Limitations on the Interest Deduction

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LIMITATIONS ON THE INTEREST DEDUCTION

DENNIS P. BEDELL

Over the years various legislative, judicial, and administrative limitations have been imposed on the deduction allowed by section 163 for interest. One category of these limitations have arisen out of the inherent requirements of the deduction: namely, that the amount for which a deduction is claimed must be interest on indebtedness and must be paid or accrued by the taxpayer during the taxable year.

The other main category of limitations on the interest deduction has been directed to situations in which it was believed that the use of the interest deduction gave rise to a tax abuse. Until recent years, the concern has generally been with what were considered to be abuses of the interest deduction of specific, limited types of situations. For example, limitations were imposed on the deductibility of interest on indebtedness earned in connection with the purchase of certain life insurance, endowment or annuity contracts (section 264), on the deductibility of interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds (section 265(2)), and on interest paid in certain situations involving related taxpayers (section 267). In addition, the courts have developed limitations on the interest deduction in situations involving tax-savings transactions. One of these limitations disallows the deduction on the basis that the tax-saving transaction was a sham and did not involve the creation of a valid indebtedness. Another judicially developed limitation disallows the deduction on the basis that the loan in question was incurred solely for the purpose of obtaining an interest deduction and served no other purpose. This limitation is applicable even though the transaction in question was not a sham and involved a valid indebtedness.

Since the late 1960's, however, concern with the interest deduction as a tax-saving or tax shelter device has become much broader and has encompassed the use of the interest deduction in a more general sense. This is seen in the limitations imposed on the deductibility of prepaid interest and on the deductibility of interest paid in connection with investments and in the proposed limitations on the deductibility of personal interest.

Inherent Requirements of Interest Deduction

Although the interest deduction is not subject to the types of limitations found in the case of other deductions, such as a requirement that the amount paid be reasonable, that it be ordinary and necessary, or that there be a business purpose for the payment, the deduction does require that there be a valid indebtedness requiring interest and that the amount of interest for which a deduction is claimed be paid or accrued within the taxable year. The treatment by the Internal Reve-

nue Service of points paid by a borrower to a financial institution in connection with obtaining a home mortgage and of finance or carrying charges imposed in connection with installment purchases of merchandise are illustrative of the basic requirement that the amount paid must indeed constitute interest; i.e., an amount paid as compensation for the use of borrowed money.\(^2\)

The Service originally held that mortgage points were not deductible because the payment at least in part might be a payment to the lending institution for services rendered by the institution in connection with the mortgage loan, such as charges for title reports, escrow, appraisal, and notary fees and charges for preparing the necessary papers.\(^3\) The Service then modified its position to recognize the fact that points can indeed constitute interest; i.e., an additional payment for the use of money. It held that, if the lending institution separately charged the borrower for the services it rendered in connection with the mortgage loan, the points paid by a cash basis borrower could be deducted as interest in the year paid.\(^4\)

In the case of finance charges imposed in connection with installment purchases of merchandise, the Service initially allowed a deduction for the interest portion of the finance charge only if it was separately stated.\(^5\) Since merchants, however, because of usury law considerations, did not usually separate the finance charges they made into the component representing interest and the component representing a charge by the merchant for services rendered in connection with the extension of credit, the finance charges generally were not considered by the Revenue Service to be deductible interest. Limited relief was provided by Congress in 1954 when, in section 163(b), it allowed a deduction for that portion of a finance charge under an installment purchase contract equal to 6 percent of the average unpaid balance.

This limited recognition that finance charges are at least in part interest continued to be the rule until 1971 when the Revenue Service began to liberalize its views with respect to finance and carrying charges.\(^6\) First, it allowed the deduction of finance charges in a situation where it was clear that the charge represented only interest and

\(^2\) Old Colony Railroad Co. v. Comm'r, 284 U.S. 552 (1932) and Deputy v. duPont, 308 U.S. 488 (1940).
\(^4\) Rev. Rul. 69-188, 1969-1 C.B. 54. In Rev. Rul. 69-582, 1969-2 C.B. 29, it was held that points paid by a cash basis taxpayer did not constitute prepaid interest which caused a material distortion of income and, accordingly, were deductible in the year paid. Accrual basis taxpayers must deduct interest including points over the period of the loan, regardless of when the interest is paid. Rev. Rul. 68-643, 1968-2 C.B. 76.
not compensation for services. Then after an initial reluctance, the Revenue Service in effect moved to the view that any consumer credit carrying charge which is specified as a finance charge under the Truth in Lending Act and is stated as an annual percentage rate constitutes deductible interest. The Truth in Lending Act, adopted in 1968, in effect treats all charges for consumer credit such as interest, service charges, credit investigation fees, and loan fees as a finance charge representing the cost to the consumer of the credit he is obtaining. The Act requires the total amount of these charges to be expressed as a finance charge at an annual percentage rate. Accordingly, at this point, finance charges imposed on consumers who purchase goods or services on credit, such as in the case of revolving charge accounts, oil company credit cards, and retail installment contracts, are considered by the Revenue Service to represent deductible interest.

