its shareholders subject to the indebtedness. The shareholders sold the bonds, paid off the loan from the proceeds, and retained the difference as the cash dividend. Taxpayer claimed the amount of the premium as an amortizable bond premium deduction under section 171 of the Internal Revenue Code of 1954.[1] The Commissioner disallowed the deduction and was sustained by the Tax Court on the ground that the transaction in the bonds was a sham to cover the real purpose of distributing a dividend.[2] On appeal, *held,* reversed. The taxpayer made actual investments in the ordinary sense of the word and was subjected to the risks of ownership for which the statute was designed to compensate. Unless Congress clearly provides otherwise, tax consequences should not be dependent upon the discovery of a purpose or a state of mind. *Fabreeka Prods. Co. v. Commissioner,* 294 F.2d 876 (1st Cir. 1961).

The court's conclusion that the investments by the taxpayer were real and therefore the deduction should be allowed leaves unanswered the question of what distinguishes a real transaction from one that is sham. The court offers no standards by which it qualitatively distinguishes this transaction from others which in the past have been found by the courts to be sham notwithstanding literal compliance with the terms of a section of the revenue code which a taxpayer claimed afforded it some tax advantage.[3]

1 INT. REV. CODE OF 1954, § 171:

"(a) General rule.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium [determined under subsection (b)] on the bond:

"(1) Interest wholly or partially taxable.—In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction. . . .

"(b) Amortizable bond premium.—

"(1) Amount of bond premium.—For purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined—

"(A) with reference to the amount of the basis (for determining loss on sale or exchange), of such bond,

"(B)(i) with reference to the amount payable on maturity or on earlier call date . . . .

"(2) Amount amortizable.—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. . . .

"(d) Bond defined.—For purposes of this section, the term 'bond' means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest. . . ."

The Senate Report on the draft of the 1954 Code pointed out that the law allowed amortization of the full premium in a single year in the case of a bond which was callable on 30 days' notice and was issued prior to Jan. 22, 1951. See S. REP. No. 1622, 83d Cong., 2d Sess. 30 (1954). The bonds in the present case were issued Feb. 1, 1948, and acquired by the taxpayer Nov. 16, 1954.

2 Fabreeka Prod. Co. v. Commissioner, 34 T.C. 290 (1960).

3 See, *e.g.,* Knetsch v. United States, 364 U.S. 361 (1960); Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938); Gregory v. Helvering, 293 U.S. 465 (1935).

The supposed distinction between real and sham transactions has its foundation in efforts by the judiciary to formulate tests to aid in the decision of cases which present situations outside the contemplation of Congress when it enacted the tax laws.[4] These tests have variously taken the form of the "sham transaction" concept,[5] decision on the basis of policy,[6] "binding transaction" concept,[7] "business purpose rule,"[8] or "step transaction rule,"[9] to name but a few. It has been suggested that only two of these tests have any substance—the so-called "business purpose rule" and the "step transaction rule." Under the "business purpose rule," in order for a transaction by the taxpayer to be given the hoped-for tax consequences, it must have a business purpose other than or in addition to the avoidance of tax liability.[10] The application of this test to the facts of the present case would appear to have dictated a result contrary to that reached by the court, since the only purpose behind the transactions in the bonds was to distribute a dividend to the shareholders in a manner which would yield a tax deduction. Under the "step transaction rule," when several steps are taken in a transaction, the end result of which could be achieved in a single step, the effect of the entire transaction is considered rather than the effects of its separate parts.[11] The application of this test to the present facts would also appear to have indicated a result adverse to the taxpayer, since the total result of the several steps in the bond transactions was the payment of a cash dividend to shareholders which ordinarily produces no tax deduction.

While the use of these tests is valuable in proper cases, they are subject to the objection that they require an inquiry into the intent of the taxpayer. In the "business purpose rule" the inquiry is directed toward the motive of the taxpayer in effecting the transaction in question. In the "step transaction rule" the inquiry is into whether the taxpayer would have taken any of the intermediate steps apart from his scheme to effect the final result. In either case the inquiry is too subjective to be susceptible of definite proof. This objection, together with the self-imposed restraints upon "judicial legisla-

4 For an indictment of such "decision by invective," see Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021 (1953).

5 See Gregory v. Helvering, 293 U.S. 465 (1935).

6 Bullen v. Wisconsin, 240 U.S. 625 (1916).

7 Johnson v. Commissioner, 86 F.2d 710 (2d Cir. 1936).

8 See Gregory v. Helvering, 293 U.S. 465 (1935).

9 See Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938).

10 See National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Higgins v. Smith, 308 U.S. 473 (1940); United States v. Lynch, 192 F.2d 718 (9th Cir. 1951); Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949). This test emphasizes the fundamental difference between entering a given transaction merely for the purpose of evading taxes and conducting one's business in a manner which will minimize its tax liability.

11 See Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Helvering v. LeGierse, 312 U.S. 531 (1941); Budd Int'l Corp. v. Commissioner, 143 F.2d 784 (3d Cir. 1944).

tion," tend to restrict the formulation or application of any of these judicial tests, except in cases of actual necessity.

