# TAX ARBITRAGE IN THE PHILIPPINE SETTING - TAX EVASION OR TAX AVOIDANCE?

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*The question of whether a certain measure to minimize taxes due constitutes the legal tax avoidance or the illegal tax evasion is one often asked but is quite difficult to answer. Tax arbitrage is one such measure, wherein taxes are minimized by profit taking in an investment where one part is taxed differently from the other. The main focus of this paper is on back-to back loans as a form of tax arbitrage. The main arguments presented favor the position that tax arbitrage is tax evasion and not tax avoidance. The writer supports this position with an analysis of legislative and jurisprudential history on the subject and of prevailing Philippine and U.S. tax doctrines relative to the concept of tax arbitrage. This paper likewise provides an introduction into the concept of tax arbitrage under both the U.S. and Philippine jurisprudence. The concept of tax arbitrage under the National Internal Revenue Code is also covered, along with a brief discussion on the distinction between tax avoidance and tax evasion.*

## INTRODUCTION

It is perhaps in the field of taxation that we find most attempts to escape requirements of the law. The interplay of high income tax rates with tax provisions granting substantially more favorable treatment of certain kinds of income has led the ingenious tax adviser to come up with myriad transactions which are entered for purposes of reducing taxes. One such transaction which has recently been the subject of renewed attention is tax arbitrage.

Tax Arbitrage[1] generally refers to any investment which generates a profit because one part of the transaction is taxed differently from the other part. The combination of making deductions of interest payments on borrowings associated with tax-preferred assets is by far

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1 The term "tax arbitrage" was coined by David Bradford. Bradford, *The Economic Policy Toward Savings*, 2 THE GOVERNMENT AND CAPITAL FORMATION 11, 41 (1980).



the most common form of tax arbitrage. Hence, where the interest deduction is not restricted and a tax-favored income may be combined with currently deductible interest, tax arbitrage is said to arise.

In the Philippine setting, many high income taxpayers resort to various forms of tax arbitrage available under the National Internal Revenue Code (NIRC). But the most risk-free and convenient form of tax arbitrage is the back-to-back loan arrangement. Thus, it is not surprising that recently, the Bureau of Internal Revenue (BIR), in its effort to improve tax collection or tax administration, has subjected interest deductions to more scrutiny.

The amount of interest payment which is deductible is not ordinarily subject to limitation. For tax purposes, the courts do not ask whether the interest charge is reasonable provided the taxpayer can show a bonafide obligation. Hence, in engaging in tax arbitrage it is inevitable that taxpayers will sometimes avoid taxes by tendering purely formal compliance with statutory requirements as a justification for nontaxability. They reason that a statute should be considered to mean no more and no less than what it says. It has been said that to abandon the moorings established through the statutory structure might create difficulties and uncertainties more objectionable in their results than any seeming inequities which would be eliminated or prevented.[2] Such reasoning may be justified for admittedly, a cursory reading of the Tax Code provision allowing interest deductions would show that it is broad enough to authorize the deduction of tax arbitrage interest.

The courts in the past seemed to have looked only at the legal relationship established by the transaction in determining tax liability. However, in recent years, the courts have demonstrated its unwillingness to be bound merely by the legal relationships set up by the taxpayer. They have evoked judicial doctrines to combat attempts of taxpayers to avoid taxes, namely, the business purpose test, the substance over form and the sham transaction doctrines. It thus appears that the courts realize that the letter of the law cannot always be the sole critirion in deciding tax cases. This is despite judicial utterances in admittedly hard cases that the remedy for preventing circumvention of taxes lies with the legislature.

At present, there is a confusion, unsettled in our jurisdiction, whether interest payments arising from abusive tax arbitrage transactions are valid deductions from gross income because they fall squarely

2 *Eaton v. White*, 70 F.2d 449, 452 (1934).

on the the Tax Code provisions allowing interest deduction (tax avoidance); or whether such interests are unallowable deductions because they are created by means of an illegal circumvention of the law (tax evasion).

*Objective of the study*

The question which this thesis aims to answer is: To what extent may a taxpayer go in manufacturing interest deduction?

This writer will determine the propriety of deducting interest on borrowings to finance tax favored investment when the transaction is entered into solely to reduce taxes by focusing on the particular form of tax arbitrage that is the most controvertial in the Philippine situation, back-to-back loan transactions.

The writer will furthermore: 1) explain the concept of tax arbitrage; 2) cite common arbitrage opportunities under the Tax Code; 3) study the legislative history of the Tax Code provisions on interest income and deductions to ascertain legislative intent; 4) distinguish tax avoidance and tax evasion; and 5) analyze all possible arguments against tax arbitrage bearing in mind the well-settled rule that the taxpayer has the right to decrease or altogether avoid his taxes by means which the law permits, his motive being irrelevant in determining the tax consequences of his transactions. Hopefully, the line drawn between tax evasion and avoidance in so far as interest deductions arising from abusive tax arbitrage transactions are concerned will be made clear.

## I. UNDERSTANDING TAX ARBITRAGE

### *A. What is tax arbitrage?*

In a nontax context, the term "arbitrage" refers to the process of profiting from the simultaneous, or nearly simultaneous, purchase and sale of assets priced differently in different markets. The term is usually used in common parlance to refer to financial or economic arbitrage which an investor can engage in simply by borrowing at a rate lower than the rate of return on investment.

Financial arbitrage would be profitable regardless of tax considerations. It does not reflect tax considerations – simply good economic sense. For example, when an investor purchases a ₱ 1 million bond bearing interest of 25% for ₱ 1 million using funds borrowed



at 20%, he clearly derives a 5% spread before tax. On the other hand, in tax arbitrage, sometimes called tax leverage, a taxpayer engages in transactions that, while not necessarily profitable before tax, are profitable after tax. By far the most common form of tax arbitrage is the process of borrowing to purchase tax-preferred assets.

The essence of tax arbitrage is: after-tax profit is possible only because the tax law treats income and deductions asymmetrically, allowing an immediate deduction for an expenditure, such as interest costs, and at the same time also allowing complete or partial deferral or exemption of the income. Simply put, taxpayers engaging in tax arbitrage seek to take advantage of a favorable differentials in the tax treatment of borrowing costs on the one hand, and investment returns on the other. If the tax arbitrage is favorable enough, it can even offset a deficit from economic or financial arbitrage.

To illustrate, suppose taxpayer A, in the 35% income tax bracket, purchases ₱ 1 million treasury bills with an interest rate of 25% and therefore yeilding an annual income of ₱250,000. This interest will be subject to a final withholding tax of 20%.[3] If taxpayer A could borrow at an interest rate of 30% to buy the treasury bills and deduct the interest expense in the amount of ₱300,000, the transaction would be profitable.[4] On the economic side, he would lose ₱50,000 per year since he would pay out ₱300,000 in interest and get back only ₱250,000. But on the tax side, for as long as A has sufficient income from other

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[3] Sections 21(c)(1), 24(e), 25(a)(6)(A) of the NIRC Tax Code imposes a 20% final tax on interest on Philippine currency bank deposits and yield or any other monetary benefit from deposit substitutes and from trust fund and similar arrangements received by citizens or resident individuals, domestic and resident foreign corporations.

[4] For the arbitrage transaction to be profitable to a corporate taxpayer, the ratio of the interest rate on the borrowing to the interest rate on the investment must be less than 16:13 computed as follows:

Let: x = borrowing rate
y = investment rate
A = principal

Financial loss = or less than Tax gain
(interest expense – interest income) =
(interest expense * 35%) – (interest income * 20%)

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\begin{aligned}
xA - yA &= [(xA * 35\%) - (yA * 20\%)] \\
A\,(x-y) &= A\,[(x * 35\%) - (y * 20\%)] \\
x - y &= .35x - .20y \\
x - .35x &= y - .20y \\
.65x &= .80y \\
x : y &= 80 : 65 \\
x : y &= 16 : 13
\end{aligned}
$$

sources, he would gain ₱55,000 representing the difference between the income tax deduction on the interest expense of ₱105,000 (₱300,000 x 35%) and the final tax on the interest income of ₱50,000 (₱250,000 x 20%). Taxpayer A will in effect profit ₱5,000 representing the difference between the financial arbitrage loss of ₱50,000 and the tax gain of ₱55,000. The profit will be more substantial if the arbitrager is an individual who becomes subject to a lower tax bracket because of the interest deduction.

Thus, it can be noted from the above illustration that tax arbitrage has the effect of converting income from other sources in the amount of ₱55,000 from ordinary to tax-exempt. This alchemy is a simple, two-step process. First, borrow enough so that the available deductible expense equals the amount of ordinary income that is to be transmuted. Then, invest the loan proceeds in tax favored investment assets. No actual capital outlay is needed for this, because that is the capital borrowed. The only essential ingredients are:

(a) a source of highly taxed income that will be offset by the interest deductions and provide the cash service to the debt,
(b) a tax favored investment assets, and
(c) a lender who will advance the funds needed to acquire the asset.[5]

### *B. Kinds of tax arbitrage*

#### 1. NORMAL VS. PURE

Steuerle classifies tax arbitrage into two types: normal and pure.[6] Normal arbitrage is the typical leverage transaction where the inclusion rate or tax rate on total nominal income is lower than that applying to the nominal interest payment.[7] An example under this type is a taxpayer who borrows and then purchases a tax preferred asset such as an equipment receiving generous cost recovery allowance.

Technically, the income from the asset need not be preferred in an absolute sense, but must only have an inclusion rate or tax rate on total nominal income lower than that applying to nominal interest payment.

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[5] Cooper, *Taming the Shrewd – Identifying and Controlling Income Tax Avoidance*, 85 COLUM L. REV. 657, 675 (1984).

[6] Steuerle, *Tax Arbitrage, Inflation and the Taxation of Interest Payments and Receipts*, 30 WAYNE L. REV. 991, 1002 (1984).

[7] *Id.*



This is defined as normal tax arbitrage because it occurs in any normal investment process in which borrowing is used to purchase assets.

Pure tax arbitrage (also known as abusive tax arbitrage) is the same as normal tax arbitrage except that the taxpayer in effect is purchasing and selling (borrowing is the equivalent of selling interest bearing asset) the same asset.[8]

An extreme example would be if a taxpayer could borrow from himself, deducting the interest expense as "borrower" but excluding interest income as lender.[9] This situation is approximated by loan arrangements which involve borrowing from a bank and investing the loan proceeds in treasury bills, certificate of time deposit or money market placement yielding interests subject to the preferential tax rate with that same bank. The money would simply make a "loop" with the only consequence being a reduction in taxes and a possible transfer of some money to the bank as fee.[10] In these situations, because the same asset is bought and sold simultaneously, there can be little or no pre-tax economic profit. The profits are induced by pure manipulation of the tax system. Pure tax arbitrage suggests that the investment has no economic benefit and that the tax benefits are not capitalized[11] nor are income recognition merely deferred?