Illustrative of the basic requirement of the interest deduction that the interest must be paid or accrued in the taxable year is the treatment of discount loans. A discount loan is one in which the lender, rather than advancing the face amount of the loan to the borrower, deducts all or a portion of the interest due on the loan and then advances to the borrower the remaining balance of the sum borrowed. In some cases, the amount deducted may be only the points in connection with a mortgage loan. In other cases, it may be the entire amount of interest due over the term of the loan. In each of these cases, the borrower is not treated as having paid the interest in question in the year in which the loan is made and, accordingly, is not allowed to deduct the interest for that year. Instead, a cash basis borrower is treated as having paid the interest over the life of the loan as he in fact repays the principal amount of the loan which includes the interest charge and, thus, is allowed to deduct the interest in question over that period. Accordingly, particularly in the case of points paid by an individual with respect to a mortgage loan, particularly on his principal residence, it behooves the borrower who wishes to obtain a current interest deduction for the points to separately pay the lender the amount of the points (such as by a separate closing cost item at settlement), rather than having the points deducted by the lender from the amount of the mortgage loan.

7 Rev. Rul. 71-98, 1971-1 C.B. 57, involving a bank credit card plan under which participating merchants paid the bank all its costs in respect to the plan except interest which was charged to the credit card holders.
10 Rev. Rul. 72-315, supra.
Prepaid Interest

In the late 1960's the matter of prepaid interest became the focus of a broad-scale concern with the interest deduction. For many years, the Revenue Service had allowed a cash basis taxpayer to currently deduct up to five years prepaid interest. In 1968, the Revenue Service changed its view and held that prepaid interest could not be currently deducted if it resulted in a material distortion of income. In addition, the Service stated that it would consider a material distortion of income to result in any case in which interest was prepaid for a period greater than 12 months after the taxable year of payment. In these cases, the Service required the prepayment of interest to be allocated over the taxable years to which it related.

In reversing its position on prepaid interest, the Service stated that it was concerned with the abuses which had arisen and that all interest prepayments were to be examined to ascertain if they resulted in a material distortion of income. In 1969, the House Ways and Means Committee expressed its agreement with the Service's concern in this regard and with its revised position regarding the deductibility of prepaid interest.

Subsequently, the Service's position on the deductibility of prepaid interest by cash basis taxpayers has been considered and in general approved by the Tax Court. In one case the court upheld the Service's disallowance of the deduction for five years of prepaid interest, and in another case the court disallowed the deduction of one year's interest which was prepaid on December 29. Instead, a deduction was allowed only for the ratable portion (3/365) of the prepayment allocable to the year of payment.

Notwithstanding the Tax Court's general approval of the Revenue Service's position on the deductibility of prepaid interest, current congressional concern has been expressed on this matter. In connection with its formulation of the Tax Reform Bill of 1975, the House Ways and Means Committee considered the subject of prepaid interest and indicated its belief that prepaid interest had become an important tax shelter device to investors who wished to obtain "year-end artificial

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15 Rev. Rul. 68-643, 1968-2 C.B. 76. Also, the acquiescences in Fackler and Court Holding Co. were withdrawn and nonacquiescences substituted. 1968-2 C.B. 3. Rev. Rul. 68-643 applies to interest prepayments made after November 25, 1968, other than prepayments for not more than a 5-year period made pursuant to a legal obligation incurred prior to November 26, 1968.


17 Andrew A. Sandor, 62 T.C. 469 (1974), on appeal to 9th Cir.

18 G. Douglas Burek, 63 T.C. 556 (1975).
losses". The Committee expressed concern, as it did in other contexts, involving so-called "accelerated deductions", that a deduction for prepaid interest could allow a taxpayer to offset, and thereby defer, his tax on unrelated income rather than offsetting the tax on the income from the investment in connection with which the interest was prepaid, which income generally would arise in later years. The Committee also felt that there was still a substantial uncertainty under present law as to the deductibility of prepaid interest because both the Tax Court and the Revenue Service required that a case-by-case determination be made with respect to the deductibility of prepaid interest.\textsuperscript{19}

Accordingly, the Committee included in its tax reform bill a provision which in general would require a cash basis taxpayer to utilize the accrual method in the case of prepaid interest.\textsuperscript{20} Under the bill, any payment of interest which is properly allocable to a taxable year following the year of payment would have to be capitalized by a cash basis taxpayer and treated as paid in the years to which it is properly allocable; i.e., the years in which it actually is a charge for the use of borrowed money during the year. This rule would be applicable without regard to whether allowing the prepaid interest to be deducted in the year of payment would materially distort the taxpayer's income for that year.\textsuperscript{21}

