Bixby v. Commissioner, 58 T. C. 757 (1972)

A transaction structured to artificially inflate basis and claim deductions through the use of foreign trusts as conduits can be disregarded as a sham.

Summary

Converse Rubber Corp. orchestrated a purchase of Tyer Rubber Co. 's assets through Bermuda trusts to inflate the basis for tax benefits. The court ruled the transaction a sham, disallowing the inflated basis and limiting interest deductions. The court also determined that annual payments from the trusts to individuals were not true annuities but trust distributions, subjecting the individuals to tax on the trust income under grantor trust rules.

Facts

Converse Rubber Corp. identified an opportunity to acquire Tyer Rubber Co. 's assets at a below-book value price. To increase the tax basis, Converse arranged for the assets to be purchased by Bermuda trusts and then resold to Converse at a higher price, funded by debentures. Concurrently, individual petitioners transferred shares in Coastal Footwear Corp. to the trusts in exchange for annuities. The trusts received dividends and redemption proceeds from Coastal, which were then distributed to the individuals as annuity payments.

Procedural History

The Commissioner of Internal Revenue challenged the tax treatment of the transactions, asserting they were shams. The Tax Court consolidated multiple cases related to Converse, Tyer, and individual petitioners. After trial, the court issued its opinion, addressing the validity of the transactions and their tax implications.

Issue(s)

1. Whether the purchase of Tyer's assets by Converse through the Bermuda trusts was a sham transaction lacking a business purpose?
2. Whether Converse's cost basis for the Tyer assets should include the amount paid to the Bermuda trusts in debentures?
3. Whether the annual payments received by individual petitioners from the trusts were true annuities or trust distributions?
4. Whether the individual petitioners should be treated as settlors of the trusts for tax purposes?
5. Whether additions to tax under section 6653(a) should be applied to certain petitioners for negligence?

Holding

1. Yes, because the transaction was a sham designed to artificially inflate the tax

basis without a legitimate business purpose.
2. No, because the debentures paid to the Bermuda trusts were not part of a valid transaction and cannot be included in the cost basis.
3. No, because the payments were not annuities but prearranged trust distributions.
4. Yes, because the petitioners were the true settlors, having provided the consideration for the trusts.
5. Yes, because the petitioners failed to prove the Commissioner's determination was erroneous.

Court's Reasoning

The court determined that the three-party transaction involving the Bermuda trusts was a sham designed to inflate the cost basis of the Tyer assets for tax benefits. Converse controlled the trusts, and the transaction lacked a valid business purpose. The court disallowed the inclusion of the debentures in the cost basis and limited interest deductions to the actual interest rate on borrowed funds. For the annuities, the court found that the petitioners retained effective control over the transferred assets, making the payments trust distributions rather than annuities. Under grantor trust rules, the petitioners were taxable on the trust income. The court upheld the additions to tax under section 6653(a) due to the petitioners' failure to challenge the Commissioner's determination.

Practical Implications

This case highlights the importance of substance over form in tax transactions. Practitioners should be cautious when using foreign trusts or intermediaries to manipulate tax outcomes, as the IRS may challenge such arrangements as shams. The decision underscores the need for a legitimate business purpose beyond tax benefits. It also clarifies that retaining control over transferred assets can disqualify payments as annuities, subjecting them to grantor trust taxation. This ruling has been cited in subsequent cases to challenge similar tax avoidance schemes and has influenced IRS guidance on the use of foreign trusts in tax planning.