#### 2. RATE VS. TIME ARBITRAGE

Block classifies tax arbitrage into rate and time arbitrage.[12] Rate arbitrage refers to leveraging through borrowing to invest in assets, the return on which is tax preferred. To engage in rate arbitrage the taxpayer simply takes advantage of the tax preferences existing in the Tax Code and magnifies the advantage by using borrowed funds. Borrowing to invest in securitites or instruments subject to preferential tax rate is an example of rate arbitrage.

In some cases, tax benefits can be achieved through borrowing even though the income from investment will ultimately be taxed at ordinary income rates or will not be subject to any particular tax preference. Tax benefits are available to taxpayers who deduct interest expense in advance of receiving ordinary income related to the ex-

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[8] *Id.*

[9] Bradford, *supra* note 1, at 1.

[10] *Id.*

[11] Koppelman, *Tax Arbitrage and the Interest Deduction*, 61 S. CALIF. L. REV., 1176 (1900).

[12] Block, *Trouble With Interest Deduction After the TRA 1986*, 40 U. FIA L. REV., 701, 714 (1988).

pense. The tax benefits achieved by the timing of income and deductions absent specific tax preferences is referred to as time arbitrage. One example of time arbitrage involves production period interest incurred in connection with the taxpayer's production of assets for resale. The taxpayer may incur interest in connection with the production but will not receive income from such assets until a subsequent tax period when the asset is actually sold.[13]

It is pertinent to note that the classification into time and rate arbitrage depends primarily on which aspect of the Tax Code provisions is taken advantage of to obtain tax benefits.

This classification does not connote the arbitrager's tax motivation in entering into the transaction. In contrast, Steuerle's classification of tax arbitrage into pure and normal is focused precisely on the arbitrager's motive, purpose and intent in undertaking a particular arbitrage transaction. And as has been said above, pure tax arbitrage transactions are entered into solely to create tax benefits while normal tax arbitrage transactions are entered into both for economic and tax reasons. Steuerle's classification is relevant for the purpose of this study in addressing the issue of whether or not tax arbitrage constitutes tax evasion or tax avoidance.

## II. COMMON ARBITRAGE OPPORTUNITIES UNDER THE NATIONAL INTERNAL REVENUE CODE

As earlier described, tax arbitrage arises from the mismatch between tax favored income and deductible interest. Arbitrage opportunities therefore exist when interest associated with a tax favored investment is deductible. Several Tax Code provisions allow such situation. Common examples of tax arbitrage include:

### *A. Borrowing to Purchase Stocks in Domestic Corporation*

A taxpayer corporation who borrows money at an interest to buy stocks in a domestic corporation yielding tax exempt intercorporate dividends may derive considerable tax benefits. First, while the interest

[13] In BIR Ruling No. 600-88 dated December 27, 1988 it was ruled that interests to be paid on loans obtained from various financial and non financial institution used in connection with the business of acquiring assets and inventories of existing companies are deductible from gross income under Section 29(b)(1) of the Tax Code.



paid can be claimed as deduction for income tax purposes,[14] the dividends received is exempt from tax.[15]

Second, if the stocks appreciate in value the unrealized gain will be subject to tax only upon actual sale because of the realization requirement.[16]

And third, the realized gain from the sale of stocks will be subject to the lower capital gains tax rate.[17] It can thus be noted that aside from the tax benefit arising from the mismatched deductible interest and the tax exempt dividend income as well as the unrealized gain on the appreciation of stocks, the taxpayer is able to convert ordinary income into capital gains to the extent of the previously deducted interest. Hence, depending on the blend of interest rates, the dividend payout rate of the investment and the market price behavior of the shares of stock, borrowing to invest in shares of stock can bring very favorable tax arbitrage profits.

### *B. Borrowing to Invest in Money Market, Bank Deposits and Treasury Bills, and Other Deposit Substitutes*

This form of tax arbitrage comes in different forms. First, it may arise when a corporate taxpayer places its ready cash in bank deposits or money market placements and finances its business operations through borrowings. In this situation, the interest on the money market placement is subject to the final withholding tax at the preferential rate of 20%,[18] while the interest payments on the loan is deductible from gross income at the ordinary income tax rate of 35%.

[14] See Section 29(b), NIRC. Investment in shares of stock is not an interest bearing obligation. Thus, the subject interest undoubtedly will be deductible because the indebtedness was not obtained to purchase obligation the interest upon which is exempt from income tax.

[15] See Section 24(e)(4),NIRC. Intercorporate dividends. – Dividends received by a domestic corporation from another corporation shall not be subject to tax.

[16] See Section 34(a), NIRC; Section 38 of the Income tax Regulations states that: "... appreciation in value of property is not even an accrual of income to a taxpayer prior the realization of such appreciation through sale or conversion of the property."

[17] See Section 24(e), NIRC. "Capital gains from sale of shares of stock. – Capital gains realized from the sale, exchange or disposition of shares of stocks in any domestic corporation shall be taxed as follows:

(A) Net capital gains x x x realized during the taxable year from the sale or exchange or other disposition of shares of stock not traded through a local stock exchange:
Not over P100,000 ............. 0%
Over P 100,000 .................. 20%

(B) Capital gains presumed to have been realized from the sale, exchange or disposition of shares of stock listed and traded through a local stock exchange – 1/4 of 1% based on the gross selling price of the share or shares of stock.

[18] See *supra* note 3.

It may also come in the form of back-to-back loans. Back-to-back loans are secured from a bank or any other financial institution the proceeds of which are placed in the same bank by way of a time deposit or money market placement, or are invested in treasury bills or other securities the interest income from which is subject to a final withholding tax at the preferential rate of 20%.

Sometimes, a taxpayer invests in interest bearing securities whose interests are subject to the preferential rate of 20% and then finances his purchase with a loan secured by said securities. In other times, a company places its funds with an investment manager under an investment management agreement and at the same time obtains a loan from the same investment manager from funds of other companies. In all these cases, the borrower claims the interest paid on the loan as deduction from gross income in computing its income tax liability computed at 35% but pays only 20% final withholding tax on the interest income.[19]

### C. *Borrowing to Fund BIR Qualified Retirement/ Pension Plans*

A taxpayer may borrow money to fund or finance contributions to a Bureau of Internal Revenue (BIR) qualified retirement plan. In so doing, the taxpayer has two sources of deductions, namely, the interest on the indebtedness and the contribution to the pension fund. More importantly, since the plan itself is not subject to tax,[20] the taxpayer may loan against the Plan at high interest (which may be deducted for income tax purposes), because such interest will not attract income tax on the part of the Plan. Alternatively, the Plan can invest its funds in bank deposits, money market placements or treasury bills and other deposit substitutes which is likewise exempt from withholding tax.[21] However, the extent to which a taxpayer may use this tax arbitrage tool is limited to the contributions allowed by the Plan in accordance with actuarially sound valuations. Moreover, the benefits cited inures more to the benefit of the Plan than to the employer-taxpayer.

[19] Items of gross income subjected to the final income tax are not included in the determination of gross income of the recepient corporation. BIR Ruling No. 33-86 dated April 4, 1986.

[20] REPUBLIC ACT 4917.

[21] It was held in *Commissoner of Internal Revenue v. GCL Retirement Plan* (CA GR No. 20426, August 27, 1990) that: "employees" trust maintained by the employers and forming part of the retirement plan for the exclusive benefit of employees are exempt from the withholding tax. The income from money placement and interest bills is not subject to the 15% (now 20%) final withholding tax."



### D. *Borrowing to Invest in Machinery Equipment and Other Fixed Assets*

Any trade or business may, as a general rule, engage in this form of arbitrage as long as the tax value of the depreciation deduction exceeds the value of economic depreciation. But this form of arbitrage is particularly applicable and limited to enterprises registered with the Board of Investments under Executive Order (EO) No. 226 or other preferred taxpayers enjoying accelerated depreciation deduction incentives on its machinery and equipment.

### E. *Other Arbitrage Opportunities*

A variety of other arbitrage opportunities exist. These include borrowing to invest in inventories and self-constructed assets,[22] borrowing to pay the taxes and duties on importation of goods,[23] borrowing by a corporation to finance service contracts reported on a cash basis,[24] arbitrage involving annuities and insurance policies[25] and borrowing to finance long term contracts.[26]

[22] Interest on loans obtained to acquire assets and inventories is currently deductible. BIR Ruling 600-88 dated December 27, 1988.

[23] Section 80 of the Income Tax Regulations in part provides: "Import duties paid to the proper customs officers, and business, occupation, license, privilege, excise and stamp taxes and other taxes of every name or nature paid directly to the Government of the Philippines or to any political subdivision thereof, are deductible."

[24] As a rule, under the cash basis method of accounting, service income will be taxable when received while interest payments are are deductible when paid.

[25] Under Section 48 of the Income tax Regulations "amounts received by an insured as a return of premiums paid by him under life insurance, endowment, or annuity contracts, such as the so-called 'dividends' of a mutual insurance company, which may be credited against the current premium, are not subject to tax. Distributions on paid-up policies which are made out of earnings of the insurance company subject to tax are in the nature of corporate dividends and should be included in the taxable income of the individual, without any credit for the amount of tax paid by the corporate at source." Note that under the current provisions of the Tax Code, dividends are subject to 0% tax.

[26] Under Section 44 of the Income Tax Regulations, a taxpayer may elect to report income either on a percentage of completion basis or on a completed contract method.

Under the completed contract method, income is reported only in the year in which the contract is completed. Similarly, costs allocable to the contract are deductible only upon completion of the contract. Certain costs, however, such as interests, are currently deductible.

Under the percentage of completion method, income is reported upon the basis of percentage of completion. All expenditures made during the taxable year on account of the contract, account being taken of the material and supplies for use in connection with the work under the contract but not yet so applied, are deductible from gross income.

It is evident even only from the few examples given that there exists various tax arbitrage opportunities in the Tax Code from which tremendous tax savings may be obtained.

It should be pointed out, however, that it is not the purpose of this study to exhaust the gamut of tax arbitrage opportunities under Philippine laws. The examples are intended only to illustrate tax arbitrage opportunities, not to catalogue all of such opportunities for that task would be unending.[27]

Philippine tax authorities seem to be more concerned with pure tax arbitrage than normal arbitrage. This is understandable because the former arrangements involve the manipulation of the tax system whereas the latter arrangements involve both tax and economic components.

