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Taxation - Federal Income Tax Deductibility of Interest on Debentures Issues as a Dividend

Jules M. Perlberg
University of Michigan Law School

TAXATION—FEDERAL INCOME TAX—DEDUCTIBILITY OF INTEREST ON DEBENTURES ISSUED AS A DIVIDEND—Taxpayer, a wholly-owned subsidiary corporation, had filed consolidated returns with its parent prior to 1934. When Congress abolished consolidated returns in that year, the subsidiary issued 6% debentures as a dividend to the parent company and subsequently deducted the interest paid on these bonds. The Commissioner claimed the interest payments were really dividends and were not deductible. The Tax Court upheld the Commissioner pointing out the tax-saving motive, absence of new investment, and parent-subsidiary relationship as factors indicating that no genuine debtor-creditor relationship existed.[1] On appeal, *held,* reversed. The debentures involved were conventional in form and created a valid indebtedness. *Kraft Foods Co. v. Commissioner,* (2d Cir. 1956) 232 F. (2d) 118.

Tax preferences accorded to debt securities, but not ownership securities, have resulted in attempts to better the corporate tax position through utilization of debt capitalization in place of ownership capital. The Internal Revenue Code permits the deduction of interest payments on indebtedness[2] but does not allow deduction of dividend payments on stock.[3] For this reason the courts scrutinize the underlying security upon which the payment is based to determine whether such instrument constitutes genuine indebtedness or merely equity capital. Despite frequent litigation in this area, no comprehensive rule has been established to aid in this distinction.[4] In the case of hybrid securities, i.e., corporate investments having char-

[1] Kraft Foods Co., 21 T.C. 513 (1954).

[2] I.R.C., §163.

[3] But see I.R.C., §247, as to deductibility of dividends on public utility preferred stock.

[4] The Supreme Court has said: "There is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether obligations are risk investments in the corporations or debts." John Kelley Co. v. Commissioner, 326 U.S. 521 at 530 (1946). See 44 MICH. L. REV. 827 (1946).

acteristics both of conventional debt and equity issues, the courts weigh such factors as nomenclature, certainty of payment, maturity date, source of payment, treatment on corporate books, voting rights, and subordination to rights of other creditors, in order to characterize the transaction.[5] However, even when there is no ambiguity as to the nature of the instrument, courts sometimes treat interest on conventional indebtedness as a nondeductible dividend.[6] The presence of a tax avoidance motive, accompanied by the absence of a business purpose,[7] are circumstances that may negate the intention to create a valid indebtedness.[8] This emphasis placed upon the tax avoidance motive has caused increasing confusion and contradiction in several recent decisions. In earlier cases the Tax Court looked primarily at the reality of the indebtedness.[9] More recently the emphasis has been placed on the taxpayer's purpose.[10] In the principal case the Second Circuit stressed that inquiry into a taxpayer's purpose was unnecessary so long as the acts were real and the taxable entities were not shams.[11] In apparent conflict with this case is another recent decision, *Gooding Amusement Co.*,[12] where deduction of interest on promissory notes issued to family partners for full property value was disallowed. The Tax Court found that the formal criteria of indebtedness were "unquestionably satisfied" but concluded that the tax avoidance motivation negated the existence of bona fide indebtedness. The result reached in the *Gooding* case could be partially attributed to a failure to distinguish between hybrid and conventional debt securities.[13] The principal case, in recognizing this

[5] See 2 P-H 1956 Tax Serv. ¶13,096 for a useful table of cases analyzing in chronological order the various tests used by the courts.

[6] Gooding Amusement Co., 23 T.C. 408 (1954), affd. (6th Cir. 1956) 236 F. (2d) 159. But cf. Toledo Blade Co., 11 T.C. 1079 (1948), affd. (6th Cir. 1950) 180 F. (2d) 357, cert. den. 340 U.S. 811 (1950).

