Section 265.—Expenses and Interest Relating to Tax-Exempt Income

Section 265(a) disallows expenses that would otherwise be allowable as a deduction when these expenses are allocable to income that is wholly exempt from Federal Income taxes. Section 265(a)(2) disallows interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income taxes. See Announcement 2004-44, page 957, and Rev. Rul. 2004-47, page 941.

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26 CFR 1.265–2: Interest relating to tax-exempt income.

Section 265(a)(2); expenses and interest relating to tax-exempt income. This ruling deals with the application of section 265 of the Code to affiliated corporate groups when one member of the group borrows from outside the group and makes funds available to another member of the group that is a dealer in tax-exempt securities.

Rev. Rul. 2004–47

ISSUE

If a member of an affiliated group borrows money and transfers the money to another member of the group that is a dealer in tax-exempt obligations, does § 265(a)(2) of the Internal Revenue Code apply to disallow the interest expense of the borrowing corporation?

FACTS

Situation 1. — P and S are corporations that are members of the same affiliated group, but file separate tax returns. P and S use the calendar year as their taxable year. S is a dealer in tax-exempt obligations, whose general business includes purchasing and carrying tax-exempt securities.

On January 1, 2004, L, a bank unrelated to the affiliated group that includes P and S, lends $40x to P for 5 years. L's loan to P provides for payments of interest on December 31 of each year at a rate higher than the appropriate applicable Federal rate. P contributes the $40x borrowed from L to the capital of S, and S uses the contributed funds in its business. Although the borrowed funds are directly traceable from P to S, they are not directly traceable to the purchase or carry of specific tax-exempt obligations by S. During its taxable year 2004, S holds an average of $500x of tax-exempt obligations (valued at their adjusted bases), and an average of $1,000x of total assets (valued at their adjusted bases). During its taxable year 2004, P holds an average of $10,000x of total assets (valued at their adjusted bases) and no tax-exempt obligations in the active conduct of its trade or business, and incurs $2x of interest expense on its $40x loan from L.

Situation 2. — The facts are the same as in *Situation 1*, except that P and S file a consolidated return.

Situation 3. — The facts are the same as in *Situation 1*, except that the funds that P borrowed from L are not directly traceable to any funds transferred from P to S and there is no other direct evidence linking the borrowed funds to any funds transferred from P to S.

Situation 4. — The facts are the same as in *Situation 1*, except that P loans to S the $40x borrowed from L on the same terms and conditions as the loan from L to P. During its taxable year 2004, S incurs $2x of interest expense on its $40x loan from P.

LAW AND ANALYSIS

In general, a deduction is allowed under § 163 of the Code for all interest paid or accrued on indebtedness. Under § 265(a)(2), however, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income taxes.

Rev. Proc. 72–18, 1972–1 C.B. 740, sets forth guidelines for the application of § 265(a)(2). Section 3.01, which applies to all taxpayers, states that the application of § 265(a)(2) requires a determination of the taxpayer's purpose in incurring or continuing each item of indebtedness, based on all the facts and circumstances. That section further states that the taxpayer's purpose may be established by either direct or circumstantial evidence.

Section 3.02 of Rev. Proc. 72–18 provides that direct evidence of a purpose to purchase tax-exempt obligations exists when 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 (3d

Cir. 1969), *cert. denied*, 396 U.S. 1008 (1970). Section 265(a)(2) does not apply, however, when proceeds of a *bona fide* business indebtedness are temporarily invested in tax-exempt obligations under circumstances similar to those set forth in Rev. Rul. 55–389, 1955–1 C.B. 276.

Section 3.03 of Rev. Proc. 72–18 provides that direct evidence of a purpose to carry tax-exempt obligations exists when tax-exempt obligations are used as collateral for indebtedness. "[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(2) [the predecessor of § 265(a)(2)] makes no distinction between them." *Wisconsin Cheeseman v. United States*, 388 F.2d 420 (7th Cir. 1968), at 422. Section 3.04 of Rev. Proc. 72–18 states that in the absence of direct evidence linking indebtedness with the purchase or carrying of tax-exempt obligations as illustrated in paragraphs 3.02 and 3.03 of Rev. Proc. 72–18, section 265(a)(2) of the Code will apply only if the totality of facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists. Stated alternatively, section 265(a)(2) will apply only when the totality of facts and circumstances establishes a "sufficiently direct relationship" between the borrowing and the investment in tax-exempt obligations. See *Wisconsin Cheeseman*, 388 F.2d at 422. The guidelines set forth in sections 4, 5, and 6 of Rev. Proc. 72–18 are used to determine whether such a relationship exists.

Section 3.05 of Rev. Proc. 72–18 provides that generally, when a taxpayer's investment in tax-exempt obligations is insubstantial, the purpose to purchase or carry tax-exempt obligations will ordinarily not be inferred in the absence of direct evidence as set forth in sections 3.02 and 3.03 of that revenue procedure. Section 3.05 provides further that in the case of a corporation, an investment in tax-exempt obligations shall be presumed insubstantial only when during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted bases) does not exceed 2 percent of the average total assets (valued at their adjusted bases) held in the active conduct of the trade or business. The *de minimis* rule of paragraph 3.05 does not apply to dealers in tax-exempt obligations.