In pure tax arbitrage,the profit is derived only from the tax system and can be earned with no net investment on the part of the taxpayer, and unlike normal tax arbitrage which has an economic component, it cannot be easily justified by a genuine or bonafide business or economic purpose. It may also be said that pure tax arbitrage gives the taxpayer an inappropriate "double benefit" of financing the purchase of tax preferred investments by borrowing money and deducting the interest paid or accrued on the loan which may frustrate the underlying principle of taxing income in accordance with the taxpayers' ability to pay.This type of arbitrage is more prone to abuse because it can be engaged in with practically no cash outlay and entails no financial risk at all. For these reasons, a taxpayer who wants to create interest deductions will likely engage in pure rather than normal tax arbitrage.

Going through the common examples of tax arbitrage given earlier, it is clear that under current law, pure tax arbitrage arises mainly in the case of back to back loan arrangements. Borrowing to invest in stocks of a domestic corporation can be easily justified as normal tax arbitrage by a business purpose such as investment or management

[27] It is noteworthy that while the opportunities and incentives for tax arbitrage are so great, not all high income taxpayers engage in it. There are a number of reasons. First, arbitrage opportunities are limited by the amount of funds loanable to the taxpayer. Second, many taxpayers, including corporations wanting to show positive financial income to shareholders, are still averse to treating non-cash income, such as unrealized capital gains as equal in value to cash flow income. Third, some element of risk is often introduced by tax arbitrage and it is sometimes difficult to hedge preferred assets exactly against debt. Fourth, many taxpayers are simply ignorant that arbitrage opportunities exist under our income tax system. Finally, as regards arbitrage involving investments subject to final income tax, the BIR has in recent years disallowed the deduction of interest on indebtedness on the mere basis that the taxpayer's income tax return shows a considerable amount of interest income subjected to final tax.



control purposes. In addition, the taxpayer assumes a real risk of loss if the market value of stocks declines or if the investee company loses and the actual book value of the shares decrease, or if no dividends are declared.

Borrowing to fund BIR qualified retirement plans may likewise be justified by the business purpose of providing retirement benefits to employees which is precisely the avowed legislative purpose for the enactment of Republic Act (RA) No. 4917. Moreover, the extent to which a taxpayer can engage in this type of arbitrage is not without limit. The contributions to the plan are fixed by actuarial or other acceptable method of valuation.

The other arbitrage opportunities cited without elaboration are generally normal arbitrage transactions because they merely involve deferral of reporting income.

As regards borrowing to invest in money market placements, this comes in two forms: (1) investing ready cash in money market and borrowing to finance operations and, (2) borrowing to invest the loan proceeds commonly termed as back-to-back loans. The first form can be justified as normal tax arbitrage since the exact association or pairing of each use and source of funds would be theoretically and practically difficult to establish. However, we cannot say the same thing for back-to-back loans because invariably, the very funds loaned are invested.

At present the most controversial form of tax arbitrage is back-to-back loans because it is subjected to greater scrutiny by the BIR than any other form of tax arbitrage. Consequently, in the succeeding parts of this study,whether back to back loans constitute tax evasion or tax avoidance will be discussed.

## III. TAX EVASION AND TAX AVOIDANCE

It is significant to define and distinguish the terms "tax evasion" and "tax avoidance." As defined in standard dictionaries, "avoid" and "evade: present a slight difference. The verb "avoid" is defined as "to expel; depart from, withdraw from; to make void; annul, vacate, defeat, evade, invalidate; keep away from; to prevent occurance or effectiveness."[28] The verb "evade" is defined as "to use craft or strategem

[28] WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE (Unabridged) (1981).

in avoidance; to elude, escape, avoid, circumvent, dodge."[29] Each is given as a possible synonym of the other, thus, in common use, the two words have only a shade of difference. However, that shade indicates the fundamental difference which the two words have acquired in the interpretation and the application of tax statutes which undertakes to draw within its field certain situations, while excluding others.

According to Black's Law Dictionary,[30] "tax evasion is to be distinguished from tax avoidance, the former meaning the illegal non payment of taxes due, the latter referring to the legal reduction or nonpayment of taxes through allowable deductions, exemptions, etc." Thus, whatever may be the similarity or difference in the two words as commonly employed, to the professional and judicial mind, there is a very sharp and fundamental distinction. This distinction between "tax avoidance" and "tax evasion" is quite clear in principle, though not always in fact: one "evades" taxes by avoiding payment without avoiding liability, while one who avoids liability "avoids" the tax. Tax avoidance is permissible while tax evasion is not. Tax avoidance might also be used as shorthand for the suggestion that the law should be changed so that some who do not now pay a tax must pay in the future.[31]

Some arrangements of transactions structured to achieve maximum tax advantage approved by the courts are the cases involving tax avoidance rather than tax evasion. This may be illustrated by the case in which a taxpayer obtains a maximum tax deduction by making desirable but not imperative repairs to business property in a high income year. Likewise, to prevent bunching of income, he may bill or collect accounts for services in a low income year, or in order to obtain advantage of capital gains provisions of the statute, he may hold a capital asset past the twelve month period before sale. Tax saving is the obvious purpose and the desired effect of the method selected to consummate the transaction in all these cases, but traditionally this has been thought to furnish no occasion for imposing a tax otherwise inappropriate.

On the other hand, those transactions which are not approved by the courts are regarded as tax evasion. Some authors call it improper, inappropriate or abusive tax avoidance. An example is a case where a taxpayer receives and cashes an interest coupon and then so arranges his books of account that its receipt is concealed.

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[29] *Id.*

[30] (5th ed. 1979).

[31] Glun, *Tax Avoidance*, 76 MICH L. REV. 733 (1978).



However, not all cases are as clear as the example above. Some tax motivated transactions are so ambiguous and difficult to characterize as either tax avoidance or tax evasion. Pure tax arbitrage in the form of back-to-back loans is one such "unclear" or "hard" case. In these situations, the BIR, in the first instance, and, the courts are confronted with this problem: does a certain course of conduct or existence of a certain set of facts have as its consequence the imposition of a tax, or do the conduct and facts fall outside of the statute and thus relieve the individual of the burden of the statute?

A question that surfaces is: Can a taxpayer who is faced with a large amount of income tax liability successfully plan to reduce such potential tax liabilityunder the following conditions: 1) at such time or times and by such amount as he may himself elect, 2) through use of preconceived transactions entered into solely or primarily to avoid income taxes which in themselves are not intended or expected to produce any gain, profit, or income, but rather are expected to produce losses and from which the only benefit must come from an interplay of the provisions of the tax statutes?

An affirmative answer would connote tax avoidance while a negative answer would indicate tax evasion. As applied to back-to-back loans, such arrangements will constitute tax evasion if the related interest expense is found to be non-deductible. This is because the taxpayer then avoids the payment of income tax without avoiding liability on an otherwise taxable ordinary income which on account of the interest deduction was transmuted to non-taxable. Conversely, back-to-back loans would constitute tax avoidance, and, a valid tax saving technique if found that the interest expense can be deducted from gross income in accordance with the interest deduction provisions of the Tax Code.

Although the Philippine Supreme Court has defined "tax evasion" as a term that connotes fraud through the use of pretenses and forbidden devices to lessen or defeat taxes,[32] this study will not consider the fraud element of tax evasion but only the propriety of interest deduction arising out of transactions entered into solely for tax benefits.

## IV. ARGUMENTS AGAINST TAX ARBITRAGE

For the past several years examining agents of the BIR have proposed to disallow the deduction for interest on indebtedness of taxpayers

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[32] *Yutivo Sons Hardware Co. v. Court of Tax Appeals*, 1 SCRA 160 (1961).

who have considerable amounts of interest income subjected to 20% final withholding tax and who, at the same time claim large amounts of interest deductions. In many instances, the proposed disallowance is intended to spot back-to-back loans and to question the proprietyof allowing deductions of interest expense paid or incurred in producing the sheltered interest income. The BIR cites various bases for such position, namely:

a. Section 29 (b) of the Tax Code which allows the deduction of interest paid or accrued within the taxable year on indebtedness in connection with the taxpayer's profession trade or business. The BIR claims that the interest expense pertaining to a back-to-back loan is not incurred in connection with the taxpayer's profession, trade or business, hence, not deductible.

b. Section 29(b) of the Tax Code which prohibits the deductibility of interest paid or incurred on indebtedness incurred or continued to purchase or carry obligation the interest upon which is exempt from taxation. The application of this provision is extended to cases where the interest on the obligation is taxed at preferential rate of 20% because in contrast to the ordinary income tax rate of 35%, the interest income on the money market placement is tax exempt to the extent of 15%.

c. Under Section 37 of the Tax Code, if the method of accounting employed by the taxpayer does not clearly reflect income, the computation of income shall be made in accordance with such method as in the opinion of the Commissioner of Internal Revenue does clearly reflect the income. Based on this section, the BIR claims that there should be a proper matching of gross income and deduction which is not achieved if the interest expense on the loan is allowed to be deducted.

Although the BIR does not invoke the judicial tax doctrines to combat tax avoidance that have evolved in the U.S., the deductibility of interest expense in back-to-back loan transactions may be questioned using the business purpose, substance over form and sham transaction rules. By the application of these tax doctrines it can be argued that the interest paid in back to back loans should be disallowed since the taxpayer does not make a genuine payment of interest on a real debt and has no purpose other than the reduction of taxes.

The succeeding part will expound on and analyze the foregoing



arguments in the light of the legislative history of the cited provisions and the prevailing jurisprudence on the application of the tax avoidance doctrines.

## V. BASIS OF ARGUMENTS AGAINST TAX ARBITRAGE

### A. *Brief Legislative History of Interest Taxation*

Commonweath Act 466, otherwise known as the "National Internal Revenue Code of 1939" first codified the internal revenue laws of the Philippines. Under this Code, all interest income including interests on bank deposits and money market placements formed part of gross income subject to the ordinary graduated income tax rates.

As it first appeared in the 1939 Tax Code as its Sec. 30, Sec. 29 (b) of Presidential Decree (PD) No. 1158, as amended, which is the present NIRC, allowing interest deduction was worded thus:

Sec. 30 Deductions from gross income. — In computing net income there shall be allowed as deductions —

(a) xxx

(b) Interest:

(1) In general. — The amount of interest paid within the taxable year on indebtedness except on indebtedness incurred or continued to purchase or carry obligations the interest upon which is exempt from taxation as income under this Title.

(2) Interest allowable to non resident aliens...

