Catholic University Law Review

Volume 34
Issue 1 *Fall 1984*

Article 7

1984

Tax-Exempts and Tax Shelters: Should the Same Person Invest in Both?

Robert A. Weiland

TAX-EXEMPTS AND TAX SHELTERS: SHOULD THE SAME PERSON INVEST IN BOTH?

*Robert A. Weiland**

In recent years, limited partnerships that invest in real estate have become immensely popular among high bracket taxpayers. Investments in such partnerships, known widely as tax shelters, are intended to result in increased income to the investor primarily through decreased personal income tax liability.

A partnership is not a taxable entity for federal income tax purposes.[1] Its taxable income or loss is determined at the partnership level and is passed through to the partners to be reported on their individual tax returns.[2] This pass-through scheme of taxation has made partnerships the most favored tax shelter vehicle.[3]

In general, tax shelter investments enable taxpayers to reduce their tax liabilities through the use of tax benefits generated by investments. The three most common elements of a tax shelter are: (1) the ability to defer tax liability to a later year;[4] (2) the opportunity to transform ordinary income into capital gain;[5] and (3) the use of borrowed funds to finance the invest-

---

* Associate, Goulston & Storrs, Boston, Mass. B.A., 1968, University of Wisconsin; J.D., Magna cum laude, 1981, Boston College Law School.

1. Internal Revenue Code of 1954, as amended I.R.C. § 701 (1984).
2. I.R.C. § 702(a) (1984).
3. It should, but may not, go without saying that the term "tax shelter" is not, in essence, one that should have any inherent pejorative connotations. The provisions of the Internal Revenue Code (I.R.C.) that foster these investments provide incentives for economic purposes approved of by Congress. An abusive tax shelter, on the other hand, is formed primarily to obtain tax benefits without regard to the economic viability of the investment.
4. Deferral involves the acceleration of deductions resulting in an interest-free loan from the Government. In the real estate tax shelter arena, deferral is aided by the Accelerated Cost Recovery System (ACRS). *See* I.R.C. § 168 (1984).
5. Conversion may be accomplished where a taxpayer takes an accelerated deduction against ordinary income, and the income that is eventually generated by the investment is taxed at the capital gains rate.

Under ACRS all gain or disposition of nonresidential real property whose cost is recovered on an accelerated basis over the allowable 18-year period (15 years in the case of low-income housing) will be treated as ordinary income, to the extent of recovery allowances previously taken under the prescribed accelerated method. Thus, in the case of nonresidential property, taxpayers may either use straight line recovery with no recapture or accelerated recovery with recapture of all recovery deductions to the extent gain is recognized. *See supra* note 4.

ments, commonly referred to as "leverage."

It is this last reason that makes real estate limited partnerships so attractive. The partnership may leverage its investment causing its depreciation deductions to exceed its partners' equity investments. In a tax shelter, the partnership finances a large part of the project with nonrecourse loans,[6] which are proportionately added to the tax basis of the individual limited partners.[7] The benefits of leveraging a tax shelter investment can be simply illustrated. Assume limited partner *A* purchases a one-tenth interest in the profits, losses, and capital of a limited partnership for $100,000 and the limited partnership borrows $3,000,000 (of which $300,000 is attributed to *A*). *A* has a basis of $400,000 in his partnership interest and may claim deductions up to this amount. The partnership may depreciate the property over fifteen years[8], assuming it is low-income housing,[9] and pass through the depreciation to *A* to be deducted from his taxes. In year one, the depreciation is equal to approximately $52,000.00 and thus appears as a loss on *A*'s tax return. Assuming *A* is in the 50% tax bracket, that loss is worth $26,000.00 to *A*.

The nonrecourse loan must, of course, be repaid. Ordinarily payments will include both principal and interest. The partnership will make the payments and the interest payment deduction will flow through to the limited partners. Generally, the Internal Revenue Code (I.R.C. or Code) allows a deduction of all interest paid or accrued within the taxable year on indebtedness.[10] Thus, in addition to claiming losses through depreciation, a limited partner will be able to deduct the interest on his pro rata share of the loan

6. In most partnership situations, investors are limited in the deduction they may take to the amount actually at risk in the partnership. However, the at-risk limitations do not apply to those who invest in real estate. I.R.C. § 465(c)(3)(D) (1984).

7. A partner's distributive share of the partnership's losses is limited by his basis in the partnership. I.R.C. § 704(d) (1984). *See* Isley, *Tax Shelter Aspects of the Limited Partnership Real Estate Syndicate*, 14 GONZ. L. REV. 855, 864-66 (1979) (a useful discourse on the limited partners' basis in the tax shelter limited partnership area).