Section 5 of Rev. Proc. 72–18 provides special rules for dealers in tax-exempt obligations. Specifically, section 5.03 states that if debt is incurred or continued for the general purpose of carrying on a brokerage business that includes the purchase of both taxable and tax-exempt obligations, and the use of the borrowed funds cannot be directly traced, it is reasonable to infer that the borrowed funds were used for all the activities of the business, including the purchase of tax-exempt obligations. Section 5 of Rev. Proc. 72–18 refers to a specific allocation formula in section 7 of Rev. Proc. 72–18, derived from the formula in *Commissioner v. Leslie*, 413 F.2d 636 (2d. Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970). The formula is applied to interest on borrowed funds that are not directly traceable to tax-exempt obligations. The formula consists of a fraction, whose numerator is the average amount during the taxable year of the taxpayer's tax-exempt obligations (valued at their adjusted bases), and whose denominator is the average amount during the taxable year of the taxpayer's total assets (valued at their adjusted bases) minus the amount of any indebtedness the interest on which is not subject to disallowance to any extent under Rev. Proc. 72–18.

In *H Enterprises International v. Commissioner*, 75 T.C.M. 1948 (1998), *aff'd*, 183 F.3d 907 (8th Cir. 1999), a parent and a subsidiary were members of the same consolidated group of corporations. The subsidiary declared a dividend and, a few days later, borrowed funds and immediately used part of those funds to make the dividend distribution to the parent. A portion of the distributed funds was disbursed to two investment divisions of the parent, which used the funds to acquire investments including tax-exempt obligations.

The court held that a portion of the subsidiary's indebtedness was incurred for the purpose of purchasing or carrying tax-exempt obligations (held in the parent's investment divisions) and, therefore, no deduction was allowed for the interest on this portion of the indebtedness under § 265(a)(2). To establish the required purposive connection under § 265(a)(2), the court reasoned that the activities of the parent corporation were relevant in determining the subsidiary's purpose for borrowing the funds. If the analysis only focused on the borrower and not the transferee, then the purpose of the borrower corporation would always be acceptable, frustrating the legislative intent of § 265(a)(2).

In both *Situations 1* and *2*, following the rationale of *H Enterprises*, the activities of S must be taken into account to determine P's purpose under § 265(a)(2) for borrowing the $40x of funds that are directly traceable to P's contribution to the capital of S. In order to determine the activities of S, however, Rev. Proc. 72–18 must be applied. Because S's brokerage business includes the purchase of both taxable and tax-exempt obligations, it is reasonable to infer under section 5.03 of Rev. Proc. 72–18 that part of P's debt was incurred for the purpose of purchasing or carrying tax-exempt obligations. Applying the allocation formula in section 7 of Rev. Proc. 72–18, the interest expense incurred by P on the $40x borrowed is subject to partial disallowance. The ratio of S's average tax-exempt obligations to S's total assets is $500x/$1,000x. Therefore, one-half of the $2x interest expense incurred by P (*i.e.*, $1x) is disallowed as a deduction to P under § 265(a)(2). P is not entitled to the 2 percent *de minimis* rule provided by section 3.05 of Rev. Proc. 72–18 because S is a dealer in tax-exempt obligations.

In *Situation 3*, there is no direct evidence that P transferred to S any portion of the $40X P borrowed from L. Without such direct evidence, the activities of S will not be taken into account to determine P's purpose under § 265(a)(2) for borrowing the $40x and it is not reasonable to infer that part of P's debt was incurred for the purpose of purchasing or carrying tax-exempt obligations. Therefore, none of the $2x interest expense incurred by P is disallowed as a deduction under § 265(a)(2).

In *Situation 4*, the $40x that P borrowed from L is directly traceable to P's loan to S. Accordingly, the two separate back-to-back loans (*i.e.*, the loan from L to P, followed by the loan from P to S) must each be examined for the potential application of § 265(a)(2). With regard to the loan from L to P, P uses the borrowed funds to make a loan to S, and separately accounts for the taxable interest income from this loan. P does not have a purpose of using the borrowed funds to purchase or carry tax-exempt obligations within the meaning of § 265(a)(2). With regard to the loan from P to S, although the borrowed

funds are not directly traceable to S's purchase or carry of tax-exempt obligations, § 265(a)(2) applies to S, a dealer in tax-exempt obligations, to disallow a portion of its interest expense. The portion of S's interest deduction that is disallowed is computed by applying the allocation formula in section 7 of Rev. Proc. 72–18. The ratio of S's average tax-exempt obligations to S's total assets is $500x/$1,000x. Accordingly, one-half of the $2x interest expense incurred by S (*i.e.*, $1x) is disallowed to S as a deduction under § 265(a)(2). S is not entitled to the 2 percent *de minimis* rule provided by section 3.05 of Rev. Proc. 72–18 because S is a dealer in tax-exempt obligations.

HOLDINGS

If a member of an affiliated group borrows money and contributes the borrowed funds to another member that is a dealer in tax-exempt obligations such that the funds contributed to the dealer are directly traceable to the contributor's borrowing, but are not directly traceable to the dealer's purchase or carry of tax-exempt obligations, § 265(a)(2) applies to disallow a portion of the interest expense of the contributor. The portion of the contributor's interest deduction to be disallowed is determined by applying the allocation formula in section 7 of Rev. Proc. 72–18 to the dealer that uses the borrowed funds in its business.

If a member of an affiliated group borrows money and there is no direct evidence linking the borrowed funds to any funds transferred to another member who is a dealer in tax-exempt obligations, § 265(a)(2) does not apply to disallow any portion of the interest expense of the borrowing member based on the dealer member's investment in tax-exempt obligations.

If the funds borrowed by a member of an affiliated group are directly traceable to a loan to another member that is a dealer in tax-exempt obligations, § 265(a)(2) does not apply to disallow the interest expense of the lending member, but does apply to disallow a portion of the interest expense of the dealer. The portion of the dealer's interest deduction to be disallowed is determined by applying the allocation formula in section 7 of Rev. Proc. 72–18.

DRAFTING INFORMATION

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