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THE DEDUCTIBILITY OF INTEREST EXPENSE WHILE OWNING TAX-EXEMPT SECURITIES

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While tax-exempt securities offer an investor the opportunity to generate tax-free income, they also create problems under section 265 of the Internal Revenue Code if an investor wants to deduct interest expense. Section 265 disallows a deduction for interest on debt incurred or continued to buy or carry tax-exempt securities[1] or mutual fund stock which distributes tax-exempt interest.[2]

In 1931, the Supreme Court concluded that the purpose of section 265 was to prevent a taxpayer from obtaining a double tax benefit by deducting interest on borrowed funds that enable her to purchase or carry securities generating tax-exempt interest.[3] Since then it has become increasingly apparent that section 265 reaches well beyond this simple intent.

Preventing this unwanted extension of the section 265's scope requires an understanding of the positions normally taken by both the Internal Revenue Service (Service) and the courts. This Article reviews these positions and suggests several steps that a taxpayer should take to increase the likelihood of obtaining an interest deduction while holding tax-exempt securities. It pays particular attention to the recent cases of *Earl Drown Corp. v. Commissioner*[4] and *Barenholtz v. United States*.[5]

POSITION OF THE SERVICE

The Service has stated that a showing of the taxpayer's purpose to use borrowed funds to purchase or carry tax-exempt securities is required before an interest deduction will be disallowed.[6] Where such a purpose is established, the deduction will be disallowed even though (1) the taxpayer has received no tax-exempt interest (*e.g.*, where the obligation is in default),[7] (2) the interest

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1. I.R.C. § 265(a)(2) (Supp. 1988).
2. I.R.C. § 265(a)(4) (Supp. 1988).
3. Denman v. Slayton, 282 U.S. 514 (1931).
4. 86 T.C. 217 (1986).
5. 784 F.2d 375 (Fed. Cir. 1986).
6. Rev. Proc. 72-18, 1972-1 C.B. 740.
7. *Id.* (citing Clyde C. Pierce Corp. v. Commissioner, 120 F.2d 206 (5th Cir. 1941)).

on the obligation has not started to accrue,[8] or (3) the taxpayer's purpose in holding the tax-exempt securities is to produce a taxable profit rather than tax-exempt interest.[9]

Types of Evidence Used to Show Purpose

The Service may use either direct or circumstantial evidence to establish that the taxpayer's purpose for incurring debt was to purchase or carry tax-exempts.[10] Direct evidence exists if the proceeds are used for, and are directly traceable to, the purchase of tax-exempt securities.[11] The Code makes an exception however, when the proceeds of a bona-fide business indebtedness are temporarily invested in tax-exempts.[12]

Direct evidence of a purpose to *carry* tax-exempts exists where the taxpayer uses the tax-exempt obligations as collateral for indebtedness.[13] Section 265 makes no distinction between one who borrows to buy tax-exempts and one who borrows against tax-exempts already owned, since their economic positions are virtually the same.[14]

In the absence of direct evidence linking indebtedness with the purchasing or carrying of tax-exempts, the Service states that section 265 "will apply only if the totality of the facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempts exists."[15] The Code provides guidelines for establishing whether this inference can be made in circumstances involving individuals, partnerships, corporations, and dealers in tax-exempt securities. Except for dealers, however, the Service will not infer a purpose where the taxpayer's investment in tax-exempts is insubstantial. For an individual, insubstantial means that the average adjusted basis of the tax-exempts is less than or equal to 2 percent of the average adjusted basis of his portfolio investments[16] and assets held in the active conduct of a trade or business. For a corporation, the investment is presumed insubstantial if the average adjusted basis of the tax-exempts is less than or equal to 2 percent of the corporation's average total assets, valued at adjusted basis.[17] Exhibit 1 illustrates this calculation for a corporation.

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8. *Id.* (citing Illinois Terminal R.R. v. United States, 375 F.2d 1016, 1022 (Ct. Cl. 1967)).
9. *Id.* (citing Denman v. Slayton, 282 U.S. 514 (1931)).
10. *Id.*
11. *Id.* at 740-41 (citing Wynn v. United States, 411 F.2d 614 (3d Cir. 1969), *cert. denied*, 396 U.S. 1008 (1970)).
12. *Id.* at 741 (citing Rev. Rul. 55-389, 1955-1 C.B. 276).
13. *Id.*
14. *Id.* (citing Wisconsin Cheeseman v. United States, 338 F.2d 420, 422 (7th Cir. 1968)).
15. *Id.*
16. *See infra* notes 20-21 and accompanying text defining portfolio investments.
17. Rev. Proc. 72-18, 1972-1 C.B. 740, 741.

Circumstantial Evidence for Individuals

The Service generally will not infer a purpose to purchase or carry tax-exempts if a borrowing transaction is primarily personal in nature. Thus, an individual who finances the purchase of his residence through a mortgage, rather than through the sale of municipal bonds he holds, generally will not have the mortgage interest deduction disallowed. The mortgage transaction is so directly related to the personal purpose of acquiring a residence that a relationship to the tax-exempts cannot be reasonably inferred.[18]

The Service also generally will not infer a purpose to purchase or carry tax-exempts if the indebtedness is (1) incurred or continued in connection with an active business and (2) not in excess of normal business needs. But the Service will presume a purpose to *carry* tax-exempts if the individual could have foreseen, at the time of purchasing the tax-exempts, she would require indebtedness to meet ordinary, recurrent business needs. The only way the individual may overcome this latter presumption is to show that business reasons unrelated to the tax-exempts dominated the transaction.[19]

Different Presumption for Portfolio Investments

If indebtedness in incurred to finance portfolio investments, rather than personal items or trade or business activities, the Service will infer a purpose to carry tax-exempt securities. The term portfolio investments generally includes transactions entered into for profit (including investments in real estate) which are not connected with the active conduct of a trade or business. Thus, an investment that gives the taxpayer a substantial interest in a corporation engaged in the active conduct of a trade or business is not considered a portfolio investment. By the same token, any ownership in a corporation not engaged in the active conduct of a trade or business is considered a portfolio investment.[20] Whether the investment is substantial is determined on a case-by-case basis.[21]

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18. *Id.*

19. *Id.*

20. Rev. Proc. 74-8, 1974-1 C.B. 419.

21. *Id.*

EXHIBIT 1

Calculation of "Insubstantial" Tax-Exempt Investment for a Corporation
Section 3.05, Revenue Procedure 72-18 (1972-1 CB 740)

Example: ABC Corporation has total assets with a tax basis of $30 million and owns tax-free municipal bonds of $1 million, The municipal bonds are pledged to the surety company that provides the company with performance bonds for its contracts.

		Tax Basis[c]
1. Tax-exempt obligations— average amount[a]		$ 1,000,000
2. Other investments— average amounts		
a. Portfolio investments[b]	$ 2,000,000	
b. Assets used in active conduct of trade or business	28,000,000	30,000,000
3. Percent that 1 is of 2. If not over 2 percent, then "insubstantial" test is met. If over 2 percent then "facts and circumstances" apply and there is risk that the Service may challenge interest deductions. If over 2 percent, list below one or more reasons why Section 265(2) should not apply.		3 1/3%
The tax-exempt bonds are pledged to obtain a surety bond needed to stay in business.		

[a] For most purposes, month-end averages are sufficient.

[b] Any transaction entered into for profit, including real estate, other than assets used in the active conduct of a trade or business. Include again the tax-exempt securities listed in (1).

[c] These amounts are gross, without reduction for debt.

