DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR
ASSOCIATE AREA COUNSEL (LMSB)

FROM: Heather C. Maloy
Associate Chief Counsel (ITA) CC:ITA

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 26, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Partnership =
State A =
$X =
$Y =
$Z =
Year 1 =
Year 2 =
Association =

ISSUE

Whether I.R.C. § 265(a)(2) applies to disallow deductions for interest paid on Partnership's repurchase agreements.

CONCLUSION

The determination of whether section 265(a)(2) applies is a facts and circumstances test. The facts indicate that a portion of Partnership's interest expenses may be subject to disallowance under section 265(a)(2).

<u>FACTS</u>

Partnership is a State A limited partnership that claimed interest expenses of $X for Year 1 and $Y for Year 2. The Service disallowed under section 265(a)(2) a portion of the claimed investment interest expense in each year. The disallowance for each year was determined by multiplying the Partnership's total investment interest expense by the ratio of the average fair market value of the Partnership's tax-exempt obligation to the average fair market value of all the Partnership's income-producing assets. The Tax Matters Partner (TMP) of the Partnership, contested the disallowance.

During the years at issue, the Partnership traded in securities, engaging in transactions in securities and derivatives thereof, including swaps, puts, calls, and options. The Partnership was not a completely passive investor, holding securities for long-term appreciation. The Partnership's investment strategy involved frequent transactions designed to take advantage of short-term market fluctuations. The Partnership was not a dealer in securities; all of the Partnership's investments were made for its own account. It did not take, make, or place any orders, investments, or positions for or on behalf of others, nor did it hold any assets, investments, or positions for or on behalf of others. None of the Partnership's assets were acquired or held as inventory or otherwise for sale to customers.

During the years at issue, the Partnership financed and carried substantial positions in treasuries and foreign government bonds (taxable bonds) with repurchase agreements ("repo" transactions). Essentially, the Partnership's repo transactions were secured loans of up to 100% of the purchase price of the taxable bonds. In a typical repo transaction, the Partnership sold the taxable bonds to a bank or broker subject to an agreement by the Partnership to repurchase them at a future date at a specified price exceeding the Partnership's original sale price, the difference between the sale price and the repurchase price representing the interest expense.

Typically, the term of a repo transaction varied from one to sixty days, but the Partnership frequently continued the financing at the end of the term by entering into successive repo transactions. The Partnership's investment objective in carrying these positions through repo transactions was to profit from short-term fluctuations in price of the taxable bonds.

The funds for repurchasing the bonds subject to a repo transaction were obtained by selling the bonds on the market. The proceeds of each repo transaction were traceable to the purchase of specific taxable bonds, which constituted the primary collateral security for the Partnership's repurchase obligation.

The investment interest expense claimed by the Partnership included the interest expense incurred in the Partnership's repo transactions. The claimed investment interest expense also included a relatively minor amount of interest expense reported on the Forms K-1 issued to the Partnership as a limited partner in second-tier partnerships.[1]

During the years at issue, the Partnership held substantial amounts of tax-exempt bonds issued by local and state governments. None of these bonds were acquired with the proceeds of the financing provided by the repo transactions. Nor were the bonds pledged or held as collateral to secure the financing provided by the repo transactions.

During the years at issue, a significant part of the TMP's investment strategy involved the use of privately negotiated notional principal contracts or swaps. The Partnership was a member of the Association, a trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors, and swaptions. The Association offers its members a master agreement (Agreement) and related documentation materials and instruments designed to reduce legal and credit risks in derivatives transactions. An Association Agreement provides security for participants in these transactions by making their respective obligations mutually dependent.

During the years at issue, the Partnership had outstanding Association Agreements with a number of institutional counter parties with which the Partnership engaged in one or more swap transactions. In a security agreement annexed to each Association Agreement, the Partnership agreed to provide one or more forms of additional security, including letters of credit, third-party guarantees, pledges of swap assets or proceeds, and required deposits with rights of offset.

Typically, an institutional counter party to an Association required that the Partnership deposit with the institution cash or high-grade fixed-income securities, such as treasuries marked to market, in an amount equal at any given time to the counter party's exposure, creating a right of offset exercisable by the institution if the Partnership defaulted. A schedule attached to the Association Agreement provided that the Partnership's failure to maintain a specified minimum level of capital, typically in treasuries and/or tax-exempt obligations, constituted a default with respect to all outstanding transactions under the Association Agreement. The agreement also provided that a default by one party gave the non-defaulting party the right to terminate outstanding transactions. It also required the defaulting party to reimburse the non-defaulting party for any losses.