Sec. 30 (b) was copied from Section 23(b) of the U.S. Internal Revenue Code of 1939, as amended.[33]

Sec. 30 (b) remained substantially unaltered despite the recodification of the Tax Code in 1977. In July of 1977, PD No. 1156 was passed applying the withholding tax system on interest income on bank deposits

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[33] Section 23 (b) of the US Internal Revenue Code as amended provides:

"Sec. 23. Deductions from gross income. In computing net income there shall be allowed as deductions:

(b) Interest. All interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) interest upon which is wholly exempt from taxes imposed by this Chapter."

in order to maximize the collection of the income tax on this type of income. Under this system, the interest income was still included in gross income in computing the depositor's income tax liability but the tax withheld was creditable against the income tax liability. The amendment required banks to withhold a creditable income tax on interest on deposits as a condition for deduction of interest from gross income.[34]

In 1978 or barely a year later with the apparent objective of preventing tax avoidance, P.D. 1351 was passed which put an end to the deductibility of prepayments of interest by individual taxpayers and of interest expense paid to a related party.[35]

Meanwhile, P.D. No. 1739 took effect on September 19, 1980 and restructured the banking system to allow it to re-channel its resources to long-term investments. To provide adequate benefits to long term funds, the Decree provided fiscal incentives to investors by imposing a 15%/20% preferential final withholding income tax on interests on bank deposits and money market placements. The 15%/20% final tax was reduced to a uniform rate of 15% effective January 1, 1985 pursuant to P.D. No. 1959. Due to the economic crisis, the withholding tax rate was increased to 17 1/2% effective January 1, 1986.

On the interest deduction side, Batas Pambansa Bilang (BP) 135 which took effect on January 1, 1982 incorporated in Section 30 (b)(1) a qualification that the indebtedness be *"in connection with the taxpayer's profession, trade or business."* This amendment precluded the deduction

[34] Subparagraph (1) of paragraph (b) of Section 30 then read as follows:

"(1) In general – The amount of interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest upon which is exempt from taxation under this Title: Provided, however, That interest on deposits paid by authorized agent banks of the Central Bank of the Philippines to depositors shall be allowed as a deduction only if it is shown that the tax on such interest was withheld and paid in accordance with the provisions of Sections 53 and 54 of this Code."

[35] A new subparagraph (3) worded as follows was added:

"(3) No deduction shall be allowed in respect of interest otherwise deductible under the preceding subparagraphs –

"(A) If within the taxable year an individual taxpayer reporting income on the cash basis incurs an indebtedness on which an interest is paid in advance through discount or otherwise: Provided, however, That such interest shall be allowed as a deduction in the year the indebtedness is paid: And Provided, further, That if the indebtedness payable in periodic amortizations, the amount of interest which corresponds to the amount of the principal amortized or paid during the year shall be allowed as deduction in such taxable year.

"(B) If both the taxpayer and the person to whom the payment has been made or is to be made are persons specified within any one of the paragraphs of sub-section (b) of Section 31."



of personal interest which before the effectivity of B.P. 135 was allowable even to an individual who derives compensation income.[36] Also, B.P. 135 codified the provision in P.D. 87, otherwise known as the "Oil Exploration and Development Act" prohibiting the deduction of interest on loans incurred to finance petroleum explorations by adding sub-subsection (C) to subparagraph (3) of subsection (b) of Sec. 30.

In 1986, E.O. 37 was passed by the Aquino government restructuring and renumbering the various provisions of the Tax Code. Sec. 30 of the 1977 Tax Code, as amended, was renumbered as the present Sec. 29(b). The proviso in subparagraph (1) introduced by P.D. 1156 requiring the withholding of taxes on interest on bank deposits as a precondition to the deductibility of interest was deleted from Sec. 29 and incorporated in Sec. 50, a general provision on witholding tax at source. The final witholding tax on interest was fixed at 20 %. As currently worded, Sec. 29(b)(1) reads as follows:

> Section 29. Deductions from gross income. — In computing taxable income subject to tax... there shall be allowed as deduction the items specified in paragraphs (a) to (i) of this section.
>
> (a) x x x
>
> (b) Interest. — (1) In general. — The amount of interest paid or accrued within a taxable year on indebtedness in connection with the taxpayer's profession, trade or business, except on indebtedness incurred or continued to purchase or carry obligation the interest upon which is exempt from taxation as income under this Title.

### B. *The Legislative Intent Behind Sec 29 (b) of the 1977 NIRC (as amended)*

There is no question that the law grants a tax preference to interest income on bank deposit and money market placements in order to encourage and increase investment in long term funds. What is debatable is whether or not the legislature intended to allow the deduction of the interest paid in generating such tax preferred interest income.

On the basis of plain common sense, the question can easily be answered in the negative. Borrowing coupled with investment does not increase aggregate investments or savings. Thus, to permit interest

[36] In BIR Ruling No. 105-84 dated June 4, 1984 it was ruled that before the effectivity of BP 135 a salaried individual could validly deduct interest paid or accrued on indebtedness within the taxable year.

deductions for investments financed with borrowed money is inconsistent with a tax subsidy designed to increase long term investments. Since the Legislature is never considered to have defeated the purpose of the law, the obvious interpretation of Sec. 29 (b) (1) is that it does not permit the interest deduction. However, Sec. 29(b)(1) was enacted in 1939, way before the tax preference on interest income was passed,and whatever the lawmaker had in mind in passing P.D. 1739 could not have affected the construction of Sec. 29(b)(1). It is therefore imperative to search for the legislative intent behind Sec. 29(b)(1).

It is a cardinal rule in taxation that the deduction provisions in the tax statutes are acts of legislative grace.[37] The question of whether the particular Tax Code provision authorizes the deduction of a certain item as in Sec. 29 (b) (1) is best resolved by reference to the underlying congressional purpose of the deduction provision in question.

Admittedly, the underlying purpose of Sec. 29(b)(1) permitting the deduction of interest paid or accrued within the taxable year on indebtedness is difficult to articulate.This provision is extremely broad embracing all interest paid on a legal debt, including interest paid on back-to-back loans. Fortunately, with the amendment introduced by BP 135, its scope has been limited to interest on "indebtedness incurred in connection with the taxpayer's profession, trade or business". Be that as it may, it is still unclear what the legislature meant by the quoted phrase. Resort to the records of the Batasan is not all that enlightening. According to the deliberations, the reason for the amendment is to portray the real intent that for interest to be deducted it should be business-cost-related so that Sec. 29(b) can no longer be resorted to by some smart taxpayers to reduce their taxes.[38] If the amendment

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[37] *Perez v. Commissioner of Internal Revenue*, CTA case no. 1707, February 10, 1969, cert. den. GR 30403, April 22, 1969; *Deputy v. DuPont*, 308 US 488 (1940).

[38] Com. Bill No. 34, 1st Batasan, 4th regular session (1981). The purpose of the amendment can be gleaned from this discussion:

Mr. Camara. On interest,... there is a new amendment xxx it says, "INCURRED IN CONNECTION WITH THE TAXPAYER'S TRADE OR BUSINESS," which means that for interest to be deducted, it has to be incurred in connnection with his trade or business?

Mr. San Juan. That is right Mr. Speaker.

Mr. Camara. Heretofore, I understand that interest incurred by the taxpayer, even if it is not in connection with his business is allowed as a deduction. Is that correct, Mr. Speaker?

Mr. San Juan. Mr. Speaker, the idea is still that such interest payments to be deducted should be business-cost-related. However, the language of the law is not so clear as to portray the real intent, and, therefore, some taxpayers are able to go around the provision of law which is not clear. It is now the intention to make it clear so that it can no longer be resorted to by some smart taxpayers, to reduce the tax that they have to pay.



was meant to exclude all interest other than that incurred in connection with business and given the fact that in back-to-back loan arrangements the taxpayer's sole purpose is to reduce taxes, then the principal inquiry in determining the deductibility of interest is whether or not a tax saving purpose is business related such that the interest expense falls within the purview of Sec. 29(b)(1). Obviously, in back-to-back transactions, the taxpayer derives economic benefit in the form of tax savings. But is this sufficient to make the indebtedness business related?

As far as this writer is aware of, there is no local precedent ruling squarely on this issue. However, the rules on statutory construction tell us that there is a presumption that a statute adopted from another country was adopted with the construction placed upon it by the courts of that state or country which should be followed if reasonable, in harmony with justice and public policy, and consistent with local law.[39] Thus, the Supreme Court has held that "the judicial statutory construction attached to the sources of statutes adopted in a jurisdiction are of authoritative value in the interpretation of such local laws."[40]

Judge Learned Hand in his dissenting opinion in *Gilbert v. Commissioner*[41] which was adopted by the US Supreme Court as its own in *Knetsch v. US*,[42] said that:

> [I]t is a corollary of the universally accepted canon of interpretation that the literal meaning of the words of a statute is seldom, if ever,

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Mr. Camara. In other words, Mr. Speaker, this proposed amendment is meant exclude to all interests other than that incurred in connection with business.

Mr. San Juan. That is right, Mr. Speaker.

Mr. Camara. For instance, Mr. Speaker,... here is a businessman; he had to borrow money from the money market. The money that he borrowed from the money market is partly used in his business and partly used for his personal purposes. Do we understand that we have to distinguish these two groups of interest payments made by the taxpayer for purposes of this provision?

Mr. San Juan. The taxpayer... will have to show proof of just how much of the fund he borrowed was used in his business or in the exercise of his profession, and how much he used for his own personal affairs. And, certainly, the burden of proof will have to be on him, otherwise he might run afoul of the law if he claims that all of it was used for business when that is not so.

Mr. Camara. In other words, Mr. Speaker, this proposed amendment is meant to exclude all interests other than that incurred in connection with business.

Mr. San Juan. That is right, Mr. Speaker."

[39] Alcantara, STATUTES Sec. 70 (1984).

[40] *Wise & Co. v. Meer*, 78 Phil 655, 670 (1947).

[41] 248 F.2d 399 (1957).

[42] 364 US 361 (1960).

> the conclusive measure of its scope. Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their 'interpretation' demands the projection of their expressed purpose, upon occassions, not present in the minds of those who enacted them. The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. *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; for we cannot suppose that it was part of the purposes of the act to provide an escape from the liabilities that it sought to impose.*[43] (emphasis supplied)

It is important to note that at the time *Gilbert* and *Knetsch* were decided, the US Internal Revenue Code did not contain a requirement that the indebtednesss must be in connection with the taxpayer's profession, trade or business, yet the court went beyond the literal meaning of the statute to reject a tax saving purpose as falling within the intendment of the statute. Considering that Sec. 29(b)(1) expressly provides for such requirement, with more reason must the aforecited ruling be applicable to the Philippine situation.

Judge Learned Hand formulated the test to determine whether a tax motivated transaction falls within the legal bounds of a tax statute: In entering into the transaction, did the taxpayer suppose that it "would appreciably affect their beneficial interests in the venture other than taxwise?"[44] Applying this test it is abundantly clear that interest arising from back to back loans,.or any pure tax arbitrage transaction for that matter, is not deductible.