8. The Economic Recovery Tax Act of 1981 introduced a new system of depreciation known as the Accelerated Cost Recovery System (ACRS) based on the entire cost of depreciable improvements, regardless of whether such improvements are financed with borrowed funds. I.R.C. § 168. *See supra* note 4. Under ACRS, a taxpayer is entitled to recover his cost basis in real property over an 18-year period (15 years in the case of low-income housing). I.R.C. §§ 168(b)(2)(A)(i), (b)(4)(A)(i) (1984). Although the straight line method can be elected, the 200% declining balance method can be used for low-income housing in the early years with a switch to the straight line method in the later years. Other real property can be depreciated using the 175% declining balance method. I.R.C. §§ 168(b)(2)(A)(ii), (b)(4)(A)(ii) (1984).

9. The term "low-income housing" means property described in clause (i), (ii), (iii), or (iv) of I.R.C. § 1250(a)(1)(B) (1984). *See* I.R.C. § 168(c)(2)(F) (1984).

10. I.R.C. § 163(a) (1984).

payments. This interest deduction is often crucial in an investor's decision to purchase an interest in a real estate limited partnership.[11]

11. An examination of the following table, typical of that which might appear in a tax shelter offering memorandum, explicates this point. Note that in each year the interest expense ranges from approximately 52% of the total expenses to be incurred to approximately 66%.

LIMITED ASSOCIATES
(A LIMITED PARTNERSHIP)
PROJECTION OF TAXABLE INCOME - LOSS

YEAR	RENTAL INCOME	INCOME ON REPLACE-MENT FUND	TOTAL INCOME	OPERATING EXPENSES	INTEREST
1982 (8/1-12/31)	82544		82544	77666	142301
1983	620503	429	620932	312346	553272
1984	683125	1583	684708	191101	510930
1985	683125	2817	685942	191101	483846
1986	683125	4127	687252	191101	459627
1987	683125	5518	688643	191101	456394
1988	683125	1355	684480	191101	454918
1989	683125	2047	685172	191101	453289
1990	683125	3309	686434	190952	440887
1991	683125	4650	687775	190952	438910
1992	683125	6073	689198	190952	436736
1993	683125	1944	685069	190952	434334
1994	683125	2672	685797	190952	431691
1995	683125	3973	687098	190952	428770
1996	683125	5354	688479	190952	425561
1997	683125	6821	689946	190952	422024
1998	683125	2738	685863	190952	418123

YEAR	DEPRE-CIATION	AMORT-TIZATION OF OTHER COSTS	TOTAL EXPENSES	TAXABLE INCOME -LOSS	CUMULATIVE TAXABLE INCOME -LOSS
1982 (8/1-12/31)	112588	3402	335957	253413	253413
1983	529471	8165	1403254	782322	1035735
1984	478210	8165	1188406	503698	1539433
1985	432929	8165	1116041	430099	1969532
1986	392931	8165	1051824	364572	2334104
1987	338831	7431	993757	305114	2639218
1988	256301	7065	909385	224905	2864123
1989	228734	7065	880189	195017	3059140
1990	222835	7065	861739	175305	3234445
1991	222835	7065	859762	171987	3406432
1992	222835	7065	857588	168390	3574822
1993	222835	7065	855186	170117	3744939
1994	222835	7065	852543	166746	3911685
1995	222835	7065	849622	162524	4074209
1996	222835	7065	846413	157934	4232143
1997	180564	7065	800605	110659	4342802
1998	20000	7065	636140	49723	4293079

Due to the tax ramifications discussed above, it is usually the taxpayer in the upper tax brackets who chooses to invest in real estate limited partnerships. It may be assumed that a fair number of such investors hold governmental obligations described in Code section 103.[12] The interest on such obligations is not to be included in gross income. That is, the interest is tax free.

Code section 265(2)[13] disallows any deductions for interest paid by a taxpayer on indebtedness incurred or continued for the purpose of purchasing or carrying tax exempt obligations. Syndicators of real estate tax shelters often warn potential investors that the Internal Revenue Service (IRS or Service) could take the position that a limited partner owning tax exempt obligations is precluded from deducting his pro rata share of the partnership's interest and expenses.[14] Arguments may be made that an investor may not deduct an allocable portion of interest incurred by him to purchase or carry his units in the partnership, since such borrowing enables him to continue to carry his tax exempt obligations. It is the position of the author, however, that I.R.C. section 265(2) cannot properly be applied to disallow deductions attributable to the partnership's borrowings.