During the years at issue, the Partnership held approximately in tax-exempt bonds, which the Partnership used to meet the minimum capital

[1]We do not have enough facts to express an opinion on whether this interest expense should be disallowed.

requirements imposed by the Association Agreement. The Partnership satisfied its minimum capital requirements under the Association Agreements with tax-exempt bonds rather than taxable bonds because the tax-exempt bonds had a better after-tax yield.

You think section 265(a)(2) should be applied to disallow interest in proportion to tax exempt obligations/total assets even without direct tracing of proceeds of repo indebtedness to tax exempts. According to your argument, the partnership is not a dealer and therefore can not have a business reason for holding tax exempt obligations; rather, it is an investor and the tax exempt bonds are part of its portfolio. You also think that, in any event, the partnership does not have a business reason for holding tax exempt bonds because liquidity requirements of third parties could have been satisfied by treasuries.

LAW AND ANALYSIS

Section 163(a) generally allows a deduction for all interest paid or accrued on indebtedness within the taxable year. Section 265(a)(2), however, disallows interest deductions on indebtedness incurred or continued to purchase or carry tax-exempt obligations.[2] The statute has been interpreted to disallow interest deductions based on the purpose of the borrowing. The statute is designed to prevent escape from taxation of income properly subject to tax by the purchase of exempt securities with borrowed money. Denham v. Slayton, 282 U.S. 514 (1931). However, it is not activated by the mere simultaneous existence of indebtedness and the holding of tax-exempt obligations. Indian Trading Post, Inc. v. Commissioner, 60 TC 497, 500 (1973), aff'd, 503 F.2d 102 (6th Cir. 1974); Bradford v. Commissioner, 60 T.C. 263 (1973). Thus, taxpayers need not automatically liquidate tax-exempt obligations before obtaining needed funds through borrowing. Indian Trading Post, Inc. at 500; Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420, 423 (7th Cir. 1968); Ball v. Commissioner, 54 T.C. 1200 (1970). Nevertheless, "a taxpayer cannot insulate himself from the prohibition of section 265(2) by merely juggling the use of his available assets so as to create a surface sanitation of the indebtedness from the acquisition or holding of tax-exempt obligations." Indian Trading Post, Inc. at 500, citing Illinois Terminal Railroad Co. v. United States, 375 F.2d 1016 (Ct. Cl. 1967); Bishop v. Commissioner, 41 T.C. 154 (1963), aff'd 342 F.2d 757 (6th Cir. 1965).

The purpose for incurring or continuing indebtedness is determined based on all the facts and circumstances and may be established either by direct or indirect evidence. See Indian Trading Post, Inc. v. Commissioner, 60 TC 497, 500 (1973), aff'd, 503 F.2d 102 (6th Cir. 1974); Section 3.01 of Rev. Proc. 72-18, 1972-1 C.B. 740. The taxpayer bears the burden of proving that no prohibited purpose existed.

[2]Section 265(a)(2) was previously designated section 265(2). For purposes of this advice, we will use the designation 265(a)(2).

Indian Trading Post, Inc. at 500; Dillon, Read & Co., Inc. v. United States, 875 F.2d 293, 298; Barenholtz v. United States, 784 F.2d 375, 379 n. 7 (Fed. Cir. 1986).

Direct evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of indebtedness are used for and are directly traceable to the purchase of tax-exempt obligations. Wynn v. United States, 411 F.2d 614 (1969), cert. denied 396 U.S. 1008 (1970); section 3.02 of Rev. Proc. 72-18. Except in the case of dealers in tax-exempt obligations, direct evidence of a purpose to carry tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness. Wisconsin Cheeseman, Inc. at 422; Barenholtz v. United States, 784 F.2d 375 (Fed. Cir. 1986); section 3.03 of Rev. Proc. 72-18. In the absence of direct evidence, section 265(a)(2) applies only if the totality of facts and circumstances support a reasonable inference that a purpose to purchase or carry tax-exempt obligations exists.[3] Wisconsin Cheeseman, Inc. at 422; section 3.04 of Rev. Proc. 72-18.