In an unnumbered BIR Ruling dated June 30, 1976, it was ruled that Sec. 30(b)(1)[45] of the Tax Code providing that "interest incurred or continued to purchase bonds and other securities, the interest upon which is exempt from tax, is not deductible" does not apply to interest expense representing cost of money used to purchase Central Bank Certificate of Indebtedness (CBCI) which are not tax-exempt government securities. Although the purchasers of CBCI are not made to pay income tax on interests earned by them from said certificates, said interests are not actually tax-free, as the Central Bank assumes payment thereon.

[43] *Gilbert,* 248 F.2d 411.

[44] *Id.* at 412.

[45] Now Sec. 29(b)(1).



From this ruling it would seem that the BIR recognizes the taxpayer's practice of borrowing to invest in tax exempt or tax preferred securities. But this cannot be applied to the present situation since the ruling was issued prior to BP 135 which expressly requires that the interest be paid in connection with taxpayer's profession, trade or business. Moreover, interest income at that time was still subject to the ordinary income tax rates, not to the preferential final income tax, hence, the tax arbitrage oppurtunity was still inexistent. The BIR was then not wary that the ruling may be used by taxpayers to justify abusive tax arbitrage.

### C. *Partial Exemption of Interest Income*

The BIR contends that the proviso "except on indebtedness incurred or continued to purchase or carry obligations the interest upon which is exempt from taxation as income under this Title" should extend to cases where the interest is preferentially taxed because the excess of the ordinary income tax rate over the preferential tax rate is a partial exemption from income tax. Thus, it seeks it disallow the interest paid allocated to the exempt portion.

The legislative history of Sec. 29(b)(1) and its interpretation shows that it disallows the deduction of "interest on indebtedness incurred or continued to purchase or carry obligations the interest upon which is exempt from taxation as income under this Title." This prohibition does not apply to interest expense related to interest income taxable at preferential rate because such interest income is clearly not exempt but is in fact subject to tax. To hold otherwise goes far beyond the plain words of the statute and the literal interpretation it received up to this time.

Sec. 29(b)(1) as the successor of Sec. 30 (b) of the 1939 Philippine Tax Code is almost a verbatim copy of Sec. 23(b) of the US Internal Revenue Code of 1939 which disallows interest deduction "on indebtedness incurred or continued to carry obligations the interest upon which is *wholly* exempt from the taxes imposed by this Chapter." It is pertinent to note that the word "wholly" which qualifies exempt was not copied into Sec. 29(b)(1) of our Tax Code. It may thus be argued that since our Tax Code does not distinguish between wholly and partially exempt interest, the interest need not be fully exempt from tax to fall under the exception.

The foregoing argument is not compelling. First, had the legislature intended the exception to apply to partially taxed interest, it could have easily said so in plain and clear language. Second, it could

have defined the allowable deduction relating to indebtedness the interest upon which is partially exempt from income tax in the same way that it defined the allowable interest deduction of non-resident aliens in paragraph 2 of the then Sec. 30(b).[46] In view of the absence of such interest limitation provision in our Tax Code, no legal basis exists for disallowing interest allocated to indebtedness the interest upon which is partially exempt from income tax.

### *D. Matching of Income and Expense*

As a matter of sound income tax policy, expenses must be associated with the income or asset with which they relate in order to accurately measure income. And where sources of income are not fully included in income, associated expenses generally must also be matched, thus, limiting the benefit of the deduction. Matching is necessary to minimize the deviation from accurate income measurement caused by the exclusion.

Interest is not the only expense associated with tax favored assets. An examination of the other expenses associated with tax preferred income indicates that in general they are treated in accordance with income tax rules. Where items of economic income are excluded from the tax base or are otherwise entitled to preferential treatment, related expenses often have been matched with that income. For example, expenses that relate to capital gains and losses have often been treated as capital items as well. Thus, commissions paid in connection with the sale of securities have been offset against the selling price not deducted against ordinary income. Various other expenses have been characterized as "capital" if they relate to a previous capital transaction. Gains from the disposition of depreciable property have been characterized as ordinary income because ordinary depreciation deductions were previously claimed.

Where items of economic income will be taxed in the future, expenses relating to that income typically must be deferred for tax purposes until that later time. Thus, expenses such as commissions paid in purchasing securities and appraisal fees in connection with the purchase of securities are currently not deductible. These expenses are added to the basis of the securities and recovered upon their disposition.

Although there does not appear to be any basis for distinguishing

[46] Section 30(b) of the Tax Code of 1939 contained a subparagraph 2 which limited the interest allowable to non resident aliens or resident foreign corporation to the proportion that the taxpayer's gross income from sources within the Philippines bears to the amount of gross income derived from all sources.



interest from other expenses, nothing in our income tax law subjects interest deductions to the limitations applied to other expenses. Perhaps because it is generally viewed as benefiting only the current year and not increasing the value of the asset to which it relates.

Notwithstanding the absence of rules requiring matching with respect to interest deduction, the BIR insists on applying the principle of matching of income and expense to interest income and expense on back-to-back loans as well. It cites Sec. 37 found in Chapter V, entitled "Accounting Periods and Methods of Accounting," Title II entitled "Income Tax" of the Tax Code as its basis. Said section in part provides:

> Section 37. General Rule. The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect income, the computation shall be made in accordance with such method as in the opinion of the Commissioner of Internal Revenue does clearly reflect the income...

Sec. 166 of the Income Tax Regulations which implements Sec. 37 provides:

> Section 166. General Rule. The method of accounting regularly employed by the taxpayer in keeping his books, if such method clearly reflects his income, is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner of Internal Revenue clearly reflects income....

Based on the foregoing, it is clear that Sec. 37 does not govern the deductibility of interest, but merely involves accounting method and periods. All that Sec. 37 is saying is that if the method of accounting adopted by the taxpayer does not clearly reflect income, the Commissioner of Internal Revenue may make his own computation which in his opinion will clearly reflect income. Sec. 37 does not authorize the Commissioner, on its basis alone, to disallow deduction of validly paid or incurred interest.

### *E. Tax Doctrines As Enunciated in U.S. Cases*

As a rule, with the probable exception of allocation of income and expense between related taxpayers under Sec. 43 and tax-free mergers

and consolidations under Sec. 34(c)(2) of the Tax Code, the substantive provisions of our income tax statutes are drawn in such a way that a tax is imposed depending upon the existence or non-existence of objective facts, and the existence or non existence of an intent to escape the tax plays no part in the determination of the tax liability. The frequency with which this rule appears in judicial opinions reliably measuring its accuracy would imply that there is nothing in the tax law that would be more certain than the principle that the tax consequences of a transaction do not depend upon whether the transaction was undertaken to avoid taxes.[47]

The United States Supreme Court as early as 1873 affirmed this principle when it ruled that a taxpayer has the right to use "device to avoid the payment of duties" if the method chosen is "not illegal."[48] In *Gregory v. Helvering*[49] the leading anti-tax avoidance case in the US, the court said: "The legal right of a taxpayer to decrease the amount of what otherwise would be the amount of his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

Justice Holmes said in the course of an opinion involving a state taxing statute:

> We do not speak of evasion, because, when the law draws a line, the case is on one side of it or the other and if on the safe side, it is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law.[50]

Judge Learned Hand, whose judicial pronouncements on the subject of tax avoidance is perhaps the most frequently cited and savored said:

> over and over again the courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for

[47] Glun, *supra* note 31, at 734.

[48] *United States v. Isham*, 84 U.S. 496 (1873). The statute in question in Isham imposed a stamp duty upon bank checks, drafts, and other specified instruments. Isham, the superintendent of a mining company, had issued unstamped scrip drawn on the company's treasurer to pay employees. Thus, the taxpayer had issued an instrument fulfilling the function of those instruments which were required to have stamps but which differed in form. The Court held that a taxpayer ha the right to use "devices to avoid the payment of duties" if the method chosen is "not illegal."

[49] 2 93 US 465, at 469 (1935).

[50] *Bullen v. Wisconsin*, 240 U.S. 625, 630-631 (1916).



> nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.[51]

> anyone who may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[52]

The Philippine Supreme Court has adopted these principles, first, in the case of *Yutivo Sons Hardware v. Court of Tax Appeals*,[53] where the Court stated that:

> ... a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes or altogether avoid them by means which the law permits. (U.S. v. Isham, 17 Wall. 496,506; Gregory v. Helvering, 293 U.S.465,469; Commr. v. Tower, 327 U.S.280; Lawton v. Commr., 194 F2d 380) Any legal means used by the taxpayer to reduce taxes are all right. A man may therefore perform an act that he honestly believes to be sufficient to exempt him from taxes.

This was reiterated in *Lidell & Co. v. Commissioner of Internal Revenue*.[54] Likewise, in *Delpha Traders Corp. v. IAC*[55] it was held that estate planning or scheme is not wrong or objectionable.

The principles set forth in the aforecited decisions have never been judicially questioned but has in fact been reiterated in a long line of U.S. cases.[56] But the Philippine Supreme Court has had no occasion

[51] *Commissioner v. Newman*, 159 F2d 848, cert. denied. 331 U.S. 859 (1947).

[52] *Gregory v. Helvering*, 69 F.2d at 810 (1934).

[53] 1 SCRA 160, at 168 (1961).

[54] 2 SCRA 632 (1962).

[55] 157 SCRA 349 (1988).

[56] To cite a few oft-quoted judicial pronouncements:

In *Marshall v. Commissioner*, 57 F.2d 633, 634 (1932), it was ruled that: "there was nothing unlawful, or even mildly unethical, in the motive of petitioner, to avoid some portion of the burden of taxation."

In *Sawtell v. Commissioner*, 82 F.2d 221,222 (1936) the First Circuit said: "Nothing is better settled than that persons are free to arrange their affairs to the best advantage for themselves under the law as it stands. A purpose to minimize or avoid taxation is not an illicit motive."

In *Commissioner v. Eldridge*, 79 F.2d 629, 631 (1935) it was said that: "It is argued by the Commissioner that the transfers by respondents to the corporation were made for the purpose of establishing a deductible loss for income tax purposes. This, if true, is unimportant. A taxpayer may resort to any legal method available to him to diminish the amount of his tax liability."

to restate these rules except in the cases mentioned above simply because it is not confronted with the tax avoidance issue as often as the U.S. courts are. Nevertheless, since our tax laws are patterned after the US, it is assumed that the Philippine Court will adopt the U. S. precedents as it did in *Yutivo* and similar cases, when confronted with similar tax avoidance issues.