[7] In disallowing the deduction of interest on conventional indebtedness, the courts sometimes rely upon the "business purpose" doctrine, originated in Gregory v. Helvering, 293 U.S. 465 (1935). In that case a transaction formally complying with statutory requirements was held to be unavailing to reduce taxes unless taken with a business purpose. Although the Gregory decision concerned reorganization, the doctrine has been applied to other areas of tax law including the determination of whether securities constitute stock or debt. See, e.g., Gooding Amusement Co., note 6 supra. See generally Rice, "Judicial Techniques in Combating Tax Avoidance," 51 MICH. L. REV. 1021 (1953).

[8] Estate of Herbert B. Miller, 24 T.C. 923 (1955).

[9] See, e.g., Annis Furs, Inc., P-H T.C. Mem. Dec. ¶43,050 (1943).

[10] Gregg Co. of Delaware, 23 T.C. 170 (1954); Estate of Herbert B. Miller, note 8 supra. But cf. John W. Walter, Inc., 23 T.C. 550 (1954); Lansing Community Hotel Corp., 14 T.C. 183 (1950).

[11] Principal case at 128.

[12] Note 6 supra.

[13] In the Gooding case the court pointed out the absence of new capital. The Kraft case dealt with the requirement of new funds to support the obligation by distinguishing decisions involving hybrid and conventional debt issues. When an ambiguous instrument is being characterized, the courts may consider the absence of new investment in not permitting the security to be considered debt. See, e.g., Wetterau Grocery Co. v. Commissioner, (8th Cir. 1950) 179 F. (2d) 158; 1432 Broadway Corp., 4 T.C. 1158 (1945), affd. (2d Cir. 1947) 160 F. (2d) 885. When an unambiguous security is created, it is held that

distinction, preserves useful approaches developed by the courts. Tax avoidance motives should invite careful scrutiny of the transaction, especially when the taxpayer desires to gain tax advantages through instruments which purport to represent indebtedness while retaining some proprietary characteristics. However, when taxpayers establish an unambiguous debt, a purpose of minimization or avoidance of taxes should not upset this legal transaction.[14] The contradictory language in the *Kraft* and *Gooding* cases emphasizes the need for the courts to continue distinguishing conventional debts, hybrid securities, and sham transactions.[15] In the light of congressional reluctance to define corporate stocks and securities for tax purposes,[16] the *Kraft* decision appears to be a definitive judicial approach which acknowledges proper consequences of unambiguous debt issues.[17]

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valid indebtedness may be created from funds originally part of the debtor's equity capital. See, e.g., Lansing Community Hotel Corp., note 10 supra; Toledo Blade Co., note 6 supra.

[14] Sun Properties v. United States, (5th Cir. 1955) 220 F. (2d) 171. See Sutherland, "Taxpayers' Motive as a Basis for Taxability," N.Y.U. EIGHTH ANNUAL INSTITUTE ON FEDERAL TAXATION 990 (1950).

[15] See Kaufman, "Income Tax Consequences of Corporate Debentures," N.Y.U. SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION 1016 at 1027 (1949).

[16] S. Rep. 1662, 83d Cong., 2d sess., p. 42 (1954).

[17] The court in the Kraft case, expressly rejecting absence of business purpose and absence of new capital as determinative factors in unambiguous debt issues, did not pass on the merits of the "thin capitalization" rule. This rule, another outgrowth of the business purpose rationale, has been used by the courts when a disproportionate ratio of debt to equity capital existed. The Kraft decision considered the thin capitalization test by showing that it did not apply when real values were used to compute the debt-equity ratio. The use of this test, therefore, still remains as a possible factor in disregarding otherwise valid indebtedness for tax purposes. The courts are divided as to the applicability of the test. See generally "Thin Capitalization and Tax Avoidance," 55 COL. L. REV. 1054 (1955). Compare Rowan v. United States, (5th Cir. 1955) 219 F. (2d) 51, with Isidor Dobkin, 15 T.C. 31 (1950).