Rev. Proc. 72-18

One focus of your advice request is whether Partnership qualifies as a being engaged in a trade or business for purposes of section 4 of Rev. Proc. 72-18, which provides guidelines for individuals (and, in this case, partnerships) and the extent, if any, to which Partnership falls under the guideline in the revenue procedure. Section 4.01 of Rev. Proc. 72-18 provides that absent “direct evidence” of the purpose to carry tax-exempt obligations, the “rule” of section 4 will apply.

Section 4.02 outlines certain situations where section 265(a)(2) will not apply to a taxpayer who holds tax-exempt obligations and incurs interest on other indebtedness. Under section 4.02, a taxpayer who holds tax-exempt obligations and ”incurs indebtedness of a personal nature,” that is, for purchases for personal consumption and for a home mortgage, may still deduct the interest on the indebtedness.

Similarly, section 4.03 of Rev. Proc. 72-18 provides guidelines for individuals (and partnerships) engaged in the active conduct of a trade or business. It states that “[t]he purpose to purchase or carry tax-exempt obligations generally does not exist with respect to indebtedness incurred or continued by an individual in connection with the active conduct of trade or business (other than a dealer in tax-exempt obligations), unless it is determined that the borrowing was in excess of business needs.” (Emphasis added.) Thus, a partnership in the active conduct of a trade or business, may under some circumstances, in addition to those laid out in section

[3] Section 5 (guidelines for dealers in tax-exempt obligations) and section 7 (procedures) of Rev. Proc. 72-18 discuss additional circumstances in which interest incurred by dealers in tax-exempt obligations will be disallowed. These circumstances will not be discussed here since Partnership was not a dealer.

4.02, purchase or carry tax-exempt obligations and also incur business-related indebtedness, provided the borrowing does not exceed the business's needs. However, section 4.03 also notes case law establishing a "rebuttable presumption" that a taxpayer has a purpose to carry tax-exempt obligations where the taxpayer could have reasonably foreseen the need to incur future indebtedness when it purchased the tax-exempt obligations.

Section 4.04 of the revenue procedure limits the general guidelines of section 4.03. Section 4.04 provides that a purpose to carry tax-exempt obligations will generally be inferred wherever the taxpayer has outstanding indebtedness which is not incurred or continued in connection with the active conduct of a trade or business and the taxpayer owns tax-exempt obligations. The section further states that the "[p]urchase and sale of securities shall not constitute the active conduct of a trade or business unless the taxpayer is a dealer in securities within the meaning of section 1.471-5 of the Income Tax regulations." (Section 5 of the revenue procedure provides guidelines for dealers.) Here, all of the Partnership's investments were made for its own account. Thus, it was not a dealer and therefore was not in a trade or business for purposes of section 4.04 of the revenue procedure. If it was not in a trade or business for purposes section 4.04 of the revenue procedure, a purpose to carry tax-exempt obligations will be inferred.[4]

Section 4 of the revenue procedure, by its reference to Wisconsin Cheeseman, is obviously intended to apply to taxpayers whose trade or business involves manufacturing or selling goods and services, or the buying of tangible assets, such as the taxpayers in Wisconsin Cheeseman, Illinois Terminal Railroad Co. v. United States, supra, or Handy Button Machice Co. Inc. v. Commissioner, 61 T.C. 846 (1974). Section 4.04 excludes those in the trade or business of buying and selling securities from the guideline because such taxpayers are likely to carry tax-exempt obligations as part of their trade or business and are also likely to borrow funds in the regular course of their business. Allowing them to hold tax-exempts and deduct interest on their borrowing without further scrutiny, on the theory that their borrowings are for the reasonable needs of the business, would defeat the purpose of the revenue procedure, as well as the underlying statute and case law. Thus, taxpayers in the trade or business of buying and selling securities are necessarily excluded from the favorable presumption in section 4.03 of the revenue procedure.

This fact is reinforced by section 4.04 of the revenue procedure, which reads, in pertinent part :

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[4]Stated differently, interest on Partnership's indebtedness will not qualify for deduction under the general guidelines of section 4.03 for individuals engaged in an active trade or business. Therefore, Partnership may deduct the interest under the guidelines of the revenue procedure only if qualifies for the relief granted under section 4.02, which it does not.