However, in frustrating the varied and ingenious plans of taxpayers and their counsel for tax minimization, the Courts have developed the so-called judicial tax doctrines namely, the business purpose test, sham transaction rule and substance over form. And when faced with a new and wondrous mechanism by which the ever hopeful taxpayer seeks to ensure tax savings, the courts prudently declare that the statute was not intended to authorize the result sought by the taxpayer.

## VI. Review of Doctrines

### *A. Development of Tax Doctrines*

As long ago as 1935, the US Supreme Court in the case of *Gregory*[57] established the so-called business purpose doctrine.

*Gregory* involved a taxpayer seeking to sell certain assets from a corporation which she owned. However, a direct transfer to her of the assets would result in a taxable dividend distribution. Thus, Mrs. Gregory created a new corporation and transferred the particular assets of the old corporation to the new entity in exchange for all of its stock. She then liquidated the new corporation, resulting in her receiving all of the assets in question. Upon the sale of the assets she reported a net capital gain, producing a lower tax than if she were taxed on receiving a dividend from the old corporation. The Court refused to recognize this as a qualifying reorganization.

In analyzing this transaction the court first recognized that taxpayers could legitimately utilize legal means to reduce their taxes but that the critical inquiry was "whether what was done, apart from the tax motive, was the thing which the statute intended."[58] The congressional intent behind the reorganization provisions involved in *Gregory*

[57] 293 U.S. 465 (1935).

[58] *Id.* at 469.



was to permit reorganization of corporate business. Therefore, the Court concluded that a reorganization had to have some relation to the business of one of the corporations involved to qualify for favorable treatment. This aspect of *Gregory*, requiring that there be some business purpose for the transaction, has been termed the business purpose doctrine and is perhaps the aspect of *Gregory* most frequently cited.

The business purpose rule is expressed in the view that a transaction which formally complies with statutory requirement will be unavailing to reduce taxes unless undertaken with a particular business purpose. The rationalization for the doctrine is a result of statutory construction, to wit: the language of the statute is interpreted in the light of the meaning intended to be put upon it by Congress, which in turn intended the statute to be applicable only to transactions which were entered into with a business purpose. The sentiment expressed in this doctrine is simple and appealing: if a transaction is arranged for business purposes, tax consequences should be recognized; when it is established for tax saving purposes, it should be ignored.

It is noteworthy that in this doctrine there is a conflict or at least a tension, between the principle that taxpayers may legitimately act to reduce their taxes and the requirement of a business purpose. This conflict will be resolved in Part VI.

*Gregory* also enunciated the principle that became the substance over form doctrine. The court refused to give effect to the purported reorganization because it was a

> mere device which put on the form of a corporate reorganization as a disguise for concealing its real character... The whole undertaking ... was in fact an elaborate and devious form of conveyancing masquerading as a corporate reorganization and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[59]

This passage provides for the development of the doctrine that the substance, rather than the form of a transaction should determine its tax treatment. The Court concluded that the substance of this transaction was in effect the payment of dividend since the corporation did not operate in reorganized form. When *Gregory* characterized the trans-

[59] *Id.* at 469-470.

action as devious and a disguise of reality it likewise established the sham transaction doctrine. The substance over form and sham transaction doctrines are founded on the fundamental income tax policy that tax is assessed upon the results of a taxpayer's various economic activities during the accounting period which is consistent with the tax system's emphasis on substance.

Although it is possible to regard the *Gregory* decision as limited to the requirement of continuity of business for a corporate reorganization, the language of the Court permits inferences of greater scope. Thus, in *Commissioner of Internal Revenue v. Transport Trading & Terminal Corp.*[60], it was held that "[t]he doctrine of Gregory v. Helvering which here told to be controlling, is not limited to cases of corporate reorganizations and 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 escape taxation." On this basis, the Courts have applied the aforesaid doctrines to other areas of taxation including interest deductions.

In our jurisdiction, the Philippine Supreme Court has employed the aforesaid US developed judicial tax doctrines sparingly but with sufficient forcefulness to show that our courts adhere to such doctrines. In *Commissioner of Internal Revenue v. Manning*[61], the Supreme Court employed the substance over form doctrine to disregard a trust instrument that made it appear through the formal declaration of non-existent stock dividends in the treasury, that the taxpayer-stockholders have not received any income from the corporation when, in fact, by such declaration they bestowed unto themselves the ownership of the stockholdings of the deceased stockholder with the use of the very earnings of the corporation. The Court regarded the amounts as a flow of cash benefits to the stockholders and accordingly imposed the income tax.

Likewise, in the case of *Commissioner of Internal Revenue v. Constantino*[62] the Supreme Court, invoking again the substance over form doctrine, treated the transaction as an agency contract and consequently imposed the broker's tax on a transaction documented as a dealer sales. The Court said that while on the surface the evidence

[60] 176 F.2d 570, at 572 (1949). cert. denied, 338 US 955 (1950).

[61] 66 SCRA 14 (1975).

[62] 31 SCRA 779 (1970).



may give the impression that the relationship with the company is that of vendor and vendee, "a closer look into the actual legal effect of the terms and conditions embodied, rather than the names of the contracts used or the terminologies employed, in the chain of documents shows that the relationship between the company and the respondent is one of principal and agent."[63]

In *Commissioner of Internal Revenue v. Rufino*,[64] the Supreme Court quoted *Gregory* extensively to emphasize the need for a business purpose in order to qualify as a tax free merger.

By the adoption by our Supreme Court of the foregoing tax doctrines,in several cases it ruled upon, it is clear that the doctrines enunciated by the U.S. courts are likewise applicable in the Philippines.

### B. *Precedents on Interest Deduction*

Tax arbitrage has afforded situations creating desirable tax consequences for a party whose non-tax position remained unchanged after the transaction. And in the area of interest deductions, the occasions whereby the courts have invoked *Gregory* have occurred with surprising frequency. The business purpose, substance over form and sham transaction tax doctrines laid down by *Gregory* and its progeny encompass pure types of tax arbitrage arrangements principally designed to reap tax benefits having little economic substance or risk.

In the Philippines, there is a dearth of jurisprudence on the deductibility of tax arbitrage interest, so that this study will refer to established jurisprudence in the US after whose laws our income tax laws has been patterned.[65]

By reviewing the precedents dealing with deductibility of arbitrage interest, one will note that the courts have adopted these tax doctrines in varying application. In spite of all that has been written about the business purpose doctrine, sham transactions and the role of the court in looking through form to find substance, the deductibility of arbitrage interest remains unsettled. Hence, an empirical study of the precedents is in order. The courts have employed at least two general tests to determine the deductibility of interest payments. The first test is the

[63] *Id.* at 782.

[64] 148 SCRA 42 (1987).

[65] The Philippine Supreme Court in the case of *Commissioner of Internal Revenue v. Vda. de Prieto*, 109 Phil 592 (1960) relied primarily on US precedents in resolving whether interest on taxes is interest on indebtedness and therefore deductible for income tax purposes.

existence of a valid indebtedness test which calls for the application of the sham transacation rule and substance over form. The other test is the business purpose test. We shall consider the former test first.

Historically, the sham transaction test cases grew out of the plan devised by Eli Livingstone, a Boston broker and securities dealer. By combining the interest deduction and the capital gains tax provisions, taxpayers in high income brackets were able to obtain substantial tax savings for a relatively small cash expense.

The first of the so-called Livingstone cases was *Goodstein v. Commissioner*.[66] In this case the scheme for creating interest deductions was held unsuccessful despite careful compliance with the formalities of indebtedness. Involved in this is an elaborate but insubstantial transaction conceived by Eli Livingstone, which in simple terms was as follows: On a day in October 1952, the taxpayer entered into an agreement for the purchase of $10 million of 1 3/8% Treasury notes. He gave to Livingstone $15,000 down payment for the purchase of the notes and Livingstone arranged a loan for the balance of the transaction. Thereupon, Livingstone ordered the bank (with which he had a security account) to accept delivery of $10 million worth of notes from a bond dealer. The bank charged Livingstone's account with the purported purchase price and credited the same amount to the bond dealer. However, within one-half hour of this transaction, Livingstone resold the notes to the dealer, which purported to pay for them with a check drawn on the credit balance he had just received from the original sale. On the same day, the taxpayer executed a promissory note to a lender investment company (which Livingstone controlled) for a loan at an interest rate of 2 3/8% or one per cent higher than that of the Treasury notes to cover the balance of the purported purchase price. He pledged the Treasury notes as collateral for his promissory note, giving the lender full right of hypothecation. The lender (a shell, with no funds to lend) directed Livingstone to sell the notes held as collateral (which Livingstone by prearrangement had already done). The purported proceeds were used to repay Livingstone for the cost of the original purchase. By this process it was made to appear that the taxpayer had borrowed $9,914,212.71 (the balance of the purchase price) from the lender. The taxpayer gave the lender checks for $40,000 and $10,000, allegedly as prepaid interest on this loan. Shortly after each of these checks were received by the lender, it issued its own check in identical amount to the taxpayer

[66] 267 F. 2d 127 (1959), affg TC 1178 (1958).



who executed a promissory note to the lender for the amount thereof so that there was never out of pocket interest expense. The entire transaction created on paper a net loss for the taxpayer, since the increment on the Treasury notes did not equal his interest payments to the lender; but the combination of interest deductions from ordinary income and capital gains treatment of the gain on the disposition of the securities would have given him a real after-tax profit.

Invoking the well-settled definition of interest as being "the amount one has contracted to pay for the use of borrowed money", the Tax Court through Judge Atkins concluded that there was no actual loan to the taxpayer. The actual purchase by Livingstone of the $10 million face value of Treasury notes was consummated only to give color to the transaction, and as pointed out, these notes were disposed of immediately. The Tax Court thought it apparent that it was the intention of all the participants that the taxpayer would not purchase, and that he would not pay any interest. He did not risk any borrowed money. The only amount he actually paid out and risked was the $15,000.

In answer to the taxpayer's contention that the lender came into funds using taxpayer's treasury notes to cover a short sale of these notes, thus enabling Goodstein to complete his purchase, the court stated that assuming such was the plan, nothing resulted but bookkeeping entries insufficient to constitute a debtor-creditor relationship between petitioner and the lender. There was no payment of actual interest. Everytime Goodstein drew a check to the lender he got the money back almost at once.[67]

The Government followed its victory in *Goodstein* with seven more defeats for the taxpayer, each involving a deal conceived and engineered by Livingstone. *Sonnabend v. Commissioner*[68], *John Fox*,[69] *Matthew Becker*,[70] and *Broome v. U.S.*[71] were so much like *Goodstein*. In the last three Livingstone cases — *Lynch v. Commissioner*,[72] *Julian v. Commissioner*,[73]

[67] The Circuit Court also cited with approval the the Tax Court's second ground for disallowing the interest deduction that "even if the transaction were considered one of substance, the taxpayer being on the cash basis, would not under the circumstances disclosed be entitled to a deduction for interest for there was no payment of interest at best there would be no more than giving of notes to evidence a liability for interest". 267 F.2d 131.