The Service offers the following example to illustrate its presumption of a purpose to carry tax-exempts while holding other portfolio investments:

> Taxpayer A, an individual, owns common stock listed on a national securities exchange, having an adjusted basis of $200,000; he owns rental property having an adjusted basis of $200,000; he has cash of $10,000; and he owns readily marketable municipal bonds having an adjusted basis of $41,000. A borrows $100,000 to invest in a limited partnership interest in a real estate syndicate and pays $8,000 interest on the loan which he claims as an interest deduction for the taxable year. Under these facts and circumstances, there is a presumption that the $100,000 indebtedness which is incurred to finance A's portfolio investment is also incurred to carry A's existing investment in tax-exempt bonds since there are no additional facts or circumstances to rebut the presumption. Accordingly, a portion of the $8,000 interest will be disallowed. . . .[22]

Rebutting Presumption for Portfolio Investments

The taxpayer may rebut the Service's inferred relationship between the indebtedness and the tax-exempts by establishing that the tax-exempts could not be sold. She cannot rebut the inference, however, by showing that (1) the securities could have been sold only with great difficulty or at a loss, (2) the proceeds from the sale would not have produced as much cash as the amount borrowed, (3) the taxpayer owned other investment assets, such as common stock, that could have been liquidated, or (4) an investment advisor recommended that a prudent man hold a particular percentage of his assets in tax-exempt obligations.[23]

Circumstantial Evidence for Partnerships

The purpose for which a partnership incurs indebtedness is attributed to the general partners in applying section 265. Each partner's interest in both partnership assets (including tax-exempts) and indebtedness is determined in accordance with his capital interest in the partnership.[24]

The Service ordinarily considers a general partner's interest in a partnership's investment in capital stock a portfolio investment. This will not be the case, however, if the investment gives the partnership a substantial interest in the corporation[25] and either (1) the partner holds at least an 80 percent interest in the partnership or (2) the business of the corporation and partner are closely related and the partner holds an interest of more than 50 percent in the partnership. A *limited* partnership interest will be considered as representing a

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22. Rev. Proc. 72-18, 1972-1 C.B. 740, 742.
23. *Id.*
24. *Id.*
25. *See supra* notes 20-21 and accompanying text discussing the determination of a substantial interest in a corporation.

portfolio investment.[26]

Circumstantial Evidence for Corporations

The Service's guidelines for corporations, other than tax-exempt dealers, parallel those provided for individuals in several respects.[27] First, the Service will not infer a purpose to carry tax-exempts if the indebtedness is incurred or continued in connection with an active trade or business and is not in excess of normal business needs. Second, the Service may infer such a purpose if the indebtedness provided funds for portfolio investments. Third, the Service may infer the purpose if the taxpayer could have foreseen, at the time of purchasing the tax-exempts, that indebtedness would be required to meet future ordinary economic needs of the corporation. Fourth, the corporation may rebut the inferred purpose by showing that business reasons unrelated to the purchase or carrying of tax-exempt securities dominated the transaction (e.g., where a mortgage debt was incurred to finance a nonrecurrent major expenditure, such as a new plant).[28]

Illustrations of the application of these guidelines to corporations both clarify and expand them. In determining usual business needs, the Service states that temporary investments of working capital in tax-exempts will not provide a basis for inferring a purpose to purchase or carry tax-exempts if the investments are liquidated frequently. If the corporation retains the tax-exempts for a substantial period, however, the purpose may be inferred. Similarly, the Service may infer such a purpose if the corporation continues indebtedness that it could have discharged, in whole or in part, by liquidating the corporation's tax-exempt holdings without withdrawing any capital committed to, or reserved for, regular business needs.[29]

A purpose to carry tax-exempts normally will not be present if the tax-exempt securities are nonnegotiable and received in the ordinary course of business as payment for services or goods provided to a state or local government.[30] Similarly, the purpose generally will not be present where such holdings are required as a condition to performing a contract to provide services or property other than money to a state or local government in the ordinary course of business.[31]

Circumstantial Evidence for Dealers in Tax-exempt Securities

The Service subjects corporations, partnerships, and sole proprietorships

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26. Rev. Proc. 72-18, 1972-1 C.B. 740, 742.
27. *See supra* notes 18-23 and accompanying text.
28. Rev. Proc. 72-18, 1972-1 C.B. 740, 743.
29. *Id.* (citing Illinois Terminal R.R. v. United States, 375 F.2d 1016, 1022 (Ct. Cl. 1967)).
30. *Id.* (citing R.B. George Mach. Co., 26 B.T.A. 594 (1932)).
31. *Id.* (citing Commissioner v. Bagley & Sewell Co., 221 F.2d 944 (1955)).

that are dealers in tax-exempts to the disallowance of interest provisions even though the securities are held only for resale.[32] If such dealers incur or continue indebtedness for the general purpose of operating a brokerage business that includes the purchase of both taxable and tax-exempt securities, the Service will infer a purpose to carry tax-exempts and will disallow an allocable portion of the interest deduction.[33] The Service generally will not infer a purpose to purchase or carry tax-exempts, however, if the dealer incurs indebtedness to acquire or improve physical facilities. Such circumstances sufficiently establish a dominant business purpose other than the purchasing or carrying of tax-exempts.[34]

Determining the Interest Disallowance

Where there is direct evidence establishing a purpose to purchase or carry tax-exempts, the Service will disallow all of the interest paid on the indebtedness. If only a fractional part of the indebtedness is directly traceable to the tax-exempts, however, that same fractional part of the interest will be disallowed. For example, if a taxpayer borrows $100,000 from a bank and invests $75,000 of the proceeds in tax-exempts, the Service will disallow 75 percent of the interest on the indebtedness.[35]

In cases where the Service uses circumstantial evidence to establish a purpose to purchase or carry tax-exempts, an allocable portion of the interest will be disallowed. The fractional part of the taxpayer's total interest cost that will be disallowed is:

$$\frac{\text{Average Amount of Tax-Exempt Securities Held}}{\text{Average Amount of Total Assets Minus Any Indebtedness Qualifying for an Interest Deduction Under Service Guidelines}}$$

Both the tax-exempts and the total assets are valued at their adjusted basis.[36]

JUDICIAL INTERPRETATION

Although the Service drew several guidelines from case law,[37] the guidelines do not fully reflect the judicial decisions rendered under section 265(a)(2). Most of these decisions centered on the taxpayer's purpose in incurring or continuing the indebtedness. Finding this purpose, however, did not depend "solely upon looking into [the taxpayer's] mind and learning what he

32. *Id.* at 742.
33. *Id.* (citing Commissioner v. Leslie, 413 F.2d 636 (1969), *cert. denied*, 396 U.S. 1007 (1970)).
34. *Id.* (citing Wisconsin Cheeseman v. United States, 339 F.2d 420, 422 (7th Cir. 1968)).
35. *Id.* at 743.
36. *Id.*
37. *See supra* notes 7-9, 11, 14, 29-31, 33-34 and accompanying text discussing guidelines drawn from case law.

was thinking; although his intentions are relevant, purpose may be inferred from his conduct and from the circumstances that confronted him."[38] Thus, the judicial decisions provide insight into what particular circumstances warrant an inference that indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt securities.

Simultaneous Holding of Indebtedness and Tax-exempt Securities

Courts generally agree that the mere existence of indebtedness and the holding of tax-exempt securities do not activate the interest disallowance of section 265(a)(2).[39] A "sufficiently direct relationship" between the incurrence or continuation of the debt and the purchasing or carrying of the tax-exempts also must exit.[40] Courts have considered several factors in inferring this relationship: (1) the timing of the borrowing and purchasing transactions, (2) the commingling of borrowed funds with other funds, (3) the foreseeability of the need to borrow at the time the tax-exempts were purchased, (4) the existence of business reasons, other than favorable tax consequences, for incurring the debt, and (5) the use of tax-exempts as collateral.

Timing of Borrowing and Purchasing Transactions and Commingling of Funds

The fact that the money borrowed is not immediately invested in tax-exempt securities does not avoid the disallowance of interest under section 265(a)(2). Similarly, commingling the borrowed money with other funds does not avoid the disallowance of interest. The Tax Court and the Sixth Circuit considered both of these factors in *Bishop v. Commissioner*[41] and *Indian Trail Trading Post v. Commissioner.*[42] *McDonough v. Commissioner* also considered the timing factor.[43]

In *Bishop*, Bishop borrowed $159,000 from a bank in 1954 to purchase taxable stocks and debentures.[44] In 1955, she borrowed $159,000 from another bank, repaid the original loan, and transferred substantially all her securities to an agency account of the second bank.[45] Nine months later, in 1956, she sold the stocks and debentures for $223,000.[46] A month later, still in 1956, she invested $217,000 in tax-exempt bonds.[47] During the next several years, she

38. Leslie v. Commissioner, 50 T.C. 11, 20-21 (1968), *rev'd on other grounds*, 413 F.2d 636 (2d Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970).
39. Bradford v. Commissioner, 60 T.C. 253 (1973).
40. Illinois Terminal R.R. v. United States, 375 F.2d 1016, 1021 (Ct. Cl. 1967).
41. 41 T.C. 154 (1963), *aff'd*, 342 F.2d 757 (6th Cir. 1965).
42. 60 T.C. 497 (1973), *aff'd*, 503 F.2d 102 (6th Cir. 1974).
43. 36 T.C.M. (CCH) 213 (1977), *aff'd*, 577 F.2d 234 (4th Cir. 1978).
44. Bishop v. Commissioner, 41 T.C. 154, 156 (1963).
45. *Id.*
46. *Id.*
47. *Id.* at 157.

