FEDERAL INCOME TAXATION: INTEREST DEDUCTION DISALLOWED BROKERAGE HOUSE UNDER SECTION 265(2) WHEN LOANS BEAR A DIRECT RELATIONSHIP TO THE CARRYING OF TAX-EXEMPT SECURITIES

In *Leslie v. Commissioner*[1] the Court of Appeals for the Second Circuit held that a portion of a stock broker's interest expense arising from a single revolving loan account which was used to purchase both taxable and tax-exempt securities was allocable[2] to the purchase and holding of tax-exempt securities and fell within the non-deductibility provisions of section 265(2) of the Internal Revenue Code of 1954.[3] Taxpayer was a partner in Bache & Co., which in the course of its business purchased and held a small[4] amount of tax-exempt securities. The company obtained these securities either on its own account as a dealer for resale or in response to customer orders. Reflecting its stated policy to hold tax-exempts for trading purposes only, as opposed to investment purposes, the company maintained a market only in those securities which it underwrote or in which it dealt. Each day, in response to the flow of cash receipts and disbursements, Bache & Co. would either borrow money or repay a portion of its debt, thus maintaining a desired cash position. In no instance were the tax-exempt securities used as collateral for the loans. Taxpayer sought to deduct his share of the interest on these loans. That portion of this deduction allocable to the purchase or carrying of tax-exempts was disallowed by the Commissioner.[5] Disagreeing, the Tax Court held that the deduction should be allowed since it could not be inferred that the loans were "incurred or continued [in order] to

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[1] 413 F.2d 636 (2d Cir. 1969).

[2] The Commissioner disallowed $25,913. This was found by multiplying Bache's total interest expense by a fraction whose numerator was the approximate average monthly assets in tax-exempt securities and whose denominator was the approximate average monthly total assets, 413 F.2d at 640 n.5.

[3] INT. REV. CODE of 1954, § 265(2).

[4] Tax-exempts constituted about 1% of total assets while tax-exempt interest income ($58,933.24) accounted for less than 1/4 of 1% of Bache's gross income. John E. Leslie, 50 T.C. 11 (1968).

[5] See note 2 *supra*.

purchase or carry" the tax-exempt securities.[6] The court of appeals reversed, finding a direct relationship between the "continuance of the debt and the carrying of tax-exempt securities."[7]

Section 265 of the Internal Revenue Code of 1954 states that a deduction is not allowable for "[i]nterest on indebtedness incurred or continued to purchase or carry obligations . . . the interest on which is wholly exempt from the taxes imposed by this subtitle."[8] It seeks to prevent the double benefit which would accrue to a taxpayer were he permitted to purchase or carry tax-exempt securities with borrowed money and then deduct his interest expense from ordinary income.[9] Were this permitted, a taxpayer with $10,000 of ordinary taxable income might borrow at a cost of $10,000, invest in tax-exempts, and pay no income tax. The first predecessor of 265(2) was contained in the Revenue Act of 1917[10] which prohibited the deduction of interest on loans "incurred to purchase" tax-exempt securities. In 1918, the wording was changed to "incurred or continued to purchase or carry."[11] Congress recognized the ambiguities inherent in the "purpose" test established by the word "to" but, in 1918,[12] 1924,[13] and 1926,[14] rejected attempts to establish a more mechanical test.[15] In 1934 an unsuccessful attempt was made to provide an alternative to the necessary inquiry into "purpose" by adding to the language "or the proceeds of which are used to purchase or carry."[16] Thus, legislative intent and the common meaning of the language

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[6] John E. Leslie, 50 T.C. 11 (1968).

[7] 413 F.2d at 641.

[8] INT. REV. CODE of 1954, § 265(2).

[9] *See, e.g.*, Illinois Terminal R.R. v. United States, 375 F.2d 1016, 1021 (Ct. Cl. 1967). *See also* 65 CONG. REC. 2428-29, 7533-49, 7594-601, 7604-09, 7668-73, 8215-16, 8254-64 (1924).

[10] Revenue Act of 1917, ch. 63, 40 Stat. 300, 330, 334.