> .04. Generally, a purpose to <u>carry</u> tax-exempt obligations will be inferred, unless rebutted by other evidence, whenever the taxpayer has outstanding indebtedness which is not directly connected with personal expenditures (see section 4.02) and is not incurred or continued in connection with the active conduct of a trade or business (see section 4.03) and the taxpayer owns tax-exempt obligations. This inference will be made even though the indebtedness is ostensibly incurred or continued to purchase or carry other portfolio investments.

74-1 C.B. at 741. The section goes on to say that portfolio investments "for purposes of this Revenue Procedure" are transactions "not connected with the active conduct of a trade or business" and then makes the crucial (for our purposes) statement: "[p]urchase and sale of securities" is not the active conduct of a trade or business. The reference to "portfolio investments" in this context, with the qualification they are not transactions "connected" with the active conduct of a trade or business for "for purposes of this revenue procedure," is further support for the conclusion that the guidelines of the revenue procedure were not intended to apply to taxpayers engaged in the trade or business of buying and selling securities.

Along these lines, section 6 of the revenue procedure provides "Guidelines for Corporations That Are Not Dealers in Tax-Exempt Obligations." Section 6.01 states that "[t]he purpose to purchase or carry tax-exempt obligations will not be inferred with respect to indebtedness incurred or continued to provide funds for carrying on an active trade or business, not involving the holding of tax-exempt obligations, unless it is determined that the borrowing was in excess of business needs." The fact that section 6.01 excludes trades or businesses that involve the holding of tax-exempt obligations, such as the trade or business of buying and selling securities, is further evidence that the revenue procedure is not intended to apply to such businesses (unless they are dealers).

Trade or Business

The prior analysis of Rev. Proc. 72-18 assumes that Partnership is engaged in the active conduct of a trade or business. This has not been established. Therefore, an inquiry into whether Partnership was engaged in a trade or business under established case law, regardless of the guidelines in the revenue procedure, is necessary.

For tax purposes, individuals and entities which purchase and sell stock and securities are either dealers, traders, or investors. "Both traders and dealers engage in the trade of business of buying and selling stocks and securities, whereas the activities of an investor do not qualify as a trade or business. Unlike a dealer whose business involves the sale of stocks or securities to customers, a trader does not have customers in his business. . . . Traders occupy an unusual position under the tax law because they engage in a trade or business which produces capital gains and losses."[5] Paoli v. C.I.R., 62 T.C.M. (CCH) 275 (1991) (citing King v. Commissioner, 89 T.C. 445, 457-58 (1987)).

The Internal Revenue Code has never contained a definition of the phrase "trade or business." Commissioner v. Groetzinger, 480 U.S. 23, 27 (1987). The determination of whether a taxpayer's trading activities rise to the level of carrying on a trade or business turns on the facts and circumstances of each case. Estate of Yaeger v. Commissioner, 889 F.2d 29, 33 (2d Cir. 1989), aff'g 92 T.C. 180, (citing Higgins v. Commissioner, 312 U.S. 212, 217 (1941)). In order to qualify as a trader engaged in a trade or business of buying and selling stocks and securities, a taxpayer's trading activities must be frequent, regular, and continuous. See generally, Commissioner v. Groetzinger, 480 U.S. 23 (1987).

Mere management of one's investments is not a trade or business regardless of how extensive or substantial the investment activities. Higgins v. Commissioner at 216; King v. Commissioner, 89 T.C. 445, 458; Steffler v. Commissioner, T.C. Memo. 1995-271. In deciding whether a taxpayer is in the trade or business of trading securities, the courts generally look to three factors: (1) the taxpayer's investment intent, (2) the nature of the income derived from the activity, and (3) the frequency, extent, and regularity of the taxpayer's transactions. Moller v. United States, 721 F.2d 810, 813 (Fed. Cir. 1983). In this regard, there is a two-part test to determine if a taxpayer who manages his own affairs is a trader or investor. A taxpayer's activity is considered that of a trader if (1) the trading is substantial and (2) the taxpayer seeks to profit from daily or short-term swings in the market. Mayer v. Commissioner, T.C. Memo. 1994-209; Dougherty v. Commissioner, T.C. Memo. 1994-597. In other words, a trader must show that he is engaged in purchasing and selling, stock regularly, frequently, and in substantial volume, and also that his objective is to profit from short-term market swings, not long-term appreciation and income. Paoli v. Commissioner, T.C. Memo. 1991-351.