bought and sold additional tax-exempt securities.[48] For the 1958 and 1959 tax years, she owned tax-exempt securities worth more than the second $150,000 loan which remained outstanding.[49]

The Service denied the interest deduction for 1958 and 1959 on the ground that the borrowed money was used to carry tax-exempt securities.[50] In Tax Court, Bishop argued that since (1) the loan was not secured by tax-exempt securities and 2) all purchases were made from commingled funds in her agency account, section 265 was inapplicable to the loan.[51] The Tax Court upheld the Service's disallowance of interest upon finding that Bishop continued the loan instead of repaying it with the proceeds from the sale of the non-tax-exempt securities.[52] This tactic enabled her to purchase and hold tax-exempt securities, and thus subjected her to the disallowance provisions of section 265(a)(2).[53] The court warned of the impact of an alternative decision on the purpose of section 265(a)(2):

> The purpose of section 265[(a)](2) is to prevent the escape from taxation of income properly subject thereto by the purchase of tax-exempt securities with borrowed money. The purpose of this section would be too easily frustrated if a borrower could avoid its impact by the simple expedient of buying non-tax-exempt securities with the borrowed funds, then selling those securities and using the proceeds of the sale to purchase tax-exempt securities instead of repaying the loan.[54]

On appeal, the Sixth Circuit affirmed the Tax Court's decision to disallow the interest deduction.[55] On the issue of the commingled funds, the court stated:

> The fact that there were other funds available in the agency account to purchase the tax-exempt securities in no way shows that such other funds were so used. It merely shows the possibility that they could have been so used. That is not enough. A taxpayer seeking a deduction must point to an applicable statute and show that he comes within its terms. The burden of proof to establish a deduction and the amount of it is upon the taxpayer.[56]

In *Indian Trial*, Indian Trail Trading Post, Inc. owned 30 acres of real estate, part of which contained a shopping center constructed in 1957.[57] In 1964 and 1965, the company made plans to construct a Woolco store on the undeveloped portion of this tract.[58] It secured interim construction financing of

48. *Id.* at 157-58.
49. *Id.*
50. *Id.* at 158.
51. *Id.* at 159.
52. *Id.* at 160-61.
53. *Id.* at 161.
54. *Id.* (citation omitted).
55. Bishop v. Commissioner, 342 F.2d 757 (6th Cir. 1965).
56. *Id.* at 759 (citation omitted).
57. Indian Trail Trading Post v. Commissioner, 60 T.C. 497, 497-98 (1973), *aff'd*, 503 F.2d 102 (6th Cir. 1974).
58. *Id.* at 498.

$630,000 from a bank and a permanent financing commitment of up to $1.1 million from an insurance company.[59] When the building was completed in 1966, the company borrowed the full $1.1 million at a 5-½% interest rate from the insurance company, paid off the $630,000 loan and related interest of $12,490, and placed the balance of the proceeds in the general corporate account.[60] Other expenses related to the expansion of the shopping center included: (1) the purchase of adjoining unimproved real estate for $100,632; (2) additional construction costs of $137,000; and (3) a $225,000 legal settlement with W.T. Grant Company, a tenant in the older section, who claimed that the Woolco store violated its lease agreement.[61] In 1966, Indian Trail also purchased $150,000 of tax-exempt securities with funds from the general corporate account.[62]

The Service disallowed $8,250 (5-½% x $150,000, face of the tax-exempt bonds) of the company's interest deduction for 1966 on the ground that the indebtedness generating the deduction was incurred or continued to purchase tax-exempt bonds.[63] In Tax Court, the company argued that there were other reasons for its decision not to liquidate its outstanding debt: (1) the debt carried a lower than current interest rate, (2) cash was needed to settle the pending litigation with W.T. Grant, (3) cash would be needed in the distant future to meet balloon payments on other indebtedness, and (4) cash would be needed for future expansion.[64]

These explanations failed to persuade both the Tax Court or the Sixth Circuit on appeal.[65] Both found that with cash on hand in excess of current business needs and with the indebtedness outstanding, Indian Trail still chose to purchase tax-exempt bonds.[66] Citing *Bishop*, the courts also held that neither the eight month lag between the borrowing and purchase transactions nor the use of commingled funds to consummate the purchase transaction was determinative.[67] The Tax Court stated:

> The lapse of some 8 months between the borrowing from the Commonwealth and the purchase of the tax-exempt bonds militates to a degree against the conclusion that petitioner incurred the indebtedness to purchase the bonds. . . . On the other hand, the facts indicate that the borrowing generated cash in excess of petitioner's current business needs and in an amount greater than the purchase price of the bonds, and there is nothing in the record herein to show that this situation did not obtain throughout the period between the borrowing and the purchase. Under these circumstances it might be said that there is a sufficient degree of tracing present to justify the inference that,

59. *Id.*
60. *Id.* at 498-99.
61. *Id.*
62. *Id.* at 499.
63. *Id.*
64. *Id.* at 502.
65. Indian Trail Trading Post v. Commissioner, 503 F.2d 102 (5th Cir. 1974).
66. *Id.* at 104; 60 T.C. 497, 502 (1973).
67. *Id.* at 104; 60 T.C. at 501.

whatever petitioner's original purpose may have been, it became so diffused by the act of allowing the funds to lie fallow that the actual use of the funds for the acquisition of the bonds provided the necessary purposive connection with the earlier borrowing.[68]

The taxpayers in *McDonough* bought a substantial number of securities on margin for twenty-eight years before they began to buy large numbers of tax-exempt securities for cash.[69] The McDonoughs did not use the tax-exempt securities as collateral —but rather held them for safekeeping in bank accounts maintained solely for tax-exempt securities and interest therefrom.[70] The McDonoughs incurred substantial interest charges on their brokerage margin accounts holding the taxable securities.[71] Additionally, they incurred interest on short-term debts used to pay taxes.[72]

The Service disallowed the portion of the taxpayers' interest deductions attributed to the purchase and the carrying of the tax-exempt securities. In Tax Court, the McDonoughs argued that the purpose of the margin account indebtedness was to purchase taxable securities. Their long and consistent history of using margin accounts for this purpose and their temporary need for a loan to pay taxes evidenced that the indebtedness bore no relation to the purchase of tax-exempt securities for cash.[73]

As in *Bishop* and *Indian Trail*, the Tax Court was not influenced by the timing of the transactions: "Although there is a lengthy history of taxable securities purchased on margin prior to the acquisition of tax-exempt securities for cash in 1966, we are unable to infer from the facts whether their intent remained unchanged subsequent to their first purchase of tax-exempt securities."[74] The court upheld the Service's disallowance of interest, but noted that the taxpayers' testimony could have changed the court's view of the case.[75] The taxpayers' failure to testify and to produce facts in their favor gave rise to the presumption that the facts produced would have been unfavorable.[76]

The Fourth Circuit affirmed the Tax Court's decision, finding that the Tax Court had determined the purpose for incurring the indebtedness from all the relevant circumstances.[77] The taxpayers' only explanation for not liquidating their tax-exempt securities to reduce their indebtedness had been "their desire to maintain a portfolio of both taxable and tax-exempt securities and to

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68. 60 T.C. at 501.
69. McDonough v. Commissioner, 36 T.C.M. (CCH) 213, 215-20 (1977).
70. *Id.* at 220.
71. *Id.* at 215-20.
72. *Id.* at 215, 226.
73. *Id.* at 225-26.
74. *Id.* at 226.
75. *Id.* at 226-27.
76. *Id.* (citing Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158, 1165 (1946)).
77. McDonough v. Commissioner, 577 F.2d 234, 235-36 (1978).

make the maximum use of the money invested in taxable securities."[78]

Foreseeability

An important, and sometimes deciding, factor in inferring a "sufficiently direct relationship" between the borrowing and purchasing transactions is whether the taxpayer could have foreseen, at the time of purchasing the tax-exempts, that she would need a loan in the near future to meet business needs. If there is no foreseeable need to borrow, then the interest on the indebtedness generally will not be disallowed under section 265 (a)(2).

