Husky Oil Co. v. Commissioner, 83 T. C. 717 (1984)

Interest and premium payments on debentures converted into stock are not deductible when the conversion extinguishes the obligation to pay them.

Summary

In Husky Oil Co. v. Commissioner, the Tax Court held that Husky Oil could not deduct interest and premium payments made to its parent company upon the conversion of debentures into the parent's stock. The court found that the conversion extinguished Husky's obligation to pay these amounts, as per the debenture indenture's terms. However, the court allowed deductions for interest on promissory notes issued to the parent in lieu of the debentures. Additionally, the court ruled that unamortized issue costs and redemption costs must be amortized over the life of the new notes, and that the premium payments were subject to withholding tax. The decision also addressed Husky's entitlement to deductions and credits for oil and gas lease operations, affirming its right to claim them based on its economic interest.

Facts

In 1972, Husky Oil issued convertible debentures that could be exchanged for shares of its foreign parent's stock. In 1977, Husky called these debentures for redemption, leading most holders to convert them into the parent's stock. Husky then issued promissory notes to its parent for the converted debentures' principal amount. Husky sought to deduct interest and premium paid to its parent, as well as unamortized issue costs and redemption costs. Additionally, Husky operated oil and gas leases under an agreement where it paid all expenses and sought to claim related deductions and credits.

Procedural History

The Commissioner of Internal Revenue disallowed Husky's deductions for interest, premium, and certain costs related to the debentures. Husky appealed to the U. S. Tax Court, which heard the case and issued its opinion in 1984.

Issue(s)

1. Whether interest and premium paid by Husky to its parent on converted debentures are deductible?
2. Whether the unamortized original issue costs and redemption costs of the debentures must be amortized over the lives of the promissory notes?
3. Whether the premium paid to the parent on the converted debentures is subject to withholding under section 1442, I. R. C. 1954?
4. Whether Husky is entitled to deductions for depreciation and intangible drilling and development costs and investment credits for its oil and gas lease operations?

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Holding

1. No, because the conversion of the debentures into the parent's stock extinguished Husky's obligation to pay interest and premium as per the indenture's terms.
2. Yes, because under Great Western Power Co. v. Commissioner, these costs are part of the cost of the new promissory notes and must be amortized over their term.
3. Yes, because the premium payments are fixed or determinable annual or periodical gains subject to withholding under section 1442.
4. Yes, because Husky had an economic interest in the oil and gas leases, bearing the risk of non-reimbursement for its expenditures.

Court's Reasoning

The Tax Court analyzed the debenture indenture to determine Husky's obligations. It found that the conversion of debentures into stock extinguished the obligation to pay interest and premium, as these payments were only due to holders on the redemption date. The court cited Tandy Corp. v. United States, emphasizing the "no adjustment" clause in the indenture that negated any obligation to pay interest or premium upon conversion. For the unamortized costs, the court applied Great Western Power Co. v. Commissioner, ruling that these costs must be amortized over the life of the new promissory notes. The court also upheld the withholding tax on the premium payments, as they were fixed gains under section 1442. Regarding the oil and gas operations, the court applied the economic interest test from Palmer v. Bender, concluding that Husky's obligation to pay all expenses and risk non-reimbursement entitled it to the claimed deductions and credits.

Practical Implications

This decision clarifies that interest and premium on converted debentures are not deductible when the conversion extinguishes the obligation to pay them. Companies issuing convertible securities should carefully draft indentures to specify obligations upon conversion. The ruling also reinforces that unamortized costs of retired debt must be amortized over new debt issued in exchange, impacting corporate finance strategies. Additionally, the case underscores the importance of the economic interest test in determining tax deductions for oil and gas operations, guiding how similar arrangements should be structured and reported. Subsequent cases, such as Tandy Corp. v. United States, have applied similar reasoning regarding the deductibility of payments upon conversion of securities.

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