It is likely that if an individual who owns tax-exempt obligations borrowed to purchase the actual unit in the partnership, the interest paid on such loan would not be deductible pursuant to Code section 265(2).[15] In short, the individual could have sold his tax-exempt obligations and bought his units with the proceeds therefrom instead of keeping the tax-exempt obli-

12. I.R.C. § 103 (1984).

13. I.R.C. § 265(2) (1984).

14. As an example, a recent offering memorandum stated:

Tax-exempt Obligations. Section 265(2) of the Code disallows any deduction for interest paid by a taxpayer on indebtedness incurred or continued for the purpose of purchasing or carrying tax-exempt obligations. The Service announced in Revenue Procedure 72-18 that the proscribed purpose will be deemed to exist with respect to indebtedness incurred to finance another "portfolio investment" (which includes a limited partnership interest) where the taxpayer also owns tax-exempt obligations. Therefore, in the case of an investor owning tax exempt obligations, the Service might take the position that the allocable portion of any interest incurred by the investor to purchase or carry his interest in the partnership should be viewed as incurred to enable him to continue carrying tax-exempt obligations, and that such investor should not be allowed to deduct his full allocable share of such interest.

It is the opinion of Tax Counsel that, if an investor holds or acquires tax-exempt obligations, unless such investment in tax-exempt obligations is insubstantial, it is likely that a proportionate amount of any interest paid by such Investor on debt incurred in connection with the purchase of an interest in the Partnerships will be disallowed as a deduction under Section 265(2), and that, while the outcome of litigation cannot be predicted with certainty, it is more likely than not that, if the issue were litigated, a court would so hold.

15. *See* Treas. Reg. § 1.265-2 (1967).

gations and borrowing to purchase the units. This is the type of transaction that Code section 265(2) was enacted to counteract.[16]

On the other hand, a taxpayer holding tax-exempt obligations should be able to deduct his allocable share of the interest on the nonrecourse loan negotiated by the partnership. It is the leveraged position conferred by the nonrecourse loan that is the principal business reason that a taxpayer invests in a real estate limited partnership. It is unlikely that a taxpayer could, or would, make the investment absent the leveraged position. That is, even if the taxpayer were to sell his entire portfolio of tax-exempt obligations, he would not use the cash realized to eliminate his allocable share of the loan that enables him to hold his tax-exempt obligations. Therefore, Code section 265(2) should not be utilized by the Service to deny a taxpayer the interest deduction of his allocable share of the nonrecourse loan, even if the taxpayer maintains investments in tax-exempt obligations.

The remainder of the article will first discuss the relevant Revenue Procedure 72-18, while showing that, even under the rationale provided by the IRS, Code section 265(2) is not applicable to the interest paid by a partner in a real estate tax shelter partnership. The article will then discuss the recent cases on disallowance of interest deductions under Code section 265(2).

I. Revenue Procedure 72-18

Revenue Procedure 72-18[17] discusses guidelines for the application of Code section 265(2). It states that direct evidence of a taxpayer's purpose of incurring indebtedness to carry tax-exempt obligations exists where the obligations are used as collateral for the indebtedness.[18] This would not be the case if a taxpayer were to make the contemplated investment in a real estate limited partnership. Where, however, there is no direct evidence of a purpose to carry tax exempt obligations, the revenue procedure provides that it is necessary to look at the totality of facts and circumstances.[19] If this inquiry supports a reasonable inference of the purpose to carry tax-exempt obligations, then, pursuant to the Revenue Procedure 72-18, section 265(2) of the Code will apply.[20]

Section 4 of the revenue procedure provides guidelines for determining, in the absence of direct evidence, whether an individual has incurred indebtedness in order to carry tax-exempt obligations. If an individual incurs either

16. *Id.*
17. Rev. Proc. 72-18, 1972-1 C.B. 740.
18. *Id.* at 741.
19. *Id.* at 740.
20. *Id.*

short-term personal indebtedness for purchases of goods and services for personal consumption, or long-term indebtedness for a mortgage incurred to purchase or improve a residence, section 265(2) will generally not apply "because the purpose to purchase or carry tax-exempt obligations cannot reasonably be inferred where a personal purpose unrelated to the tax-exempt obligations ordinarily dominates the transaction."[21] Likewise, where an individual incurs indebtedness in connection with the active conduct of a trade or business (other than a dealer in tax-exempt obligations), Code section 265(2) will not ordinarily apply unless it is determined that the borrowing is in excess of business needs.[22]