[68] 26 F.2d 319 affg TC Memo 1958-178 (1958).

[69] TC Memo 1958-205 (1958).

[70] TC Memo 1959-19 (1959).

[71] 170 F. Supp. 613 (1959).

[72] 273 F.2d 867 (1959) affg 31 TC 990 (1958).

and *Miles v. Commissioner*[74] the bookkeeping reached such perfection that hardly any money, no US notes, and no banks, no securities vendor were required. In these cases the taxpayers "purchased" US Treasury bonds from Livingstone and "borrowed" money from a lender (a longtime friend and law partner of Livingstone) to finance the "purchase". The taxpayers executed non recourse notes for the "loan" in favor of the lender and "pledged" the bonds as security. The lender raised additional funds to loan to taxpayers by selling short to or through Livingstone the identical type and amount of bonds pledged by the taxpayers for the same price paid by the taxpayers. Since the lender owed Livingstone in behalf of the taxpayers and since Livingstone owed the lender a like amount due to the lender's short sale to Livingstone, the liabilities cancelled. No Treasury bonds were physically transferred between Livingstone and the lender. The taxpayers paid interest on the loan and claimed interest deductions.

But a new theme appears in these three cases. The taxpayer in *Lynch* argued that even if his transactions lacked business purpose or commercial substance, "it is of no moment, for a deduction pursuant to Sec. 23(b) is not subject to limitation on this basis."[75] Judge Bruce although sustaining the Commissioner also on the no-real debt ground took pains to overturn this argument and thereby applied the doctrine in *Gregory* to the interest deduction. If a taxpayer seeking to avoid tax make it appear to be something which in reality it is not, the court "will ignore the form the transaction has assumed, declaring it to be a sham or lacking in economic reality, and will ascertain the tax impact based upon the substantive nature of the transaction."[76] A transaction having no business purpose other than the avoidance of taxes by creating a deduction "is clearly not within the intendment of the taxing statute and will be ignored for tax purposes. Businessmen, more often than not, desire to profit from their enterprises."[77] But here the only hope of realizing a profit rested on the interplay of the capital gains tax and the interest deduction and the transaction was not economically feasible without the favorable tax impact.

[73] 31 TC 998, affd sub nom *Lynch v. Commissioner*, supra.

[74] 31 TC 1001 (1958).

[75] 31 TC 990, 995 (1959).

[76] *Id.*

[77] *Id.*



In *Miles*,[78] Judge Bruce stated the thesis more succinctly:

> Throughout the above mentioned cases is an underlying theme that only bonafide business transactions having a legitimate business purpose in addition to the minimization of taxes will be recognized for tax purposes, and then only if the characterization the taxpayer places on the transaction is in reality what it purports to be in form.

On appeal the *Lynch* and *Julian* cases were affirmed on the more fundamental ground that the elaborate drawing of checks, execution of notes and bookkeeping entries did not in fact produce the legal transactions which they simulated. Here no money was used or forborne. When the series of transactions was completed they were exactly where they had been at the outset, save only that each taxpayer had paid money for a contractual right to the delivery of the Treasury notes. The dim prospect of a profit through market appreciation cast doubt on the claim of a purpose other than tax avoidance.

Notwithstanding the consistent ruling of the courts sustaining the Commissioner in the *Livingstone* cases, the Tax Court excused itself and ruled for the taxpayer in the case of *Stanton v. Commissioner of Internal Revenue*.[79] Writing for the majority, Judge Merduck rested his opinion on the intent of Congress not to limit the interest deduction except where debt was incurred to buy or carry tax exempt securities.

The facts of this case are as follows: In December 1952, Mr. Stanton borrowed $8,888,925 from various banks at 3% interest, giving his full recourse promissory notes to buy $9,000,000 principal amount of Commercial Investment Trust (CIT) non-interest bearing notes for $8,888,937. He paid interest of $144,032 on his loan in December 1952 and in June of 1953, sold the CIT notes for $8,996,388 — a gain of $ 107,451. The transaction resulted in an economic loss of $ 36,581, which the taxpayer sought to convert into an after-tax profit by claiming an ordinary deduction for the interest paid and reporting the gain as a capital gain.

The Tax Court found as a fact that Stanton "anticipated that the interest he would have to pay on the loans would exceed the gain he would have on the notes but he would have a net gain after taxes from the transaction."[80]

[78] 31 TC 1007.

[79] 34 TC 1 (1960).

[80] *Id.* at 2.

That the taxpayer had actually borrowed money, purchased the CIT notes and paid interest on his own promissory notes was not questioned. The majority of the court allowed the interest deduction on the ground that the transaction did not come within the explicit statutory exception to the allowance of a deduction for interest paid on indebtedness incurred to purchase or carry tax exempt obligations under Sec. 23(b) of the 1939 Internal Revenue Code. The majority reasoned that since Congress enacted only one exception, the maxim "inclusio unius est exclusio" applies, that is, Congress intended no other exception or limitation on the deductibility of interest on indebtedness.

Stating that Congress had in the past rejected limitations on the interest deduction somewhat comparable to that urged by the Commissioner, the court held: "Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit or that it cannot be borrowed for personal or nonbusiness tax benefits and the Tax Court has no authority to write or read such requirements in the law."[81] The Court distinguished the so-called *Livingstone* line of cases on the ground that the alleged purchases, borrowings and interest payments involved there were sham. There was no genuine indebtedness on which interest was paid.

Four judges dissented from the *Stanton* decision. The prevailing theme of their opinions was that the taxpayer's transaction had "no genuine business purposes" and that the Code was not intended to provide tax benefits for "transactions which, standing alone and without regard for tax considerations, are not economically sound and are engaged in solely for the purpose of creating tax deductions which by means of the interplay between various sections of the Code will result in tax-free income."[82]

They opined that the provisions allowing the deduction of interest were intended to apply to transactions founded upon economic reality and not to facilitate the practices disclosed in these cases. As a general proposition one of the dissenting opinions in *Stanton* quoted Judge Learned Hand in *Transport Trading and Terminal Corporation*[83]: "The doctrine in Gregory v. Helvering means that in contruing words of

[81] *Id.* at 7. Note that the Philippine Tax Code by virtue of the amendment introduced by BP 135 now prohibits the deduction of personal interest.

[82] *Id.* at 12.

[83] *Transport Trading*, 176 F.2d 570.



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 escape taxation."[84] This view expressed in the dissenting opinion became the business purpose test aspect of determining the deductibility of interest.

It is obvious from the above cases that the court merely looked through the form of the transaction in order to determine true substance. Its only concern was to determine whether the transaction was a sham. In doing so, the court viewed the nature of the transaction in its entirety to determine whether there was any significance to what the parties did or the same position they previously occupied in such a manner as to call the transaction a sham. The court merely interpreted the terms "interest" and "indebtedness" according to the common meaning, to wit: "interest" is the "amount which one has contacted to pay for the use or forebearance of money"[85] while "indebtedness" is "an unconditional and legally enforceable obligation for the payment of money."[86] Since in the *Livingstone* cases no loan was actually made and no interest actually paid, the alleged interest payments were disallowed. On the other hand, in *Stanton*, the interest deduction was allowed because the transaction was real, the indebtedness genuine, even though the motive of the taxpayer was purely one of achieving a tax rather than an economic gain.

A more difficult case arose when a taxpayer took more steps to make his indebtedness seem more real in a transaction that could not benefit him aside from its tax consequences. In *Knetsch*, the taxpayer, bought from an insurance company $4,004,000 worth of 2 1/2 per cent single — premium annuity bonds, paying $4,000 down and signing a note for the balance. His note bore 3 1/2 per cent interest and was secured by the bonds as collateral. The interest on the bonds accrued in value to $100,000 each year, and Knetsch borrowed $99,000 of this amount each year under the contract, while paying in advance his 3 1/2 per cent interest obligation. After two years the transaction was closed with Knetsch having borrowed $203,000 against increased cash value and paid a total of over $294,570 in interest. Although the trans-

[84] *Stanton*, 34 TC at 13.

[85] *Old Colony Railroad Co. v. Commissioner*, 284 US 552 (1931); Deputy v. Du Pont, 308 US 488 (1940).

[86] *Autenreith v. Commissioner*, 115 F.2d 856 (1940).

action before taxes cost Knetsch $91,570, interest deductions against ordinary income offset only by the capital gains tax on the accrual realized have given Knetsch a tangible after-tax benefit of more than $233,000. Knetsch's transaction with the insurance company did not appreciably affect his beneficial interest except to reduce his tax because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relatively low $1,000. The Supreme Court affirmed the lower courts in denying the deduction, saying:

> [I]t is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly 'lent' back was in reality only the rebate of a substantial part of the so-called interest payments. The $91,570 difference retained by the company was its fee for providing the facade of loans whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $233,297.68. There may well be single- premuim annuity arrangements with nontax substance which create an indebtedness for the purpose of 23(b) of the 1939 Code and 163(a) of the 1954 Code but this one is a sham.[87]

Despite the readiness of the Court to conclude that Knetsch's transactions were a sham, it must be noted that they were not without substance nor economic significance. Knetsch actually paid the sum for which an interest deduction is claimed. The bonds were actually purchased, and posted as collateral for the purchase price owed; the acquisition was not fictitious as in the Livingstone cases. Justice Douglas, dissenting and with whom Justices Whittaker and Stewart concurred, said that the lack of any chance for economic gain of the transaction, aside from tax benefits, should not affect the deductibility of interests paid pursuant to an arrangement that was not " hocus-pocus." The dissenters did not regard the transaction as a sham, pointing out that no economic distinction could be made between Knetsch's arrangement and a taxpayer who loans from an outsider at a given interest rate to buy securities that accrue in value at a lower rate or one with money in the bank earning 3% borrows at the same bank at a higher rate. Moreover, it was argued that the insurance company to which the interest payments were made reported the receipts as income and paid tax thereon.[88]

[87] 364 U.S. 361, at 366.

[88] The deductibility of interest is not determined by the fact that it is taxable to the recipient. Irving N. Klien 31 BTA 910, affd 84 F. 2d 310 (1936).



A meaningful appraisal of the import of the Supreme Court's decision in *Knetsch* requires analysis of what the majority meant in calling the transaction a sham. There was no question as to what was done by the taxpayer, nor was any element of concealed intent present. The opinion of the majority suggests that the determining fact was that Knetsch stood to gain nothing from the transaction, apart from tax advantage. It was not economic significance which was absent from the transaction but an economic purpose other than tax saving.