In your facts you state that during the years at issue Partnership engaged in "transactions in securities and derivatives thereof, including swaps, puts, calls, and options." You further state that Partnership's investment strategy "involved frequent transactions designed to take advantage of short-term market fluctuations." You also state that Partnership's investment objective in the repo transactions "was to profit from short-term fluctuations in price of the taxable bonds." [redacted]

[5] However, if a trader in securities makes the election under § 475(f) of the Code, any gain or loss associated with the trader's trade or business of trading stock or securities is treated as ordinary income or loss.

Nonetheless, as noted above, this is a facts and circumstances test. In Paoli, the taxpayer engaged in 326 sales of stocks or options during the year at issue. Some 63 percent of these transactions involved stocks held for less than 31 days. In holding that the taxpayer was not a trader, the court noted that nearly 40 percent of the transactions were made during a one-month period at the beginning of the year. Some 71 percent of the sales occurred in January, February, March, and May, and approximately 90 percent of the taxpayer's total proceeds for the year came from these sales, as well as 70 percent of the taxpayer's total losses. Additionally, in the last three months of the year there was only one sale. The court held that the taxpayer's pattern of buying and selling was not sufficiently regular and continuous during the year to constitute a business. Although the court conceded that his activity in the first month of the year resembled that of a trader, it nonetheless ruled against him because this pattern did not continue throughout the year.

It should also be emphasized that mere volume of transactions is not enough to convert an investor to a trader. In Estate of Yeager, the decedent had over 2000 transactions in the two years at issue and "pursued his security activities vigorously and extensively." 889 F.2d at 33. Nonetheless, the court stated "'[n]o matter how large the estate or how continuous or extended the work required may be,' the management of securities investments is not the trade or business of a trader." Id. at 34, citing Higgins v. Commisioner, 312 U.S. at 218. The court instead looked to the length of time Yeager had held his securities and the fact that most of his profit came from holding undervalued stock until the market improved. Id. at 34.

Similarly, in Mayer v. Commissioner, T.C. Memo. 1994-209, the court held that a taxpayer's trading was "substantial," in both number of trades and dollar amount because he had more than a thousand transactions in each of three years and his gains were in the millions of dollars for each of the years. Thus, he met the first prong of the two-part test. However, because his average holding periods for the years were 317, 439, and 415 days, respectively, the court held that his emphasis was on capital growth and profit from resale. Since he did not seek to profit from short-term market swings, he did not meet the second prong of the test and therefore was not in a trade or business.

[redacted]

Prohibited Purpose

Whether or not Partnership was engaged in a trade or business, it still has, as noted above, the burden of proving that it did not incur the debt at issue for the prohibited purpose of carrying tax-exempt obligations. As further noted above, the determination is based on the totality of the facts and circumstances.[6]

Where there is direct evidence that the taxpayer incurred the debt for the purpose of purchasing or carrying tax-exempt obligations, the interest on the debt is disallowed, even though the taxpayer acquired the obligations for resale, and not to earn tax-exempt income. Leslie v. Commissioner, 413 F.2d 636 (2d Cir. 1969), cert. denied, 396 U.S. 1007 (1970). Section 3.02 of Rev. Proc. 72-18 states that "[d]irect evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations." This principle is firmly established in case law. Wynn v. United States, 411 F.2d 614 (1969), cert denied 396 U.S. 1008 (1970).

Section 4.03 of Rev. Proc. 72-18 provides that "[t]he purpose to purchase or carry tax-exempt obligations generally does not exist with respect to indebtedness incurred or continued by an individual in connection with the active conduct of trade or business...unless it is determined that the borrowing was in excess of business needs." Thus, an individual (or, in this case a partnership), in the active conduct of a trade or business, may under some circumstances, purchase or carry tax-exempt obligations and also incur indebtedness, provided the borrowing does not exceed the business's needs.