Section 3.05 of Revenue Procedure 72-18 discusses the inapplicability of Code section 265(2) to an individual taxpayer who holds only insubstantial amounts of tax-exempt obligations.[23] Insubstantial investment is presumed "where during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2% of the average adjusted basis of . . . [the individual] portfolio investments . . . [plus] any assets held in the active conduct of a trade or business."[24] This exception applies only where there is no direct evidence linking indebtedness with a purpose to purchase or to carry tax-exempt obligations.[25]

Section 4.04 of Revenue Procedure 72-18 provides:

> a purpose to *carry* tax-exempt obligations will be inferred, unless rebutted by other evidence, wherever the taxpayer has outstanding indebtedness which is not directly connected with personal expenditures . . . and is not incurred or continued in connection with the active conduct of a trade or business . . . 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.
>
> A sufficiently direct relationship between the incurring or continuing of indebtedness and the purchasing or carrying of tax-exempt obligations will generally exist where indebtedness is incurred to finance portfolio investments because the choice of whether to finance a new portfolio investment through borrowing or through the liquidation of an existing investment in tax-exempt obligations typically involves a purpose either to maximize profit or to main-

21. *Id.*

22. *Id.*; *see also* P.R. 83-32010 (interest payments deductible where taxpayer who owns tax-exempt securities borrows to finance the purchase of real estate in connecton with an active trade or business).

23. Rev. Proc. 72-18, 1972-1 C.B. 740, 741.

24. *Id.*

25. *Id.*

> tain a diversified portfolio. This purpose necessarily involves a decision, whether articulated by the taxpayer or not, to incur (or continue) the indebtedness, at least in part, to purchase or carry the existing investment in tax-exempt obligations.
>
> A taxpayer may rebut . . . [this] presumption . . . by establishing that he could not have liquidated his holdings of tax-exempt obligations in order to avoid incurring indebtedness.[26]

An analysis of the language of the revenue procedure leads to the conclusion that a taxpayer may indeed invest in a limited partnership for the purpose of garnering a real estate tax shelter and deduct his interest expenditures on loans generated by the partnership notwithstanding his holdings of tax-exempt securities. The rationale of the revenue procedure is that the interest deduction will be disallowed because the taxpayer has a "choice of whether to finance a new portfolio investment through borrowing or through the liquidation of an existing investment in tax-exempt obligations."[27] If a taxpayer owned tax-exempt obligations and borrowed money from a bank in order to buy stock, the Internal Revenue Service correctly would disallow the deduction for interest on the bank loan. The taxpayer could have sold his tax-exempt obligations to finance the purchase of stock instead of borrowing the money from the bank.[28]

When a taxpayer invests in a real estate limited partnership, however, an entirely different scenario is presented. The funds that are borrowed by the partnership (and attributed to the individual limited partner) supply the motivation to most investors purchasing limited partnership interests to make those purchases. The leveraging allowed by depreciation on the borrowed money, in addition to the funds directly invested by the limited partner, is the principal attraction of a real estate tax shelter limited partnership. Thus, a limited partner generally would borrow funds through the partnership to leverage his investment. Even if such a taxpayer sold every one of his tax-exempt obligations, he would still borrow money through the partnership. He would not use the funds realized from the sale of the tax-exempt obligations to pay the debt created by the partnership borrowing. Thus, the entire rationale of the revenue procedure discussed above should not apply to a taxpayer who owns tax-exempt obligations at the time the investment in a real estate limited partnership is made. The taxpayer's choice is not whether to finance his leveraged investment in the limited partnership through the liquidation of his investments in tax-exempt obligations or through borrowing. Rather, the choice is whether to invest at all in a limited partnership by

26. *Id.* at 741-42.
27. *Id.* at 742.
28. *Id.*

borrowing money through the partnership.[29]

II. THE CASES

As expressed in judicial decisions beginning with *Denman v. Slayton*,[30] the purpose of I.R.C. section 265(2) is to prevent a taxpayer from reaping a double tax benefit by deducting interest on borrowed funds that the taxpayer uses to purchase or to carry obligations bearing tax-exempt interest.[31] It is crucial to an understanding of Code section 265(2) that the Court has found that Congress has proscribed the interest deduction only when there is a purposive connection between the purchase or holding of tax-exempt obligations and the borrowing of money.[32] The basis for the reasoning on this issue is found in the legislative history of section 265(2) that clearly reveals that Congress intended to disallow an interest deduction only upon a showing that the indebtedness was either incurred or continued for the "purpose" of acquiring or holding tax-exempt obligations.[33] As stated by one commentator, "[t]he history furnishes no support for the disallowance of interest on indebtedness merely because the taxpayer owns tax-exempt obligations."[34]

Following the legislative intent, the courts have interpreted Code section 265(2) as requiring a "purposive connection" or a "sufficiently direct relationship" between a taxpayer's indebtedness and his ownership of tax-exempt obligations.[35] Thus, it is settled that section 265(2) does not

29. Furthermore, a potential investor probably would be foreclosed from paying off the bank loan by the partnership agreement to which he is a signatory.