Here, as in the *Gregory* case, it is clear on its facts that the transaction could not have had an economic purpose, or motivation, apart from tax avoidance. The possiblity of a business purpose is absent. Moreover, in both Knetsch and Gregory the absence of any conceivable business purpose made it easy for the court to reach its desired result by reliance on an activistic construction of legislative intent.

The sham transaction rule was likewise applied in the companion cases of *Weller vs Commissioner of Internal Revenue*[89] and *Emmons vs Commissioner of Internal Revenue*[90] which arose from similar factual situations.[91] In these cases the taxpayers bought an annual premium annuity paying the first premium. They then borrowed from the bank, pledging the contract as collateral and used the money to prepay all future premiums. Shortly after the issuance of the contract, the taxpayers borrowed against the paid up contract using the proceeds to retire the bank loan. The taxpayers prepaid the interest for which they claimed interest deduction. In the following year, the taxpayers paid interest to the issuing company and borrowed from the same company to increase in the cash value. Thereafter, the Commissioner assessed income tax as a result of the the claimed deductions. Thus, the taxpayers disagreedwith the action of the Commissioner and brought the matter to the Tax Court.

In holding for the Commissioner, the Tax Court disagreed with the taxpayers' contention that there was no indebtedness. The ground on which the Tax Court eached its decision was that the entire transaction lacked substance. The court said, "[p]etitioner did not seek an annuity, and in fact gave up all substantial rights of an annuitant in order to reach his true goal, deductions in an amount large enough to reduce his taxes in a sum greater than the net consideration or cost to him

[89] 31 TC 33 (1959).

[90] 31 TC 26 (1959).

[91] Both affd 270 F.2d 294, cert. denied (1960).

of the entire operations."[92] The court concluded that "the entire transaction, although in terms within Sec. 23(b), was an elaborate and devious attempt to create a deduction for tax purposes masquerading as the purchase of an annuity policy."[93]

The Third Circuit affirmed the Tax Court in both cases using the principle laid down by Judge Learned Hand in *Gilbert*:

> If... the taxpayer enters into a transaction that does not affect his beneficial interest except to reduce his tax the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from liablities that it sought to impose.[94]
> The Third Circuit went on to state that:

> the words of these statutes which describe commercial transactions are to be understood to refer to transactions entered into upon for commercial purposes and not to include transactions entered upon for no other motive but to escape taxation.[95]

The court ignored the taxpayers' contention that the transactions involved independent economic purpose, pointing to the 4% interest rate paid by the taxpayers as against the 2.85% discount rate on the prepaid interest.

Thus, while it is true that the court called the transactions in *Knetsch, Emmons* and *Weller* a sham, the main thrust of the opinion was that the interest deductions were denied to the taxpayers because the transactions were not for any other purpose than to reduce their taxes.

Therefore, it is clear from the foregoing cases that where a transaction is a sham, the interest is denied to the taxpayer as in the *Livingstone* cases. However, the "sham" standard is not the only one that must be considered. The existence of a valid indebtedness is also important if the required business purpose for entering into the interest deduction generating transaction is not present. To have an interest deduction, first, there must be a valid indebtedness and, second, the indebtedness must have a business purpose.

[92] *Emmons*, 31 TC at 31.

[93] *Id.* at 32.

[94] 248 F.2d 411.

[95] *Id.* 412.



The application of the two-step test was made clear in *Goldstein v. Commisioner.*[96] Tillie Goldstein won the Irish Sweepstakes resulting in a substantial increase in her income. She borrowed significant amounts from two banks and used the funds to purchase US Treasury notes, which she pledged as collateral to secure a loan. Goldstein prepaid interest on the loan and claimed the expense as an interest deduction in the year the Sweepstakes proceeds were declared as income. The interest which the taxpayer paid on the loans at 4%, was substantially higher than what she earned on the government obligations, at 1 1/2%.

The Second Circuit held that the transactions were not shams, relying on four factors. First, the banks involved were independent financial institutions, unlike the lenders in the Livingstone cases where their sole function was to finance the transactions such as those before us. Second, the loans did not return the parties to their starting points within a few days. Third, the independent financial institutions had significant control over the future of the loan arrangements such as, the right to accelerate the maturity of the note after 30 days and the right to demand increase in collateral. Fourth, the notes were recourse notes in contrast to the *Livingstone* cases where the taxpayers issued nonrecourse notes. Hence, the Second Circuit concluded that the transactions were not shams but created genuine indebtedness.

Despite the finding that the transactions were not shams, the Second Circuit nonetheless refused to allow an interest deduction on the loan. The evidence showed that the taxpayer would suffer an economic loss on the transaction given the excess of the interest rates paid on the loan over those earned on the purchased Treasury obligations. The court rejected the taxpayer's explanation that the transaction might produce a profit if the market for Treasury obligations rose. It thus concluded that the taxpayer entered the transactions "without any realistic expectation of economic profit and "solely" in order to secure a large interest deduction in 1958 which could be deducted from her sweepstake winnings in that year. Hence, the court concluded that Sec. 163[97] did not permit an interest deduction where the transactions "can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences."[98]

[96] 364 F.2d 734 (1966) cert. denied 1967.

[97] Section 163(a) of the 1954 Internal Revenue Code was Section 23(b) of the 1939 Code.

[98] *Goldstein*, 364 F.2d at 740.

The Second Circuit attempted to harmonize the broad scope of Sec 163(a) and the question of motive addressed in *Gregory*. The court admitted that the congressional purpose behind section 163(a) was broad, but it believed that there are limits inherent in Congress' decision to encourage purposive activity financed through borrowing. The court wrote that:

> Section 163(a) should be contrued to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. In other words, the interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. After all we are frequently told that a taxpayer has the right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by any means the law permits.xxx On the other hand, and notwithstanding Section 163(a)'s broad scope, this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction; and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that return less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential. Certainly, the statutory provision's underlying purpose as we understand it, does not require that a deduction be allowed in such a case. Indeed, to allow a deduction for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction from income, would frustrate Section 163(a)'s purpose; allowing it would encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress. When it enacted Section 163(a) Congress could not have intended to permit a taxpayer to reduce his taxes by means of an interest deduction that arose from a transaction that had no substance, utility, or purpose beyond the tax deduction.[99]

The two step analysis established by *Goldstien* was followed in *Lifscultz v.Commissioner*[100] and *Rothschild v. US*,[101] and in the more recent

[99] *Id.* at 741.

[100] 393 F.2d 323 (1968).

[101] 407 F.2d 404 (1969).



cases of *Salley v. Commissioner*[102] and *Bail Bonds by Marvin Nelson v. Commissioner*[103], where the court disallowed interest deduction either because the transaction was a sham or it failed to create an interest deduction since there was no expectation for economic profit.

## VII. ARGUMENTS IN FAVOR OF TAX ARBITRAGE

Taxpayers raise the following defenses against an assessment disallowing interest arising from back-to-back loan transactions:

First, they argue that the deductibility of interest in pure tax arbitrage situations should be left to Congress, and the courts should not decide it by judicial legislation. They point out that Congress has failed to require in the statute that the indebtedness be not undertaken solely to escape the burden of taxation, unlike in Sec. 34(c)(6) where it is expressly provided that for a merger or consolidation to qualify as tax-free, it must be undertaken for a bonafide business purpose and not solely for the purpose of escaping the burden of taxation; and in Sec. 43, where related taxpayers are prohibited from manipulating intercompany income and expense accounts in view of the authority expressly conferred upon the Commissioner of Internal Revenue to distribute, apportion or allocate said income and expense in order to prevent evasion of taxes. From this they conclude that Congress must intend that interest on back-to-back loans be deductible.

Second, they invoke the aspect of *Gregory* that the taxpayer has the right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by any means the law permits. Accordingly, they argue that the taxpayer's tax avoidance motive should be irrelevant in determining the tax consequences of a transaction.

It is difficult to determine the intent of the legislature by considering what it did not do in a given situation. In interpreting tax statutes, we must be governed by what the legislature did. We have the Tax Code passed by the legislature which imposes liabilities upon taxpayers based on their financial transactions. As Judge Learned Hand said in *Gilbert*[104]: "We cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.

[102] 464 F.2d 479 (1972).

[103] 820 F.2d 1543 (1987).

[104] 248 F.2d at 411.

The US Supreme Court said in *Gregory*[105]: "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." On the question of statutory intent the Court said further that: "[T]he rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[106]

Judge Learned Hand's analysis is similar to our Supreme Court's approach in the *Yutivo* case. It is not the tax avoidance motive of the taxpayer which defeats the transaction but the fact that the transaction is not what the statute intended. Therefore, transactions, though tax motivated, must have economic reality and substance apart from the tax result because the legislature never intended Section 29(b)(1) to allow interest deductions on debts that were created for no other reason than to obtain a deduction.

In a back-to-back loan arrangement, the transaction can not appreciably affect the taxpayer's beneficial interest except reduce his tax. There is no way he can make a profit, except for the tax deduction. Hence, to allow the interest deduction would violate the spirit and intent of the statute.

## CONCLUSION

We have seen from the foregoing discussion that the interest arising from back to back loan arrangements are not deductible from gross income because Sec. 29(b)(1) of the Tax Code expressly requires that the indebtedness be in connection with the taxpayer's profession,trade or business. And from the deliberations of the Batasan in enacting BP 135 which provided for such requirement it is clear that the requirement was imposed precisely to preclude the taxpayer from taking advantage of the apparent loophole arising from the broad language of the then Sec. 30(b)(1).

But even without the amendment introduced by BP 135, the disallowance of interest on back-to-back loans is justified by the application of the tax avoidance doctrines. The study of the precedents applying these tax doctrines to interest deductions revealed that two levels of analysis were necessary. First, the court analyzed the transaction to determine if there existed a valid indebtedness by using the sham transaction test and penetrating the form to find substance. After passing the test for a valid indebtedness, the next level of analysis was the business purpose tests.

Actually, there are only two purposes which are pertinent in these cases: if the courts find that no business purpose exists, the clear corollary is that the sole purpose of the taxpayer was to save taxes. Then the intention of the taxpayer to save taxes clearly becomes material, for it is evidently that a tax saving purpose alone is not a business purpose, avoiding taxation is not a business activity. This is true because the legislature intended Sec. 29(b)(1) to be made applicable only to transactions which are entered into for commercial or industrial purpose. Moreover, the underlying principle of taxing income in accordance with the ability to pay should preclude allowing taxpayers with capital to incur economic losses in order to realize after tax gains.

Since interest on back-to-back transactions is not deductible, the inevitable conclusion is that back-to-back loans is a form of tax evasion and not a worry-free tax saving device.

[105] 69 F.2d at 469.

[106] *Id.* at 470.