Nevertheless, section 4.03 also provides that that "there is a rebuttable presumption that the purpose to carry tax-exempt obligations exists where the taxpayer reasonably could have foreseen at the time of purchasing the tax-exempt obligations that indebtedness would have to be incurred to meet future economic needs of the business of an ordinary, recurrent variety." This principle is based on Wisconsin Cheeseman. 388 F.2d at 422. There, the Seventh Circuit held that collateralizing indebtedness with tax-exempt securities was direct evidence of the prohibited purpose. Id. However, no court has adopted the so-called "Cheeseman corollary," which posits that if interest on loans collateralized with tax-exempt obligations is conclusively nondeductible, then interest on loans collateralized with

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[6]The fact that the indebtedness and interest deductions at issue arise as a result of repurchase transactions should not preclude the difference between the sales and repurchase prices as qualifying as interest under section 265(a)(2).   Although the Tax Court in New Mexico Bancorporation v. Commissioner, 74 T.C. 1342 (1974), held that the repurchase agreements at issue were not loans for purposes of section 265(a)(2), this conclusion was based partially on the fact that the repurchase agreements were "ordinary bank deposits" and "the form of the transaction is an ordinary and customary despository transaction." 74 T.C. at 1352. The court further noted this distinction between a bank's indebtedness and other taxpayers' indebtedness in McDonough v. Commissioner, T.C. Memo. 1982-236.

taxable obligations is conclusively deductible. This theory was specifically rejected in Dillon, Read & Co. v. United States, 875 at 296. Thus, the fact that the repos were collateralized with taxable obligations does not conclusively show that Partnership did not have the prohibited purpose.

Section 4.04 creates a rebuttable presumption of a purpose to carry tax-exempt obligations whenever a taxpayer owns tax-exempt obligations and has outstanding indebtedness which is not incurred or continued in connection with the active conduct of a trade or business, even though such indebtedness is ostensibly incurred or continued to purchase or carry other portfolio investments. If the court were to rule that Partnership is a trade or business for purposes of the revenue procedure (a result which we do expect, as discussed above), it might also rule that section 4.04 does not apply, since the indebtedness was incurred or continued in connection with Partnership's business. However, this means that the rebuttable presumption created by the revenue procedure does not apply; it does not necessarily mean that the court would ignore favorable case law.

[redacted] Furthermore, "the finding of the taxpayer's purpose does not depend solely upon looking into his mind and learning what he was thinking; although his intentions are relevant, purpose may be inferred from his conduct and from the circumstances that confronted him." Leslie v. Commissioner, 50 T.C. 11, 20-21 (1968), rev'd on other grounds, 413 F.2d 636 (2nd Cir. 1969). The inquiry is "whether there is a sufficient purposive connection between the borrowing and the investment." H Enterprises, International, Inc. v. Commissioner, T.C. Memo. 1998-97, aff'd, 183 F.3d 907 (8th Cir. 1999).

In E.F. Hutton Group, Inc. v. United States, 811 F.2d 581 (Fed. Cir.), the court held that the fact that the taxpayer "may not have incurred the subordinated indebtedness specifically to purchase tax-exempts is not dispositive." However, "where trading in tax-exempts and the incurring of long-term indebtedness both represent a regular, continuous, routine, and substantial part of taxpayer's daily business, taxpayer's decision to continue (rather than retire) its subordinated indebtedness undoubtably facilitates the ability to carry tax-exempts." The appeals court noted a "continued, solid tie between the incurring of subordinated indebtedness and the purchase and maintenance of tax-exempts." 811 F.2d at 584.

Similarly, in Commissioner v. Leslie, supra, involved brokerage firm that routinely borrowed on a day-day basis to finance its operations and held tax-exempt obligations. It also commingled the proceeds of the loans with its other funds, making direct tracing of the loan proceeds impossible. In holding that section 265(a)(2) applied, the court noted that since the taxpayer "borrowed money for the purpose of conducting its business, including the holding of some tax-exempt securities" and "since the use of the borrowed funds cannot be traced, it is reasonable to allocate them to all the business purposes" of the taxpayer. 413 F.2d at 639. Accordingly, "[t]here was a direct relationship between the continuance of the debt and the carrying of tax-exempt securities." Id. at 641. As the Tax Court put it in Bradford v. Commissioner, Leslie "permits the proscribed purpose to be inferred from a continuous course of conduct involving borrowing and the acquisition of tax-exempt securities..." 60 T.C. at 260-61. Here, Partnership appears to be routinely borrowing at the same time that it holds the tax-exempts; therefore, the logic of Leslie may apply.