Foreseeability as a Contributing Factor

In *Wisconsin Cheeseman v. United States*,[79] the Seventh Circuit used the foreseeability factor to affirm the district court's decision to disallow part of the taxpayer's interest deduction. Wisconsin Cheeseman, a corporate taxpayer, operated a seasonal mail-order business that was most active during the last three months of each calendar year.[80] To provide for high working capital needs during this time, the taxpayer obtained short-term bank loans that were collateralized by tax-exempt municipal bonds.[81] The loans were repaid with each year's sales receipts.[82]

The district court disallowed the interest deduction on the short-term loans primarily because they believed Congress did not intend an interest deduction for the taxpayer who simultaneously earned tax-free interest.[83] The Seventh Circuit struck this reasoning, but nonetheless upheld the disallowance on the basis of finding a sufficiently direct relationship between the borrowing and purchase transactions.[84] That the taxpayer (1) used the tax-exempt bonds as collateral and (2) could reasonably have foreseen that the loans would be needed to meet its ordinary, recurrent, economic needs evidenced this sufficiently direct relationship.[85]

In several instances, the Tax Court has used the foreseeability factor to support the taxpayer's interest deduction. In *Ball v. Commissioner*,[86] for example, the Tax Court upheld the deduction largely because the taxpayers' "loans were used to finance major, nonrecurring opportunities which were conducive to long-term financing, and were not foreseeable when the tax-exempt securities were purchased."[87] Similarly, in *Handy Button Machine Co. v.*

78. *Id.* at 236.
79. 388 F.2d 420 (7th Cir. 1968).
80. Wisconsin Cheeseman v. United States, 265 F. Supp. 168 (W.D. Wis. 1967).
81. *Id.* at 169.
82. *Id.*
83. *Id.* at 171.
84. Wisconsin Cheeseman v. Commissioner, 388 F.2d 420, 422 (7th Cir. 1968).
85. *Id.* at 422-23.
86. 54 T.C. 1200 (1970).
87. Ball v. Commissioner, 54 T.C. 1200, 1209 (1970).

Commissioner,[88] the Tax Court found it important that the corporation had bought most of its tax-exempts before there was any foreseeable need to borrow for the redemption of stock.[89] This combined with the court's finding that the corporation purchased the tax-exempts for legitimate business reasons, led the court to uphold the taxpayer's interest deduction.[90]

In *Estate of Norris v. Commissioner*,[91] the Tax Court again used the foreseeability factor in the taxpayer's favor. Here, except for approximately $2 million in tax-exempt securities, the (decedent) taxpayer's $80 million portfolio consisted primarily of low-basis Texaco stock.[92] A business consultant recommended that the taxpayer diversify this portfolio and make family gifts to reduce her eventual estate tax liability.[93] In carrying out this plan, the taxpayer incurred millions of dollars in gift and income taxes, which she initially satisfied through the sale of part of her Texaco holdings.[94] Since this only generated more taxes (given the stock's low basis), the consultant advised her that further selling would be like "chasing [her] tail" and a better alternative would be to borrow the money needed for taxes.[95] The taxpayer followed this advice, but the Service subsequently disallowed the portion of her interest deduction attributable to the purchase and carrying of tax-exempt securities.[96]

In Tax Court, the Service argued that the *Wisconsin Cheeseman* decision supported its disallowance of Norris' interest.[97] The Tax Court, however, distinguished *Estate of Norris* from *Wisconsin Cheeseman* in two respects.[98] First, in *Estate of Norris* the taxpayer did not use the tax-exempts as collateral for the borrowings, as did the taxpayer in *Wisconsin Cheeseman*.[99] Second, whereas Wisconsin Cheeseman's regular business pattern showed it would be necessary to borrow each fall if it purchased or held tax-exempts, the tax-exempts in *Estate of Norris* were purchased before the option of borrowing funds was ever contemplated.[100] The taxpayer in *Estate of Norris* clearly could not have foreseen the need to borrow at the time the tax-exempts were purchased.[101] In fact, she gave no thought to the tax-exempts when planning the loan transactions — a factor not surprising to the court due to the small percentage of the taxpayer's portfolio represented by the tax-exempts.[102]

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88. 61 T.C. 846 (1974).
89. Handy Button Mach. Co. v. Commissioner, 61 T.C. 846, 853 (1974).
90. *Id.* at 852-54.
91. 42 T.C.M. (CCH) 408 (1981).
92. Estate of Norris v. Commissioner, 42 T.C.M. (CCH) 408, 408-412 (1981).
93. *Id.* at 409.
94. *Id.*
95. *Id.* at 414.
96. *Id.* at 412.
97. *Id.* at 415.
98. *Id.* at 416.
99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.* at 415.

In upholding the taxpayer's deduction, the court warned that its decision was not meant "to imply that in every case where a taxpayer borrows funds to pay his taxes, section 265[(a)](2) will be inapplicable."[103] Another case, upon close analysis, might involve nothing more than a "mere juggling of assets creating only a 'surface sanitation' of the indebtedness from the acquisition or holding of exempt obligations."[104]

Foreseeability as the Deciding Factor

In the recent Tax Court case of *Earl Drown Corp. v. Commissioner*,[105] the foreseeability factor was, for the first time, the deciding factor in a section 265(a)(2) case. Earl Drown Corporation was a 25 percent general partner of Drown News Agency (DNA), a distributor of magazines and paperback books.[106] DNA, a cash-basis taxpayer, tried to control its taxable income by making large December payments to its major suppliers.[107] The corporation financed these payments with an unsecured loan from a related corporation, Drown Properties, Inc. (DPI), and a related trust, Drown Trust.[108] Additionally, through an overdraft line of credit with its bank, DNA automatically received funds when its accounts were overdrawn.[109] The bank collateralized any amounts drawn on this overdraft line of credit by tax-exempt municipal bonds which it held in a custodianship account.[110] During two of the three years in question, 1976 and 1977, the tax-exempt holdings represented 73 percent and 83 percent, respectively, of the taxpayer's total assets.[111] The record was incomplete with respect to DNA's total assets at the end of 1978.[112]

Relying primarily on *Wisconsin Cheeseman*, the Service disallowed a portion of DNA's interest deduction on both the bank and related party loans.[113] Earl Drown conceded the disallowance of its interest on the bank loans since they were collateralized by the tax-exempt securities.[114] The corporation, however, contended that the Service erred in using the foreseeability factor of *Wisconsin Cheeseman* as a basis for denying DNA's deductions on the related party loans.[115] First, unlike Wisconsin Cheeseman, DNA was not engaged in a

103. *Id.* at 417.
104. *Id.* (quoting Indian Trail Trading Post v. Commissioner, 60 T.C. 497, 500 (1973)).
105. Earl Drown Corp. v. Commissioner, 86 T.C. 217 (1986).
106. *Id.* at 218-19.
107. *Id.* at 219-20.
108. *Id.* at 221-22.
109. *Id.* at 220.
110. *Id.*
111. *Id.* at 221 n.6.
112. *Id.*
113. *Id.* at 223-24; *see* Wisconsin Cheeseman v. United States, 388 F.2d 420, 422 (7th Cir. 1968).
114. Earl Drown Corp. v. Commissioner, 86 T.C. 217, 222 n.9 (1986).
115. *Id.* at 227.

seasonal business.[116] Second, the length of time for which financing was required by DNA was much shorter than that required by Wisconsin Cheeseman.[117] Third, since the corporation conceded the nondeductibility of interest on its collateralized bank loans, the question of foreseeability with respect to DNA's bank financing was rendered moot.[118]

The Tax Court struck down each of the taxpayer's arguments and added another factor in upholding the Service's disallowance of the issue. The court found the seasonable business distinction between DNA and Wisconsin Cheeseman irrelevant.[119] In its view, the fact that the taxpayer had an ordinary recurrent need for cash — not the fact that it was engaged in a seasonable business — was the pivotal point in *Wisconsin Cheeseman.*[120] DNA had a similar need for cash that was foreseeable at the time when it purchased the tax-exempt bonds.[121] Furthermore, unlike the situation in *Wisconsin Cheeseman*, DNA's cash payments at year end were not necessitated by business reasons. Most of the payments were discretionary and made only to gain the advantages offered by the cash basis of accounting.[122]

The Tax Court also did not find the taxpayer's distinction of the time required for payment persuasive.[123] In fact, the court used the taxpayer's claim that DNA could have repaid the loans within four and seventeen days after their execution in 1976 and 1977, but chose not to, as support for its finding that the loans were incurred and continued to purchase and carry tax-exempt securities.[124]

Assuming that the term "bank financing" used in the taxpayer's final argument included the DPI and Drown Trust loans, the Tax Court disagreed that the foreseeability question was moot.[125] In the court's view, the Seventh Circuit in *Wisconsin Cheeseman* articulated the foreseeability factor as an *alternative* basis for finding a sufficiently direct relationship between the borrowing and the purchasing of tax-exempts.[126] The fact that the DPI and Drown Trust loans were not collateralized was deemed irrelevant following the Seventh Circuit's specific statement: "Under this [foreseeability] test, the deduction would be disallowed here even if the municipals were not used as collateral for the short-term loans."[127]

The final factor used by the Tax Court to support its finding was that

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116. *Id.* at 226.
117. *Id.*
118. *Id.* at 227.
119. *Id.* at 226.
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.*
125. *Id.* at 227.
126. *Id.*
127. *Id.* (quoting *Wisconsin Cheeseman*, 388 F.2d at 423 n.3).