The necessity which justifies such judicial rule-making has its foundation in the fact that congressional draftsmen cannot be expected to be foresighted enough to draft a tax code with sufficient precision to eliminate all unintended loopholes. Even if such a precise code could be drawn, it would be undesirably complex and unwieldy.[12] Therefore, enterprising taxpayers may be expected to devise schemes which satisfy the literal terms of the statute, but which lead to results which could not possibly have been intended by Congress. To the courts then must necessarily fall the burden of preventing these unintended results. The courts' job is not merely one of statutory construction but rather it is often one of making rules to fill in the interstices of the statutory law. In many instances not only the language of a statute fails to touch the case at hand, but its legislative history fails to reveal any congressional intent whatsoever, since the particular transaction in question was never envisioned by Congress.[13] The damage which flows from permitting such tax avoidance schemes to succeed is not simply the loss of revenue from those taxpayers. Other taxpayers may be tempted to take advantage of the same schemes, thus increasing the burden of tax administration. When purely formalistic compliance with statutory requirements is allowed to produce tax bounties, public confidence in the fair apportionment of the tax burden is impossible—further hampering efficient tax administration. Judicial rule-making is justified, then, when extra-statutory rules are necessary to prevent these prospective damages. In the absence of such danger, however, the tax laws should be given literal application so as to permit the planning of business affairs with the desired amount of certainty.

Section 125 of the 1939 Code,[14] the predecessor of section 171, provided for amortization of bond premiums to maturity or to the earliest call date. This allowed a holder of bonds callable at the will of the issuer to amortize the entire premium in a single year and claim it as a deduction from its income, regardless of whether the bonds were actually called. This generated extensive trading in callable bonds by which taxpayers purchased the bonds, claimed the premium deduction for that year, held the bonds for six months,

12 See Rice, *supra* note 4, at 1022.

13 It was curious that the opinion of the court suggested that § 171 was designed to compensate holders of callable bonds for the risk that the bonds would be called before maturity producing a capital loss. The legislative history of the section indicates that the deduction was aimed merely at equalizing the position of holders of taxable bonds with the position of holders of non-taxable bonds. Since part of the "interest" received on a premium bond is actually considered to be recovered capital, it was deemed unfair that it should be taxed as income to holders of taxable bonds and not taxed at all to holders of tax-exempt bonds. See H. REP. No. 2333, 77th Cong., 2d Sess. 47 (1942).

14 Int. Rev. Code of 1939, § 125, added by 56 Stat. 822 (1942).

and then could dispose of the bonds at market price, paying only capital gains rates on the amount received upon resale which was in excess of the basis of the bonds. The basis had, of course, been reduced by an amount equal to the amortized premium which had been allowed as a deduction.[15] In 1954 the new code changed the then-existing law by providing that bond premiums could be amortized to the earliest call date only in the case of bonds which were callable more than three years from the date of issue,[16] but limited this provision to bonds issued after January 22, 1951, in order to protect the value of issues outstanding at the time of the enactment of the code.[17] The legislative history of the 1954 Code indicated that the changes to section 125 were expressly designed to prevent the exploitation of the unwarranted tax avoidance possibilities of the existing law.[18] Taxpayers found, however, that the same scheme could be achieved simply by buying callable bonds after they were more than three years old. In 1958 Congress again amended section 171 to provide that premiums on callable bonds must be amortized to maturity in the case of all bonds acquired by taxpayers after December 31, 1957, regardless of the date of issue.[19] Thus, future imitation of the scheme presented by this case is virtually impossible, and the possibility of the prospective detriment to the federal tax program, which supports judicial rule-making, was not present when this case was finally decided.[20] In the absence of such necessity and in view of the plan adopted by Congress which attempted to curb the type of scheme presented by this case without resorting to any test of taxpayers' intent, which is necessarily involved in the court-made rules, the decision probably should have been based upon a literal application of the statute without a consideration of the meaningless distinction between real and sham transactions.

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15 INT. REV. CODE OF 1954, § 1016(a)(5) provides for an adjustment to the basis of any bond as defined in § 171(d), the interest on which is not tax exempt, to the extent of the deduction allowed pursuant to § 171(a)(1).

16 Int. Rev. Code of 1954, § 171(b)(1)(B), 68A Stat. 61.

17 Since the bonds here in question were issued Feb. 1, 1948, they were within the express exception to the 1954 change.

18 See S. REP. No. 1622, 83d Cong., 2d Sess. 30 (1954).

19 72 Stat. 1610 (1958). See also S. REP. No. 1983, 85th Cong., 2d Sess. 130 (1958). Of course, if a taxpayer is presently holding callable bonds which were acquired prior to Dec. 31, 1957, he might still devise some scheme to take advantage of the rule in this case. The history of the trading in such bonds, however, would not indicate any grave danger to the federal revenue represented by this sort of bondholder.

20 Substantially the same issue was presented in a number of cases immediately before and after the present case, and all were decided in the same way. Hanover Bank v. Commissioner, 369 U.S. 672 (1962); Evans v. Dudley, 295 F.2d 713 (3d Cir. 1961), *cert. denied*, 370 U.S. 909 (1962); Maysteel Prods., Inc. v. Commissioner, 287 F.2d 429 (7th Cir. 1961). Two companion cases were decided along with the principal case, Sherman v. Commissioner and Friedman v. Commissioner, 294 F.2d 876 (1st Cir. 1961).