Bradford v. Commissioner, like Leslie and E.F. Hutton, involved a brokerage firm that held tax-exempts and regularly borrowed on a daily basis for its business needs. The court rejected as "far too simplistic" the taxpayer arguments that it borrowed simply to maintain bank balances necessary to carry on its business and that application of section 265(a)(2) to its situation would "substitute a mechanical allocation for the 'purpose' test." 60 T.C. at 259. This approach, the court said, would allow the taxpayer to escape section 265(a)(2) simply because it dealt in "both taxable securities and tax-exempt bonds." Id. Here, Partnership should not necessarily escape section 265(a)(2) simply because of the range of securities and instruments it holds.[7]

Here, although Partnership apparently holds the tax-exempts rather than trading them, the indebtedness at issue, that is, the repo transactions, seems to represent "a regular, continuous, routine, and substantial part of taxpayer's daily business," as in E.F. Hutton. The terms of the repo transactions varied from one to sixty days, but the fact that Partnership frequently continued the financing at the end of the term by entering into successive repo transactions may serve to characterize the repo transactions as long-term indebtedness. Furthermore, as Commissioner v. Leslie and Bradford v. Commissioner, demonstrate, it is does not appear to be necessary to show that the actual instruments were long-term. (In any case, this fact was not necessarily critical to the Federal Circuit: "[T]he fact that E.F. Hutton's subordinated borrowings were made on a long-term basis rather than daily is irrelevant and does not compel a different result." 811 F.2d at 585.))

We also see some similarity to a case involving an investor, Bishop v. Commissioner, 41 T.C. 154 (1963), aff'd 342 F.2d 757 (6th Cir. 1965). There, the taxpayer borrowed funds to purchase stocks and debentures, which had taxable returns. She subsequently sold the stocks and bought tax-exempts. The court

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[7]The fact that E.F. Hutton, Leslie, and Bradford all involved brokerage houses should not make a difference in their application here. As noted previously the Tax Court held in Bradford that section 265(a)(2) "on its face makes no distinction between classes of taxpayers." 60 T.C. at 259.

concluded she “continued the loan instead of repaying it with the proceeds of the sale of the non-tax-exempt securities, so that she would have the funds to purchase and hold tax-exempt securities.” 41 T.C. at 160-61. Here, it can be argued that Partnership continued the repo transactions so that it could have the funds to hold the tax-exempts.

Additionally, under Wisconsin Cheeseman, interest deductions are generally disallowed to the extent the subject indebtedness is incurred to meet recurring expenses and that the taxpayer at the time it acquired the tax-exempt obligations could reasonably foresee that it would probably have to incur indebtedness to meet such expenses. 388 F.2d at 422. The indebtedness at issue here is of a recurring nature and, thus, the need to incur it is foreseeable. Partnership should not be able to “insulate” itself from “the prohibition of section 265(2) by merely juggling the use of [its] available assets so as to create a surface sanitation of the indebtedness from the acquisition or holding of tax-exempt obligations.” Indian Trading Post, Inc. at 500.

Finally, regarding the Partnership’s liquidity requirements, there is nothing in the facts to indicate that those liquidity requirements could only be met by tax-exempts. In New Mexico Bancorporation, supra, the court’s finding that section 265(a)(2) did not apply was based in part on the fact that the purchase of state and municipal bonds was necessary to satisfy the taxpayer’s liquidity and pledge requirements. As the Tax Court subsequently stated, “[i]ndebtedness of a bank to its depositors is not treated as indebtedness incurred to purchase tax-exempt securities, largely because such treatment would seriously interfere with the marketing of Government securities that are mostly purchased by banks.” McDonough v. Commissioner, T.C. Memo. 1982-236, 43 TCM 1273, 1283. Absent such a showing here, Partnership’s holding of the tax-exempt obligations in the face of its recurrent borrowing indicates the presence of the prohibited purpose.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted][8] [redacted]

[redacted]

[redacted]

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[8] [redacted]

[redacted]

[redacted]

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Please call if you have any further questions.

Heather C. Maloy
Associate Chief Counsel (ITA)

By: ______________________________

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