DNA never attempted to liquidate its substantial investment (73 to 83% of total assets) in tax-exempt bonds to cover its year-end cash needs or to reduce or eliminate its obligations to DPI or Drown Trust.[128] In the court's view, "[S]uch a substantial investment in tax-exempt securities, while not necessarily dispositive, makes it more difficult to find that the relationship between the loans and the tax-exempt securities was merely a coincidence."[129]

Business Reasons

If the reasons dominating the taxpayer's use of financing are business or nontax-motivated, courts generally will not disallow the taxpayer's deduction. Decisions on this issue have been both for and against the taxpayer.

In *Drybrough v. Commissioner*,[130] neither the Tax Court nor the Sixth Circuit could find a legitimate business reason to substantiate the taxpayer's incurrence of interest. In Tax Court, Drybrough argued that the money he used to purchase the tax-exempt securities at issue was his wife's rather than his own.[131] He contended that he had borrowed the money, turned it over to his wife in payment of a debt or as a gift, and his wife then had purchased the securities for herself.[132] The Tax Court, however, found that Drybrough had carte blanche use of what he claimed was his wife's money.[133] Having the securities purchased in his wife's name was merely a way of avoiding the application of section 265(a)(2).[134] Thus, the Tax Court concluded that "the purpose for which Drybrough incurred the interest expenses was to effect the purchase of tax-exempt securities, not to carry on a legitimate business function."[135] Accordingly, the court denied the interest deductions.[136]

In *Illinois Terminal Railroad Co. v. United States*,[137] the Court of Claims also could not find a legitimate business reason for the continuation of debt. The taxpayer could have sold some or all of its tax-exempt securities to reduce its outstanding debt without withdrawing any capital committed to, or held in reserve for, the corporation's activities.[138] That the corporation chose, instead, to maintain its debt evidenced "the taxpayer had the forbidden purpose . . . . There were undoubtedly good business reasons for holding the

128. *Id.*
129. *Id.* at 227-28.
130. 42 T.C. 1029 (1964), *aff'd in part and rev'd in part*, 376 F.2d 350 (6th Cir. 1967) (the court of appeals reversed to the extent that it found the assumption of the 1953 loan should be considered money received by Drybrough; in all other respects, the Tax Court's decision was affirmed).
131. 42 T.C. at 1033, 1050-54.
132. *Id.*
133. *Id.* at 1051.
134. *Id.* at 1052-53.
135. *Id.* at 1053.
136. *Id.* at 1054.
137. 375 F.2d 1016 (Ct. Cl. 1967).
138. *Id.* at 1021.

[tax-exempt] bonds apart from the favorable tax aspects, but the latter dominated."[139] The court, however, made it clear that if a loan is needed to sustain a taxpayer's business operations rather than its ownership of tax-exempt securities, the prohibitions of section 265(a)(2) will not apply.[140]

The Seventh Circuit used the business reason test espoused in *Illinois Terminal* to support part of the taxpayer's interest deduction in *Wisconsin Cheeseman v. United States*.[141] In addition to the seasonal loans on which the interest was disallowed,[142] Wisconsin Cheeseman had a mortgage loan on a new plant intended to meet the growing demand for its products.[143] It used the entire proceeds of the loan to pay for the plant and put up no municipal bonds as collateral for the loan.[144] In deciding to allow the interest deduction on the mortgage loan, the court found several factors persuasive: (1) the taxpayer would have had fewer liquid assets and would have encountered difficulty in borrowing to meet seasonal needs if the tax-exempt securities had been sold to pay for the plant, (2) plant construction is a major, nonrecurrent expenditure that normally is financed over the long-term; (3) a reasonable person would not sacrifice liquidity and security by selling tax-exempt holdings instead of incurring mortgage debt to finance a new plant, and (4) business reasons dominated the mortgaging of the property.[145]

Business reasons also were the deciding factors in the district court cases of *March Monument Co. v. United States*[146] and *Batten v. United States*.[147] In *March Monument*, the taxpayer/corporation sold tile to a local government subdivision and the government subdivision paid with "drain orders" — municipal obligations delaying payment — that included 6 percent tax-exempt interest.[148] In the same tax year, the corporation borrowed $212,000 for business expansion under a long-term Small Business Administration (SBA) loan.[149] The Service disallowed the interest deduction on the SBA loan on the ground that it carried the tax-exempt drain orders.[150] The district court, however, concluded that several business reasons, rather than the holding of the tax-exempts, dominated the purpose of the SBA loan and thus precluded the interest disallowance under section 265(a)(2).[151] First, the corporation did not even purchase the tax-exempt obligations for investment purposes; instead, it

139. *Id.* at 1023.
140. *Id.* at 1021.
141. Wisconsin Cheeseman v. United States, 388 F.2d 420 (7th Cir. 1968).
142. *See supra* notes 79-85 and accompanying text.
143. Wisconsin Cheeseman v. United States, 388 F.2d 420, 421 (7th Cir. 1968).
144. *Id.* at 421, 423.
145. *Id.* at 423.
146. 301 F. Supp. 1316 (E.D. Mich. 1969).
147. 322 F. Supp. 626 (E.D. Va. 1971).
148. Marsh Monument Co. v. United States, 301 F. Supp. 1316, 1318 (E.D. Mich. 1969).
149. *Id.* at 1319.
150. *Id.* at 1321.
151. *Id.* at 1321-22.

acquired the tax-exempts as payment for work performed in the ordinary course of corporate business.[152] Second, the corporation took the SBA loan to expand its business and the loan was negotiated before the taxpayer could have known how many municipal construction projects on which it would bid, much less for which it would contract.[153] Third, because of the high discount cost involved in disposing of the tax-exempts (10 percent discount compared to a 5 percent going rate on borrowed funds), the taxpayer could not have avoided borrowing by liquidating the tax-exempt obligations.[154]

In *Batten*, the taxpayer had $400,000 of stock in a closely held corporation, $63,000 of tax-exempt securities, $400,000 of real estate, $96,000 in a checking account, and $125,000 of United States Treasury bonds.[155] When another stockholder of the closely held corporation died, the taxpayer, in accordance with a previous agreement, bought his share for $116,000 in cash and a ten-year, four percent, $220,000 note payable.[156] The Service disallowed the taxpayer's interest deductions on the note on the grounds that it was used to carry his tax-exempt holdings.[157] As in *Marsh Monument*, however, the district court found that business reasons unrelated to the tax-exempt holdings dominated the loan.[158] The taxpayer had sufficient liquid assets to pay the note and related interest at its maturity date without disposing of any of the tax-exempt securities.[159] Additionally, the low four percent interest rate on the note made prepayment of the note unwise from a strictly nontax business point of view. The court also concluded that the relatively small percentage of the taxpayer's net worth invested in tax-exempt securities indicated that he did not incur the debt solely to avoid taxes or obtain a double tax benefit.[160]

Business reasons again were the deciding factor, but not in the taxpayers' favor, in *Levitt v. United States*.[161] The Levitts borrowed money to purchase (at a discount) United States Treasury bonds to use (at par) to pay their federal estate taxes.[162] The taxpayers also had substantial tax-exempt holdings which they could have liquidated to purchase the bonds or pay the loans.[163] The Eighth Circuit affirmed the district court's decision to disallow part of the interest on the loans, largely because the taxpayers advanced no independent business reasons, except future tax benefits [use of the bonds to pay estate tax], to justify holding the tax-exempts while borrowing to obtain funds for

152. *Id.* at 1321.
153. *Id.* at 1322.
154. *Id.*
155. Batten v. United States, 322 F. Supp. 629, 631 (E.D. Va. 1971).
156. *Id.* at 630-31.
157. *Id.* at 631.
158. *Id.* at 631-32.
159. *Id.* at 632.
160. *Id.*
161. 517 F.2d 1339 (8th Cir. 1975), *aff'g on this issue* 368 F. Supp. 644 (S.D. Iowa 1974).
162. Levitt v. United States, 368 F. Supp. 644, 647, 649 (S.D. Iowa 1974).
163. *Id.*

the purchase of the treasury bonds.[164] The Eighth Circuit stated:

> The fact that the borrowing may have been advantageous for federal estate tax purposes does not evidence a purpose unrelated to the taxpayers' purchase and holding of tax-exempt securities. Rather, the absence of any adequate business justification for the loans compels the conclusion that the taxpayer borrowed money in order to retain his or her tax-exempt securities. By retaining all of their tax-exempt securities while borrowing to purchase taxable securities, the Levitts have, in effect financed an estate tax reduction plan. The entire justification for the interest deduction is undercut in this case, for the interest expense incurred on the indebtedness was directly and purposefully offset by income on which there was no tax.[165]

Using Tax-Exempts as Collateral

In *Wisconsin Cheeseman*, the Seventh Circuit seemed to indicate that a taxpayer who uses tax-exempt securities as collateral for indebtedness establishes a "sufficiently direct relationship" between the tax-exempts and the indebtedness, and thereby, proves the existence of the prohibited purpose of section 265(a)(2).[166] As the court stated, "one who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position. Section 265[(a)](2) makes no distinction between them."[167]

Tax Court position. The Tax Court has not interpreted *Wisconsin Cheeseman* as holding that the use of tax-exempts as collateral ipso facto establishes the required direct relationship. In *New Mexico Bancorporation v. Commissioner*,[168] the Tax Court stated its interpretation:

> While the use of exempt securities as collateral is a relevant factor, it does not automatically compel application of section 265[(a)](2). Courts, including the Seventh Circuit Court of Appeals in *Wisconsin Cheeseman, Inc.*, historically look to all of the facts and circumstances to see whether there is a "sufficiently direct relationship" between the debt and the carrying of the tax-exempt bonds.[169]

Using this interpretation, the Tax Court upheld the taxpayer's deduction of interest paid in connection with certain repurchase agreements which provided the bank an additional source of deposits that were exempt from normal interest and reserve requirements.[170] Under the agreements, the bank received deposits in exchange for certain tax-exempt securities that the bank agreed to purchase within a stated period of time (usually twenty-eight days) at the original transfer price plus stated interest (negotiable by the parties to the

164. Levitt v. United States, 517 F.2d 1339, 1344 (8th Cir. 1975).
165. *Id.* at 1344-45.
166. Wisconsin Cheeseman v. United States, 388 F.2d 420, 422 (7th Cir. 1968).
167. *Id.*
168. 74 T.C. 1342 (1980).
169. *Id.* at 1354.
170. *Id. passim.*

agreement).[171] The repurchase agreements (deposits) generally were backed by the tax-exempt securities.[172]

Looking at the taxpayer's entire operation, the Tax Court concluded that the "repurchase agreements, using State or municipal obligations, were similar to other types of bank deposits and were not the types of loans or indebtedness intended to be covered by section (265[(a)](2)."[173] Furthermore, there were a number of business reasons independent of the holding of the tax-exempt securities to warrant the offering of the repurchase agreements to the bank's customers.[174]

In subsequent cases involving the use of tax-exempts as collateral for indebtedness, the Tax Court has reiterated its interpretation in *New Mexico Bancorporation*, but has not ruled for the taxpayer. In both *Ball v. Commissioner*[175] and *Lang v. Commissioner*,[176] for example, the court used the following factors, in addition to the collateralization of the indebtedness with the tax-exempts, to support its disallowance of interest under section 265(a)(2): (1) the indebtedness was not incurred to finance a major nonrecurring, long-term expenditure; (2) a reasonable person would have sold the tax-exempts rather than incur the indebtedness; and (3) business reasons did not dominate the incurring of the indebtedness.[177]

"Barenholtz": A Recent Federal Circuit Decision

In the recent case of *Barenholtz v. United States*,[178] both the Claims Court and the Federal Circuit made the collateralization factor the key issue in deciding to disallow the taxpayer's interest deduction under section 265(a)(2). Barenholtz owned and operated a book publishing company organized as a sole proprietorship from September 1970 through 1977.[179] In 1971, the company began to take out a series of loans, with Barenholtz signing promissory notes that initially were either unsecured or secured by common stocks.[180] Beginning in 1973, however, Barenholtz sent tax-exempt bonds to the bank as collateral for the loans.[181] The bank retained all the securities

171. *Id.* at 1346-47.
172. *Id.* at 1347.
173. *Id.* at 1357.
174. *Id.*
175. 54 T.C. 1200 (1970).
176. 46 T.C.M. (CCH) 335 (1983).
177. Ball v. Commissioner, 54 T.C. 1200, 1209 (1970); Lang v. Commissioner, 46 T.C.M. (CCH) 335, 344 (1983) (same factors used to support deduction of mortgage interest in Wisconsin Cheeseman v. United States, 388 F.2d 420, 423 (7th Cir. 1968)).
178. 784 F.2d 375 (Fed. Cir. 1986).
179. *Id.* at 377.
180. *Id.*
181. *Id.*

until the loans were repaid in full in 1977.[182]

The Service disallowed Barenholtz's interest deductions from 1971 through 1977 to the extent the deductions were equal to or less than the amount of tax-exempt income received from the bonds.[183] The statute of limitations barred the assessment of additional taxes for 1971 through 1974, but due to charitable contribution and operating loss carryovers, the correct liabilities for the years at issue — 1975, 1976 and 1977 — could not be computed without computing the correct liabilities for the earlier years.[184]

After a trial, the Claims Court delivered an oral opinion on the interest deduction issue.[185] The court held that before Barenholtz began using his tax-exempts as collateral in September 1973, "there was not a sufficient business."[186] Section 265(a)(2), therefore, applied only to the interest deductions taken after that time.[187] The court, using a different method than the IRS, held that for periods when the outstanding loan balance exceeded the amount of the tax-exempt bonds used as collateral, interest attributable to the portion of the loan balance secured by the bonds was not deductible.[188] Any interest attributable to the excess loan balance was deductible.[189]

In the appeal, Barenholtz argued that there was a lack of nexus or prohibited purpose in that he did not need to use the tax-exempt bonds as collateral.[190] The value of his other assets far exceeded the amount of the loans.[191] The Federal Circuit, however, deemed it irrelevant that he could have used other assets for collateral.[192] That he used the tax-exempts as collateral was determinative, because it was "direct evidence of the prohibited purpose."[193]

Barenholtz also argued that his case fell within the exception to the general rule that the use of tax-exempts as collateral was sufficient to establish the prohibited purpose.[194] Citing the Claims Court's decision in *Investors Diversified Services, Inc. v. United States*,[195] he contended that the general rule applied only where (1) the taxpayer had a business purpose for the loan and (2) retention of the tax-exempt securities resulted from some compelling nontax reason.[196] The Federal Circuit found a business purpose for Barenholtz's loan, but not a compelling nontax reason for retention of the tax-exempt

182. *Id.*
183. *Id.*
184. *Id.*
185. Barenholtz v. United States, No. 356-82T (Cl. Ct. Mar. 4, 1985).
186. Barenholtz v. United States, 784 F.2d 375, 378 (Fed. Cir. 1986).
187. *Id.*
188. *Id.*
189. *Id.*
190. *Id.* at 379.
191. *Id.*
192. *Id.*
193. *Id.*
194. *Id.* at 379-80.
195. 575 F.2d 843, 847-48 (Ct. Cl. 1978).
196. Barenholtz v. United States, 784 F.2d 375, 380 (Fed. Cir. 1986).

securities.[197] On this latter point, the court stated:

> The exception for compelling nontax reasons applies where an entity in the business of attracting deposits, such as a bank or an investment company, is legally required to retain securities to meet reserve requirements. . . . Similarly, courts have applied the exception where the taxpayer was compelled to accept tax-exempt securities as payments and the securities were not salable. . . . Here, Barenholtz demonstrated no compelling nontax reason for holding his tax-exempt bonds while incurring and continuing loans. Sale of his bonds would have eliminated his need for indebtedness, at least to the extent of the value of the bonds. . .; and he was subject neither to any legal requirement that he retain the bonds nor to any impediment to selling them.[198]

Evidence of Sufficiently Direct Relationship in Broker and Dealer Cases

The factors used by the courts as evidence of a sufficiently direct relationship in cases involving brokers and dealers have been similar to those in other cases. For example, in *Leslie v. Commissioner*,[199] the deciding factor in both the Tax Court's decision to allow the taxpayer's interest deduction and the Second Circuit's decision to disallow this interest deduction was the "business" purpose of the loan on which the interest was incurred. The taxpayer, Leslie, was a partner of Bache & Company, a brokerage firm whose business consisted of buying and selling securities and commodity contracts for its customers.[200] Bache acquired tax-exempt securities as a dealer for resale to customers, either by purchasing them on the open market or through its participation in syndicates that underwrote new issues of tax-exempt securities.[201] Bache also accepted tax-exempt orders from customers and maintained a market in issues that it underwrote or in which it dealt.[202] The firm did not encourage investments in tax-exempt securities, and sold its holdings as quickly as possible (90 days was the "house rule").[203] Bache did not use any of the securities it owned as collateral for any indebtedness it incurred or continued.[204] Furthermore, the funds in Bache's general purpose checking accounts were so commingled that their source could not be traced through the accounts to any particular application.[205]