30. 282 U.S. 514 (1931).

31. *Id.* at 519-20. This case also ruled the predecessor to I.R.C. § 265(2) constitutional. *Id.* at 518-19 considering § 214(a)(2), 42 Stat. 239 of the Revenue Act of 1921). *See also* Levitt v. United States, 517 F.2d 1339, 1343-44 (8th Cir. 1975); Norfolk Shipbuilding & Drydock Corp. v. United States, 321 F. Supp. 222, 229 (E.D. Va. 1971).

32. *Denman*, 282 U.S. at 519.

33. For an excellent discussion of the legislative history, see Craven, *Disallowance of Interest Deduction to Owner of Tax-Exempt Bonds*, 24 THE TAX LAW. 287, 287-89 (1971). The earliest version of I.R.C. § 265(2) appeared in § 1201(1) of the Revenue Act of 1917, Pub. L. No. 65-50, 40 Stat. 300, 330, which amended § 5(a) cl. Second of the Revenue Act of 1916 to preclude the deduction of interest on "indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title." In years subsequent to the adoption of the predecessor to I.R.C. § 265(2), the House attempted to eliminate the "purpose" test by proposing amendments to the statute that would have allowed a deduction only for interest paid in excess of the amount of income interest received by a taxpayer from tax-exempt securities. The Senate rejected these amendments and prevailed over the House. *See* Craven, *supra* at 287-89; *see also, e.g.*, H.R. REP. NO. 767, 65th Cong., 2d Sess. 10 (1918); S. REP. NO. 617, 65th Cong., 3d Sess. 6-7 (1918); H.R. REP. NO. 179, 68th Cong., 1st Sess. 21 (1924); S. REP. NO. 398, 68th Cong., 1st Sess. 24 (1924).

34. Craven, *supra* note 33, at 289.

35. *See, e.g.*, Swenson Land & Cattle Co. v. Commissioner, 64 T.C. 686, 696 (1975); *see also* Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420, 422 (7th Cir. 1968); Illinois

automatically bar an interest deduction "merely because a taxpayer incurred or continued indebteness at the same time that he held tax-exempt securities."[36]

Any other construction of section 265(2) would serve no purpose. The reason for the Code provision is to disallow a taxpayer from claiming a deduction for the interest paid on the borrowed funds while using those funds to buy tax-exempt obligations. If such interest deductions were allowed, serious economic dislocations would certainly follow.[37] However, if there is insufficient connection between the borrowed funds and the ownership or purchase of tax-exempt obligations, that is, if a taxpayer is not able to buy or to hold tax-exempt obligations *because* he has an outstanding loan, invocation of Code section 265(2) would be unreasonable.[38] Thus, the courts have held that where the facts establish that the indebtedness is independent of the holding of tax-exempt obligations, the prohibited purpose of a manipulative double tax benefit will not be found.[39]

The test imposed by the courts[40] for the requisite purpose is generally one of facts and circumstances.[41] A similar test should be invoked when a tax-

---

Terminal R.R. v. United States, 375 F.2d 1016, 1021 (Ct. Cl. 1967); Baker v. Commissioner, 75 T.C. 166, 172 (1980).

36. Mariorenzi v. Commissioner, 490 F.2d 92, 93 (1st Cir. 1974), *cited with approval in* Levitt v. United States, 517 F.2d 1339, 1344 (8th Cir. 1975); Handy Button Machine Co. v. Commissioner, 61 T.C. 846, 852 (1974).

37. Posit a rational taxpayer *A* in a tax world absent I.R.C. § 265(2). He certainly would borrow every dollar possible to buy tax-exempt obligations. Suppose *A* is a 50% taxpayer. From a bank he borrows $100,000 at 16% interest and uses the funds borrowed to purchase tax-exempt securities which pay 9%. Assuming the principal of the loan is not repaid, *A*'s payments to the bank are $16,000 per year. His interest deduction of 50% produces a real outlay (payment to bank less interest deduction from income) of $8,000 per year. His tax free return on his investment is $9,000 per year, producing $1,000 per year in his pocket for doing nothing but negotiating a loan and purchasing securities.