[11] Revenue Act of 1918, ch. 18, § 214(a)(2), 40 Stat. 1066.

[12] *See* S. REP. No. 617, 65th Cong., 3d Sess. 6-7 (1918); H.R. REP. No. 1037, 65th Cong., 3d Sess. 1 (1919); H.R. REP. No. 767, 65th Cong., 3d Sess. 10 (1918).

[13] *See* S. REP. No. 398, 68th Cong., 1st Sess. 24 (1924); H.R. REP. No. 844, 68th Cong., 1st Sess. 19 (1924); H.R. REP. No. 179, 68th Cong., 1st Sess. 21 (1924).

[14] *See* S. REP. No. 52, 69th Cong., 1st Sess. 21 (1926); H.R. REP. No. 356, 69th Cong., 1st Sess. 34 (1926); H.R. REP. No. 1, 69th Cong., 1st Sess. 7 (1925).

[15] The proposal basically was to allow the deduction of all interest expense paid in excess of the amount of tax-free interest received. See notes 12-14 *supra*.

[16] *See* S. REP. No. 558, 73d Cong., 2d Sess. 27 (1934); H.R. REP. No. 704, 73d Cong., 2d Sess. 22 (1934).

continue to mandate judicial inquiry into "purpose" before a deduction may be disallowed. The longevity of the "purpose" test indicates that mere concurrent holding of tax-exempt securities and indebtedness was not necessarily intended by Congress as being dispositive of the question of deductibility.

Finding the "purpose" for which the indebtedness is "incurred or continued,"[17] however, has been as difficult as anticipated by Congress. In two early cases[18] contractors were permitted to deduct interest on loans the security for which was unmarketable state warrants. The warrants had been received from the state in exchange for merchandise and subsequently, to enable the contractors to remain in business, had been pledged as security for the loans. These cases were long cited for the proposition that the existence of a *concurrent* business purpose would permit the interest deduction.[19] More recently, however, the proscribed purpose has been inferred from evidence of a "direct relationship" between the indebtedness and the purchase or carrying of tax-exempts, even where there may be other concurrent business purposes. In *Illinois Terminal Railroad v. United States*[20] deduction was disallowed where the railroad used tax-exempt municipal bonds as security to gain a higher rating in issuing its own bonds. The railroad received marketable municipal bonds in partial payment for the sale of its largest asset, a bridge, to the city. Some of the bonds were sold, but the remainder was pledged as security for its own bond issue. The proceeds from this bond issue were used to liquidate a pre-existing debt. The court recognized the "business purpose" in gaining the higher credit rating, but, because the company could have liquidated a substantial portion of the debt by selling the tax-exempts and because the tax-exempts were used as security for the bond issue, the court found the proscribed purpose *dominant*.[21] This dominant purpose test was applied again in *Wisconsin Cheeseman, Inc. v. United States*.[22] Because of highly seasonal sales, the

[17] INT. REV. CODE of 1954, § 265(2).

[18] Sioux Falls Metal Culvert Co., 26 B.T.A. 1324 (1932); R.B. George Machinery Co., 26 B.T.A. 594 (1932). *See also* Rev. Rul. 55-389, 1955-1 CUM. BULL. 276.

[19] *See generally* Kanter, *Interest Deduction: Use, Ruse, Refuse*, 46 TAXES 794, 831 n.102 (1968).

[20] 375 F.2d 1016 (Ct. Cl. 1967).

[21] *Id.* at 1023.

[22] 388 F.2d 420 (7th Cir. 1968).

taxpayer's cash needs were great for a short time each year, and it would borrow money, using tax-exempt securities as collateral. The interest deduction was disallowed on the ground that a "direct relationship" was established because the securities were pledged as collateral. Furthermore, the court held that the recurring nature of the debt in conjunction with the continued holding of tax-exempts would be sufficient evidence of the proscribed purpose even without the pledging.[23] In the same decision, however, the court allowed the company a deduction for interest on a real estate mortgage on its newly constructed building. If the company had reduced the mortgage by selling its tax-exempts, it would have sacrificed liquidity. Therefore, the court concluded that the "business purpose" of the mortgage was dominant.[24]