Bache's primary reason for borrowing the money was to finance

197. *Id.*
198. *Id.*
199. 413 F.2d 636 (2d Cir. 1969), *rev'g* 50 T.C. 11 (1968), *cert. denied*, 396 U.S. 1007 (1970).
200. Leslie v. Commissioner, 50 T.C. 11, 12 (1968), *rev'd*, 413 F.2d 636 (1969).
201. *Id.*
202. *Id.*
203. *Id.* at 12-13.
204. *Id.* at 13.
205. *Id.* at 14.

customers' purchases of securities in margin accounts.[206] Bache determined the amount of money borrowed on a daily basis by comparing total receipts to total disbursements.[207] The firm never considered liquidating some of its tax-exempt securities to reduce the amount that had to be borrowed since these securities were necessary for the brokerage business.[208]

For the tax year in question, Bache's borrowings averaged $80 million, while its tax-exempt holdings averaged $2 million.[209] The Service disallowed part of Bache's interest deduction on its loans on the ground that a portion was allocable to the tax-exempt securities.[210]

The Tax Court admitted that there was some relationship between the borrowings and the tax-exempts ("if it had held no tax-exempts, it would have had to borrow less"), but concluded that the circumstances did not justify an inference that the money was borrowed for the purpose of acquiring the tax-exempts.[211] The Second Circuit, however, sided with the Service.[212] The court found that in computing its daily cash needs for the purpose of borrowing, Bache indeed considered the amount of tax-exempt securities it intended to purchase.[213] Without the tax-exempts, the company's assets and liabilities would have been lower.[214] The fact that Bache borrowed in connection with its overall business operations did not mean that its borrowings were not incurred in order to permit the firm to deal in tax-exempts.[215] The allocation of interest was made only as a measure of the disallowance.[216] The continuance of the debt was directly related to the carrying of the securities, and thus, a portion of the interest was not deductible.[217]

Effort to Distinguish Dealers and Brokers

In *Kirchner, Moore and Company v. Commissioner*,[218] the taxpayer, a dealer that used its tax-exempt holdings as collateral for loans, tried to convince the court that part of its interest should be deductible because its debt had a three-fold purpose: (1) purchase, (2) carrying, and (3) resale of the bonds.[219] The taxpayer conceded that interest incurred relative to the purchase

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206. *Id.* at 14, 23.
207. *Id.* at 14.
208. *Id.* at 21.
209. *Id.* at 15.
210. *Id.*
211. *Id.* at 21.
212. Leslie v. Commissioner, 413 F.2d 636 (2d Cir. 1969), *rev'g* 50 T.C. 11 (1968), *cert. denied*, 396 U.S. 1007 (1970).
213. *Id.* at 640.
214. *Id.* at 639.
215. *Id.* at 639-40.
216. *Id.* at 640-41.
217. *Id.* at 641.
218. 448 F.2d 1281 (10th Cir. 1971), *aff'g* 54 T.C. 940 (1970).
219. *Kirchner*, 448 F.2d at 1282.

and carrying of the bonds was nondeductible, but argued that interest allocable to the resale of the bonds was not within the scope of section 265(a)(2) and, therefore, was deductible.[220]

Both the Tax Court[221] and the Tenth Circuit[222] rejected the taxpayer's argument (termed "ingenious" by the Tenth Circuit[223]) and disallowed the entire interest deduction. The Tenth Circuit explained its decision:

> It is apparent that resale of the securities was one of the main purposes of petitioner's business. However, the debts were incurred to buy the securities and the length of time the debt existed was determined by the holding for resale, but the resale was not an event for which the money was borrowed. The *business* of the petitioner perhaps had three stages or "cycles" as it calls them, but the borrowing and the interest charges under this record were for the purchase and the holding, as the Tax Court found. This finding is supported by the record and is sufficient to invoke section 265 [(a)](2) of the Code as to all interest charges incurred.[224]

Conflicting Decisions

The Court of Claims reached two different decisions in two cases involving the same taxpayer and, with one exception, the same facts.[225] The taxpayer, Phipps, contributed tax-exempt securities for his share in the securities brokerage partnership of Smith, Barney & Company.[226] As a limited partner, Phipps was to receive annually 5 percent interest on his capital contribution, whether or not earned, plus 1 percent, if earned.[227] If the partnership used the tax-exempt securities as collateral for its own borrowings, interest on the borrowings was to be deducted from the 5 percent and 1 percent returns.[228] Additionally, in the second case, the partnership agreement provided that "if any item of 'income, gain, loss, deduction or credit' with respect to pledged securities should be treated for tax purposes as received or incurred by the partnership, each such item should be 'distributable entirely and solely to the partner who pledged' the security."[229]

In both cases, the Service viewed the arrangement between Phipps and the partnership as a conduit to obtain both tax-free income and an otherwise prohibited interest deduction.[230] The Service, therefore, taxed Phipps on his

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220. *Id.*
221. Kirchner, Moore & Co. v. Commissioner, 54 T.C. 940, 952 (1970).
222. *Kirchner*, 448 F.2d at 1284.
223. *Id.*
224. *Id.*
225. Phipps v. United States, 414 F.2d 1366 (Ct. Cl. 1969); Phipps v. United States, 515 F.2d 1099 (Ct. Cl. 1975).
226. 414 F.2d at 1369; 515 F.2d at 1101.
227. *Id.*
228. 414 F.2d at 1370; 515 F.2d at 1101.
229. *Phipps*, 515 F.2d at 1101.
230. 414 F.2d at 1374; 515 F.2d at 1102.

full return—i.e., undiminished by the interest paid by the partnership on its borrowings secured by Phipps' tax-exempt securities.[231]

In the first case, the Court of Claims ruled against the Service on the ground that the partnership, not Phipps, incurred the debt.[232] The court also stated that even if the interest deductions were not allowable to the partnership (an issue not involved), all of the partners, not just Phipps, should have borne the brunt of the disallowance.[233] In the court's view, section 265(a)(2) could not "be stretched to encompass the instant case."[234]

In the second *Phipps* case, which involved subsequent taxable years, the Court of Claims held that the clause not found in the first case shifted the disallowance to Phipps.[235] He was imputed the full 5 percent interest as the taxpayer-partner, and thus, he also was imputed the interest paid under the added provision.[236] Since the interest paid was not deductible because it was incurred to carry tax-exempt securities, Phipps could not deduct the imputed interest.[237]

NEW RULES FOR FINANCIAL INSTITUTIONS

Before the Tax Reform Act of 1986,[238] banks, thrifts and other financial institutions were partially immune from the application of section 265(a)(2). Legislative, judicial and treasury interpretations generally permitted such institutions to invest their depository funds in tax-exempt obligations without losing their deduction for interest paid on their deposits or short-term obligations.[239] Tax-preference rules, however, required financial institutions to

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231. 415 F.2d at 1370; 515 F.2d at 1102.
232. 415 F.2d at 1373-74.
233. *Id.* at 1373.
234. *Id.* at 1374.
235. 515 F.2d at 1103.
236. *Id.*
237. *Id.*
238. I.R.C. § 1-7872 (1986).
239. I.R.C. § 265(a)(2) (1986), formerly I.R.C. § 265(2) (1954), read as follows before amendment and redesignation by I.R.C. § 902(b) (1986):

> (2) *Interest.*—Interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle, or to purchase or carry any certificate to the extent the interest on such certificate is excludable under section 128. In applying the preceding sentence to a financial institution (other than a bank) which is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 and following) and which is subject to the banking laws of the State in which such institution is incorporated, interest on face-amount certificates (as defined in section 2(a)(15) of such Act), issued by such institution, and interest on amounts received for the purchase of such certificates to be issued by such institution, shall not be considered as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle, to the extent that the average amount of such obligations held by such institu-

reduce their interest deduction allocable to tax-exempts by 20 percent.[240]

The Act tries to place financial institutions on an equal plane with other taxpayers. Section 265(a)(2), as amended,[241] denies banks, thrift institutions, and other financial institutions a deduction for interest incurred after December 31, 1986,[242] and allocable to buying or carrying tax-exempt securities acquired after August 7, 1986.[243]

Calculation of Disallowable Interest Deduction

The amount allocable to the buying or carrying of tax-exempts is that portion of a financial institution's otherwise allowable interest expense that is equivalent to the ratio of the average adjusted bases of tax-exempt obligations held by the institution and acquired after August 7, 1986 to the average adjusted bases of the financial institution's total assets.[244] For tax-exempt obligations acquired after January 1, 1983 and before August 8, 1986, the twenty percent disallowance rule of prior law continues in effect.[245]

> *Example.* Thirty percent of Security State's assets, valued at adjusted bases, consist of tax-exempt securities acquired after August 7, 1986, and an additional 20 percent consist of tax-exempt securities acquired after January 1,

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> tion during the taxable year (as determined under regulations prescribed by the Secretary) does not exceed 15 percent of the average of the total assets held by such institution during the taxable year (as so determined).