38. If the Tax Code is not being manipulated by a taxpayer in order to benefit doubly from interest deductions and from tax-free income, the Service should not interfere with the interest deduction.

39. *See* Investors Diversified Services v. United States, 575 F.2d 843, 855 (Ct. Cl. 1978); New Mexico Bancorporation v. Commissioner, 74 T.C. 1342, 1357 (1980); *cf.* Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420, 422-23 (7th Cir. 1968).

40. The taxpayer has the burden of proving his legitimate purpose for incurring or continuing his indebtedness. *Handy Button Machine Co.*, 61 T.C. at 852.

41. There are two factual circumstances where the courts generally infer the requisite purposive connection. The first is when the proceeds of the borrowing are traceable directly to the purchase of tax-exempt obligations. *See, e.g.*, Wynn v. United States, 411 F.2d 614, 615 (3d Cir. 1969); Kirchner, Moore & Co. v. Commissioner, 54 T.C. 940, 944 (1970); Bishop v. Commissioner, 41 T.C. 154, 158-59 (1963). Similarly, most courts have disallowed the interest deduction where tax-exempt obligations are used as collateral for the indebtedness. *See, e.g.*, *Levitt*, 517 F.2d at 1342-43, 1345; *Wisconsin Cheeseman, Inc.*, 388 F.2d at 422; *but see New Mexico Bancorporation*, 74 T.C. at 1353; *cf.* R.B. George Machinery Co. v. Commissioner, 26 B.T.A. 594 (1932).

payer who owns tax-exempt obligations claims a deduction for interest payments on his ratable share of a limited partnership loan.

Of primary importance is *Israelson v. United States*,[42] where the taxpayer had extensive holdings in tax-exempt obligations. The court considered interest deductions on two types of loans. The first was a bank loan, the proceeds of which were used to make charitable contributions, purchase stocks and bonds, and for general personal and business expenses.[43] The court found that the taxpayer could have avoided the bank borrowing by selling his tax-exempt obligations and that, therefore, "the interest paid . . . on the bank loan . . . was interest on indebtedness purposefully incurred or continued to carry the tax-exempt bonds."[44] As a consequence, the interest was not deductible.[45]

The second type of loan incurred by the taxpayer was purchase money mortgages obtained as part payment for real estate purchases.[46] Notwithstanding the taxpayer's tax-exempt holdings, the court held that the interest paid on the mortgage notes was deductible. The court reasoned that "[s]uch mortgages are a customary method of financing such purchases, if not *the* customary method."[47] The court seemed to imply that borrowings made in the ordinary course of business would nullify, ipso facto, the prohibited purposive connection between borrowing and holding of tax-exempt obligations that section 265(2) was inacted to counteract. In other words, if the exigencies of business are such that everyone makes an investment in a certain way, a court should not infer a purpose of borrowing to carry tax-exempt obligations. Such reasoning, standing alone, would appear to be incorrect. Pursuant to Revenue Procedure 72-18, in the context of a trade or business, the intent to carry tax-exempt obligations will be inferred when the taxpayer could reasonably have foreseen at the time of purchasing the obligations that indebtedness probably would have to be incurred to meet the ordinary, recurrent economic needs of the business.

Of greater import is the second reason that the *Israelson* court found to hold the mortgage note interest deductible: "Moreover, although Taxpayer engaged in the real estate transactions as an investor, in each instance he was a member of a joint venture and necessarily considered the desires of his fellow venturers as to how the respective purchases should be financed."[48]

42. 367 F. Supp. 1104 (D. Md. 1973).
43. *Id.* at 1106-07.
44. *Id.* at 1107.
45. *Id.*
46. *Id.* at 1106.
47. *Id.* at 1107.
48. *Id.*

Getting along with fellow venturers in an investment was considered by the court to evidence lack of a connection between the purchase money mortgage and the tax-exempt obligations. Whether the court was lax in its use of the term "desires" rather than "demands" of his fellow venturers is important only insofar as a taxpayer in Israelson's shoes is, or is not, able to meet his burden of proving the absence of purposive connection. In the context of a real estate limited partnership, where the agreement mandates that the partnership borrow money, it is not merely the desires of the other partners that a taxpayer must respect, but their demands. Absent agreement on this essential condition, a prospective taxpayer will not be allowed into the partnership. This is a business reason for borrowing money far greater in impact than satisfying the "desires" of fellow investors. Therefore, *Israelson* is central to a discussion of real estate limited partnerships.