The brokerage house which buys and sells tax-exempts is placed in a unique position by a "purpose" test. Since its business will frequently include the purchase and carrying of tax-exempts with borrowed funds, the "business purpose" and the proscribed purpose will coincide. Brokers are not specifically excluded from the operation of section 265(2) as are certain "financial institutions,"[25] nor have they been excluded because their purpose was to buy and sell tax-exempts and not to collect tax-exempt interest.[26] Recently in *Wynn v. United States*[27] the Court of Appeals for the Third Circuit affirmed a district court decision which denied a brokerage house the interest deduction on a loan account used in the buying and selling of tax-exempt securities. In *Wynn* a separate loan account was maintained to buy and resell tax-exempt securities. The securities were pledged as collateral for the loan. The court found as a matter of fact that there was no intent to hold the tax-exempts for the interest income. It held, however, that the purpose proscribed by section 265(2) was the acquisition and holding of securities the interest on which was tax-exempt and that the statute was not limited to situations involving an intent to collect tax-exempt interest. *Wynn* could be factually distinguished

[23] *Id.* at 422-23.

[24] *Id.* at 423.

[25] *See* Denman v. Slayton, 282 U.S. 514 (1931); Rev. Rul. 61-222, 1961-2 CUM. BULL. 58.

[26] *See* Denman v. Slayton, 282 U.S. 514 (1931); Clyde C. Pierce Corp. v. Commissioner, 120 F.2d 206 (5th Cir. 1941); R.O. Holton & Co., 44 B.T.A. 202 (1941); Prudden & Co., 2 B.T.A. 14 (1925).

[27] 288 F. Supp. 797 (E.D. Pa. 1968), *aff'd per curiam*, 411 F.2d 614 (3d Cir. 1969).

from *Leslie,* however, because the *Wynn* case more clearly involved a "direct relationship." Not only were the securities pledged as collateral but all of the borrowed funds were specifically applied to the purchase of tax-exempts.

In *Leslie* the Second Circuit overruled the Tax Court which had not found the proscribed purpose. The Tax Court had reasoned that no conscious consideration was given to the liquidation of tax-exempts to reduce the loan, that the tax-exempts were held for a minimum length of time with no thought of investment, and that no "direct relationship" could be established because of the relatively small expenditure on tax-exempts from a large, commingled, general purpose checking account.[28] The purpose of the loan, it held, was to conduct a "large and many-sided business."[29] In reversing, the court of appeals held that it could allocate a part of the large loan to a minor portion of the business because it had found a "direct relationship"[30] between the continued indebtedness and the purchase and holding of tax-exempt securities. It reasoned that Bache & Co. consciously considered its tax-exempt requirements in computing its daily borrowing needs. Furthermore, employing a "but for" test, the court found that had Bache not purchased tax-exempts it "presumably would"[31] have borrowed less. Since the purpose of the loan was to facilitate the conduct of its business, since part of that business was the purchase and carrying of tax-exempt securities, and since part of the loan could be directly linked to the purchase and carrying of tax-exempts, the court found that the purpose for part of the loan was the purchase and carrying of tax-exempts.

One aspect of *Leslie* appears to represent a small but consistent extension of the existing law pertaining to section 265(2).[32] After the *Illinois Terminal Railroad* case and the lower court decision in *Wisconsin Cheeseman,*[33] there was concern that the proscribed purpose was inferred in so indirect a manner as to jeopardize the interest deduction of any taxpayer who concurrently held tax-exempt securities.[34] Any extension of the "but for" analysis used