Only the first sentence of this passage is included in the amended and redesignated § 265(a)(2).

For judicial interpretations of the exemption for financial institutions, see, *e.g.*, New Mexico Bancorporation v. Commissioner, 74 T.C. 1342 (1980) (interest on "repurchase agreements", a type of bank savings deposit, deductible even though secured by tax-exempts).

The Service conceded that indebtedness incurred in the daily operations of accepting regular or time deposits is not subject to interest disallowance in Rev. Rul. 61-222, 1961-2 C.B. 58. For additional interpretations by the Treasury, see, *e.g.*, Rev. Proc. 70-20, 1970-2 C.B. 499, as modified by Rev. Proc. 83-91, 1983-1 C.B. 38 (a direct connection between a bank's short-term indebtedness incurred in day-to-day operations and a tax-exempt investment generally will not be inferred in cases involving bank deposits, including interbank deposits and certificates of deposits, short-term notes, short-term Eurodollar deposits and borrowings, federal fund transactions, repurchase agreements, and borrowings from the Federal Reserve to meet reserve requirements); Rev. Rul. 67-260, 1967-2 C.B. 132, as corrected by Special Announcement, 1967-37 I.R.B. 6 (deduction barred for interest paid on certificate of deposit issued in exchange for tax-exempt bonds); Rev. Rul. 81-200, 1981-2 C.B. 81 (deduction barred for allocable portion of interest incurred by a mortgage company that received tax-exempt interest on construction loans made to public housing agencies).

240. I.R.C. § 291(a)(3) (1986).

241. *See supra* note 239 (showing effect of the Tax Reform Act of 1986 on § 265(a)(2)).

242. I.R.C. § 902(f)(1) (1986).

243. *Id.* § 265(b).

244. *Id.* § 265(b)(2).

245. *Id.* § 291(e)(1)(B).

1983 and before August 8, 1986. Security State will be denied 34 percent of its otherwise allocable interest deduction — 30 percent attributable to tax-exempts acquired after August 7, 1986, plus 4 percent (.20 x 20 percent) attributable to tax-exempts acquired after January 1, 1983 and before August 8, 1986.

Exception for Qualified Tax-Exempt Obligations

Qualified tax-exempt obligations acquired by a financial institution are not subject to the 100 percent disallowance rule under the new law.[246] Instead, these obligations are treated as through they were acquired on August 7, 1986. This makes them subject to the twenty percent disallowance rule of prior law.[247]

Qualified tax-exempt obligations include obligations that (1) are not private activity bonds and (2) are designated as qualified tax obligations by an issuer not expected to issue more than $10 million of tax-exempt obligations (other than private activity bonds) during the calendar year.[248] Furthermore, the issuer (including subordinate governmental entities) cannot have designated more than $10 million for any calendar year.[249]

TAX PLANNING OPPORTUNITIES

The Service guidelines and cases analyzed in this Article reveal several general steps that a taxpayer can take to remain outside the realm of section 265(a)(2). These steps, however, are only generalizations, not hard and fast rules.

Avoid Using Tax-Exempts as Collateral

The Service and, with a few exceptions, courts consider the use of tax-exempts as collateral for borrowed funds direct evidence of the prohibited purpose of section 265(a)(2).[250] Thus, the taxpayer should avoid using tax-exempt holdings as collateral for borrowed funds. If a bank loan document makes all of a taxpayer's assets held at the bank collateral for a defaulted loan, the taxpayer should either see that the document is modified or keep the tax-exempt securities out of a bank custodian account.

Keep Investment in Tax-Exempts "Insubstantial"

The magnitude of the taxpayer's investment in tax exempts have influenced both the courts and the Service. In *Earl Drown*, for example, the court

246. *Id.* § 265(b)(3).
247. *Id.* § 265(b)(3)(A).
248. *Id.* § 265(b)(3)(B), (C).
249. *Id.* § 265(b)(3)(D), (E).
250. *See supra* notes 13-14, 166-98 and accompanying text.

termed the taxpayer's substantial investment in tax-exempts an important, if not determinative, factor in its decision to invoke section 265(a)(2).[251] The Service, on the other hand, provided an "insubstantial" safe harbor of two percent of (1) portfolio investments, plus assets held in the active conduct of a trade or business, for individuals and (2) average total assets for corporations.[252] In both cases, the assets are valued at their adjusted tax bases (see exhibit 1).[253] Keeping the investment in tax-exempts insubstantial, preferably within the two percent safe harbor, is an obvious step for avoiding the prohibition of section 265(a)(2). What is not so obvious, however, is that some taxpayers may be underutilizing their ability to generate tax-free income. The two percent limit is based on assets valued at adjusted bases, not net equity, and thus, taxpayers with highly leveraged investments, such as real estate, may benefit from increasing their tax-exempt holdings to the 2 percent limit. Consider the following example.

> *Example.* A corporation in a fifty percent (federal plus state) tax bracket holds $100 million (adjusted tax basis) of assets subject to $98 million of mortgage debt. The corporation would be better off purchasing $2 million (two percent of average total assets) of tax-exempt securities yielding 7-½% than reducing a $2 million mortgage with a 10% interest rate. The after-tax benefit of reducing the mortgage by $2 million would be $100,000 per year (the $200,000 interest not paid, reduced by taxes of 50%, or $100,000), whereas the tax-exempt investment would produce a benefit of $150,000 (7-½% of $2 million).

Document Transactions to Avoid Reasonable Foreseeability Disallowance and/or Evidence Business Purpose

Documentation of transactions provides a powerful strategic advantage when dealing with such subjective matters as "reasonable foreseeability" and establishing that non-tax business reasons dominated the use of financing. On the foreseeability issue, such documentation should evidence that when the taxpayer purchased tax-exempt securities there was little probability that the funds used for the purchase would be needed to meet the ordinary, recurrent future economic needs of the business.[254] Cash flow projections prepared at the time of purchase, or reasonably contemporaneously, probably offer the best type of evidence on the foreseeability issue. The taxpayer, however, should support this evidence with testimony that financial decisions are routinely based on such projections. Further, she should document and retain evidence showing the unexpected nature of the situation that caused the borrowing and the reasons why liquidating or selling the tax-exempt securities was not an

251. *See supra* notes 128-29 and accompanying text.
252. *See supra* notes 16-17 and accompanying text.
253. *Id.*
254. *See supra* notes 79-129 and accompanying text discussing the foreseeability factor in judicial decisions.

appropriate financing solution.

Documentation of the business reasons for borrowing or continuing a loan should be specific and long-term.[255] In several cases, the courts have disallowed the taxpayers' interest deductions on short-term seasonal loans, but not loans for long-term projects. The documentation, therefore, should identify the projects to which the loans relate, as well as explain why part of the financing was not provided by liquidating the tax-exempts.

CONCLUSION

Congress enacted section 265(a)(2) to prevent a taxpayer from obtaining a double tax benefit: an interest deduction on borrowed funds and tax-free interest income on securities purchased with or carried by the borrowed funds. Application of section 265(a)(2), however, seldom has focused only on this simple intent. Both the Service and the courts have held that a showing of purpose to use borrowed funds to purchase or carry tax-exempts generally is required before an interest deduction will be disallowed. What has created uncertainty, and thus a need for careful planning, for the taxpayer are the number and variety of factors used, particularly by the courts, to gauge the existence of this purpose. The cases analyzed in this Article show some steps a taxpayer can take to remain outside the realm of section 265(a)(2), but these are subject to change as the courts continually interpret and add to them.

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255. *See supra* notes 130-65 and accompanying text discussing the effect of business reasons in judicial decisions.