In *Estate of Dellora A. Norris*,[49] the taxpayer, while maintaining investments in tax-exempt obligations, borrowed money from a bank in order to pay her taxes. The court held that Code section 265(2) was not applicable and that the interest payments on the bank loan were deductible.[50] The court noted that the bank loan was specifically earmarked to pay the taxes and that the taxpayer had no motivation to create tax-exempt income or to obtain a double benefit.[51] Likewise, in the tax shelter context, any loans made by the partnership that flow through to the taxpayer would be specifically earmarked for partnership activities. Finally, the court in *Norris* stated that the borrowing evidenced good business judgment and, "therefore, [was] motivated by business considerations wholly unrelated to her tax-exempt holdings."[52] Therefore, any loan proceeds that flow through to a taxpayer who has invested in a real estate limited partnership would be wholly unrelated to his tax-exempt holdings.

In *New Mexico Bancorporation v. Commissioner*,[53] the tax court articulated the following tests for the application of Code section 265(2):

> Section 265(2) does not apply unless the facts reveal that the purpose of incurring or continuing indebtedness is to purchase or carry tax-exempt securities. Such prohibited purpose must be established by the showing of a sufficiently direct relationship between the indebtedness and the exempt securities. Evidence that indebtedness was incurred at the same time the tax-exempt securities were held is not enough to establish the requisite prohibited

49. 42 T.C.M. (CCH) 408 (1981).
50. *Id.* at 414-15, 417.
51. *Id.* at 415.
52. *Id.*
53. 74 T.C. 1342 (1980).

> purpose. A more direct nexus must be shown. *For example, section 265(2) should not be applied to disallow an interest deduction where indebtedness is incurred for substantial business reasons independent of the purposes for which exempt obligations are held.* 'In a word, where the issue is disputed there should always be an inquiry, more-or-less particularized, into the connection and relationship between the tax-exempts and the indebtedness so as to discover whether in fact the taxpayer used borrowed funds for the primary purpose of purpose of purchasing or carrying those securities.'[54]

Thus, it is clear that were a taxpayer to invest in a limited partnership, the partnership loan proceeds passed through to him would certainly be "incurred for substantial business reasons independent of the purposes for which exempt obligations are held."[55] Moreover, it is equally clear that the taxpayer would not have used the borrowed funds for the primary purpose of purchasing or carrying tax-exempt obligations, but rather to leverage his investment in the partnership. Thus, the taxpayer's potential investment would fall totally outside of the scope of Code section 265(2).

In *Baker v. Commissioner*,[56] the taxpayer obtained interest-free loans from his corporation over a three-year period to pay estimated taxes. The court held that Code section 265(2) was not applicable because the loans were used to make estimated tax payments and there was no showing of any nexus between the indebtedness and the tax-exempt securities.[57] Likewise, a taxpayer who invests in a real estate limited partnership could clearly show that the purpose of the loans is peculiar to his investment in the partnership and has nothing to do with his holding of tax-exempt obligations.

In *Swenson Land & Cattle Co. v. Commissioner*,[58] the corporation incurred interest expenses due to outstanding bond long-term indebtedness. The corporation was empowered to prepay in whole or in part on December 31st of each year. During several of the years in which the corporation had outstanding bond indebtedness, it invested large portions of its available funds in short-term tax-exempt securities. The court held that the corporation did not incur or continue its indebtedness for the purpose of carrying tax-exempt securities as contemplated by Code section 265(2).[59] In so holding, the court emphasized that the corporation's decision not to prepay any

54. *Id.* at 1352-53 (quoting Investors Diversified Servs. v. United States, 575 F.2d 843, 848 (Ct. Cl. 1978)) (emphasis added).
55. *Id.* at 1353.
56. 75 T.C. 166 (1980).
57. *Id.* at 171-72.
58. 64 T.C. 686 (1975).
59. *Id.* at 700.

of its bond indebtedness reflected business judgment: "In support of this, petitioner asserts that even if it had liquidated its holdings in tax-exempt securities at that time, it would not have prepaid any of its debt in view of the business needs."[60]

Thus, should a taxpayer invest in a real estate limited partnership, even if he liquidated all his holdings in tax-exempt securities, he would not prepay any of the debt imputed to him through the partnership, because of the business exigencies connected with the investment in the partnership. The linchpin of the tax court's decision in *Swenson* appears to be the taxpayer's contention that even if it had sold the tax-exempt securities it would not have repaid the debt.[61] This is clearly the correct holding because Code section 265(2) specifically applies only when "the *purpose* for which the indebtedness is incurred or continued is to purchase or carry tax-exempt obligations."[62]