[28] 50 T.C. 11 (1968).
[29] *Id.*
[30] 413 F.2d at 639.
[31] 413 F.2d at 641.
[32] INT. REV. CODE of 1954, § 265(2).
[33] 265 F. Supp. 168 (W.D. Wis. 1967).
[34] *See* Kanter, *supra* note 19, at 830-39; McCollom, *Recent Cases Threaten All Interest*

by the court of appeals in the *Leslie* case might result in the realization of that fear. "But for" Bache's holding of tax-exempts, for example, the brokerage house could take a smaller real estate mortgage if it were to build. The court in *Leslie,* however, may not have applied such a broad "but for" test. They found not only that Bache had consciously considered purchasing tax-exempts with the borrowed money, but also, that had Bache not purchased and held tax-exempts, it *"presumably would"*[35] have borrowed less, not *could* have borrowed less. This latter distinction may indicate that the same analysis would not be used where there is a business reason for borrowing a particular amount regardless of concurrent tax-exempt holdings.[36] Because any extension of the "but for" test could easily lead to a "mere concurrency" test, the decision in *Leslie* is most soundly based on the "conscious consideration" of tax-exempt holdings and purchases in fixing the size of the recurring loan. In this light the allocation of part of the large loan to a minor portion of the business is entirely proper. If *Wynn* is correct in holding that interest on a loan account used exclusively to buy and sell tax-exempt securities is non-deductible, there should be no exception made for a company which merely combines accounts to purchase both taxable and tax-exempt securities from the same account.[37] Neither is the small amount of tax-exempts purchased from the account persuasive in negating the proscribed purpose. A taxpayer should not be able to conceal the proscribed purpose in a larger transaction. In this respect *Leslie* represents a departure from the notion that liquidation of tax-exempts must substantially eliminate any need for borrrowing, if the "purpose" test is to be met.

Even if it can be assumed that the interest accrued on all tax-exempt securities held for however short a time by Bache is

Deductions for Holders of Tax-Exempts, 27 J. TAXATION 194 (1967). Not only would such a concurrency test seem contrary to the intent of Congress because of its adherence to the purpose test, but it would also interfere in some instances with the orderly and rational conduct of business affairs. *See, e.g.,* Rev. Rul. 55-389, 1955-1 CUM. BULL. 276.

[35] 413 F.2d at 639 (emphasis added).

[36] A large home or building mortgage, for example, might be very desirable during a period of rising interest rates or in an effort to preserve liquidity.

[37] It is interesting to note, for example, that Bache & Co. earned $58,933.24 in tax-exempt income compared with allocated carrying costs of $25,913. In *Wynn* the brokerage house earned $7,608.70 compared with $23,044.03 in actual carrying costs. Leslie v. Commissioner, 413 F.2d 636, 638, 640 n.5 (2d Cir. 1969); Wynn v. United States, 288 F. Supp. 797, 799 (E.D. Pa. 1968), *aff'd per curiam,* 411 F.2d 614 (3d Cir. 1969).

eventually paid to Bache by the purchaser and is non-taxable to Bache, the result seems at odds with the legitimate purpose of the statute. To disallow the deduction places a burden on the conduct of the broker's business in that the costs of financing what amounts to its stock-in-trade is non-deductible. The legitimate reach of the statute should be confined to insuring that the government does not finance *investment*[38] in tax-exempt securities. Perhaps section 265(2) can be interpreted to so confine its effect. The difficulty lies in describing exactly what purpose is proscribed. *Wynn* holds that a brokerage house need not intend to receive tax-exempt interest to fall within 265(2).[39] This is not an unreasonable construction if subsection (2)[40] is read by itself. It could be further argued that the specific exemption allotted to certain "financial institutions"[41] excludes the possibility that Congress intended to grant special consideration to any other businesses. However, the title of section 265 reads: "Expenses and Interest Relating to Tax-Exempt *Income*."[42] A construction which would allow any taxpayer to affirmatively show that his purposes did not include receipt of tax-exempt income would not involve a special concession to any particular business. Further, this construction would end the coincidence of a stock broker's business purpose with what has been found to be the proscribed purpose. The non-deductibility provisions of section 265(2) should be applicable only to that portion of taxpayer's interest expense which is allocable to the income resulting from investment in tax-exempt securities.

[38] "Investment" is used here as understood by the Second Circuit in *Leslie* to mean a desire to hold for the purpose of earning tax-exempt income. 413 F.2d at 637, 640.

[39] See note 9 *supra* and accompanying text.

[40] INT. REV. CODE of 1954, § 265(2).

[41] See note 25 *supra*.

[42] INT. REV. CODE of 1954, § 265 (emphasis added).