In *Levitt v. United States*,[63] the taxpayer borrowed money from a bank to buy Treasury bonds while he held tax-exempt securities which could have been liquidated to pay off the bank loan. The court stated: "§ 265(2) prevents a taxpayer from simultaneously paying no tax on income from tax-exempt securities and deducting interest on loans that he would not be incurring or continuing *but for* his desire to acquire or carry the tax exempts."[64] In the case of a taxpayer investing in a real estate limited partnership, there is no "but for." Even if the taxpayer sold the tax-exempt securities, he would still borrow through the partnership. The court in *Levitt* quoted with approval the district court's finding that "[t]here is no good business reason, other than the desire to carry tax-exempt securities, offered why the tax-exempts or trust income were not used . . . to purchase the government bonds rather than borrow additional sums from the bank."[65] Unlike the situation in *Levitt*, however, there is a very good business reason why capital raised through liquidation of a taxpayer's tax-exempt securities would not be utilized to pay off a loan flowing through to him from a limited partnership. The reason is that it is only because of the leveraging afforded him by such a loan that a purchase of a limited partnership interest of the sort contemplated is economically rational to an investor in the taxpayer's position.

That section 265(2) does not apply when a taxpayer cannot reduce his indebtedness through the sale of tax-exempt securities is reiterated in *Inves-*

60. *Id.* at 696.
61. *Id.* at 700.
62. Leslie v. Commissioner, 413 F.2d 636, 638 (2d Cir. 1969) (emphasis added).
63. 517 F.2d 1339 (8th Cir. 1975).
64. *Id.* at 1344 (emphasis added).
65. *Id.* at 1344 n.7.

tors Diversified Services v. United States.[66] The court in *Investors* stated that "[t]his inability to affect the amount of its indebtedness supports our view that the relationship between the certificates (representing the indebtedness) and the tax exempts is too remote for section 265(2) to apply."[67] That is, if the government can show that a taxpayer has the ability to avoid borrowing by sale of his tax-exempt securities, Code section 265(2) might apply.[68] If a taxpayer invested in the limited partnership, however, he could not avoid borrowing through the partnership by selling his tax-exempt securities. Thus, the rationale for the application of Code section 265(2) would not exist.

Finally, in *Ball v. Commissioner*,[69] the tax court reaffirmed the doctrine that there must be a "sufficiently direct relationship" between the debt and the carrying of tax exempts in order for interest deductions to be disallowed under Code section 265(2). In *Ball*, the tax court allowed interest deductions where a taxpayer having an investment portfolio totaling more than six million dollars, of which approximately five percent were in tax-exempts, borrowed money in order to create profitable investments without regard to tax considerations and with "no direct relationship to creating tax-exempt income."[70] The *Ball* court emphasized:

> All of petitioner's loans were used to finance major, non-recurring opportunities which were conducive to long-term financing, and were not foreseeable when the tax-exempt securities were purchased. Business reasons were the sole motivation for petitioners incurring indebtedness to finance new ventures. Petitioner owned what both he and his investment advisor considered to be an 'absolute minimum' of tax-exempt securities during the entire taxable period. *A reasonable person in his position would not necessarily have sacrificed the liquidity and security provided by his tax-exempt holdings by liquidating these holdings instead of incurring indebtedness to finance his ventures.*[71]

III. CONCLUSION

Many taxpayers may find themselves in the position of owning both tax-exempt securities and investments in limited partner real estate tax shelters. These taxpayers should not be penalized, because they own tax-exempt se-

66. 575 F.2d 843 (Ct. Cl. 1978).
67. *Id.* at 853.
68. *Cf.* Israelson v. United States, 367 F. Supp. 1104 (D. Md. 1973). *See supra* notes 42-48 and accompanying text.
69. 54 T.C. 1200 (1970).
70. *Id.* at 1209.
71. *Id.* at 1209 (emphasis added).

curities, by loss of their deduction for interest paid on non-recourse loans generated by the partnership. In fact, these taxpayers have no choice but to incur an interest cost if they are to remain partners in the real estate investment. Such an investment is independent from an investment in tax-exempt securities. Moreover, no relationship exists between these two investments. Therefore, because these loans are negotiated in the partnership's regular course of business and because the proceeds of the sale of the tax-exempt securities would and could not be utilized to reduce the debt and interest payments, Code section 265(2) should not be applicable to such a taxpayer.