The Committee also indicated that points to the extent they otherwise qualify as interest for tax purposes are to be treated as a prepayment of interest and with one exception are to be deductible only under the accrual method provided by the bill. The one exception to this rule would allow points to be currently deducted by a cash basis taxpayer if they are paid in connection with an indebtedness which is both incurred in connection with the purchase or improvement of his principal residence and is also secured by that principal residence.\textsuperscript{22}

Presumably, in determining the taxable years to which an interest prepayment is properly allocable, a taxpayer would not be required in all cases to allocate the prepayment ratably over the term of the loan. For example, where principal and interest on a loan are paid on


\textsuperscript{20} H.R. 10612, 94th Cong., 1st Sess. § 205 (1975). Hereinafter, the Tax Reform Bill of 1975, as reported by the House Ways and Means Committee on November 7, 1975, is referred to as "H.R. 10612." The limitation on the deductibility of prepaid interest contained in § 205 of H.R. 10612 would apply to amounts paid after September 16, 1975, in taxable years ending after that date, except in the case of amounts paid before January 1, 1976, pursuant to certain binding commitments made prior to September 17, 1975. In addition, such limitation would be applicable to all taxpayers, not just individuals.

\textsuperscript{21} H. Rep. No. 94-658, 100.

\textsuperscript{22} H. Rep. No. 94-658, 101, and § 461(g), as proposed to be added by H.R. 10612, § 205(a).
a combined level payment basis over the term of the loan, the interest
does not accrue ratably over the term of the loan but instead is pro-
portionately greater in the earlier years of the loan since a proportion-
ately greater amount is being borrowed in those years. Accordingly, if
points were paid by the taxpayer in connection with such a level pay-
ment loan, and the loan did not relate to the taxpayer’s principal resi-
dence, it would appear that the taxpayer should be allowed to allocate
the points over the years of the loan in proportion to the relative
amount of interest paid by the taxpayer in each year by means of
the level payments. Although the Committee did not focus on this
specific question, it did recognize the fact that interest on a level pay-
ment loan is proportionately greater in the earlier years of the loan.28
The corollary of this, of course, is that the outstanding principal
amount of such a loan is proportionately greater in the earlier years
of the loan. Since the basic thrust of the proposed prepaid interest rule
in the Committee’s bill is to treat prepaid interest as paid by the tax-
payer “in the periods in which (and to the extent that) the interest
represents a charge for the use . . . of borrowed money during each
such period”,24 it would follow that an appropriate nonratable alloca-
tion of the prepaid interest should be permitted.

Limitation on the Deduction of Nonbusiness Interest

During its consideration of the Tax Reform Act of 1969, Congress
expressed a much broader concern with the use of the interest deduc-
tion as a tax-saving or tax shelter device than it had in the past. As
part of that consideration, Congress examined the tax returns of a
number of very high income taxpayers who had paid no tax. It
noted that a substantial number of those taxpayers had utilized large
interest deductions in reducing their tax liability to zero.26 Congress
also stated that in an investment context the allowance of the interest
deduction could result in a mismatching of income and expense and
presented an opportunity for taxpayers to convert ordinary income
into capital gain income. These results could occur, for example, where
an individual acquired an investment, such as stock, that produced
little current income and that would result in capital gains income when
sold, with the proceeds of a large loan and then took a current deduction
for the interest on the loan.26 This was considered by Congress to be
an abuse of the interest deduction. Accordingly, for taxable years
beginning after 1971, Congress in section 163(d) limited the amount
of investment interest which an individual would be allowed to
currently deduct.27

26 H. Rep. No. 91-413 (Part I), supra, 72.
27 Excess investment interest was a tax preference item for purposes of the
It is possible, however, that the limitation imposed in 1969 on the deductibility of investment interest will turn out to be merely the forerunner of an even broader limitation on the interest deduction. During its consideration in recent months of the Tax Reform Bill of 1975, the House Ways and Means Committee focused its attention on the deduction of personal interest; for example, the interest incurred by an individual on a home mortgage or in connection with credit purchases of consumer goods, such as automobiles and appliances. The Committee indicated that to some extent the deduction for personal interest may be viewed as a tax shelter device in that it permits a taxpayer to shelter income from his income-producing activities by the use of deductions that are unrelated to that income. The Committee also expressed its belief that a deduction should not be allowed for interest on a loan used to acquire luxury items and to thereby provide the taxpayer with a standard of living that is clearly out of the ordinary.\textsuperscript{28}

As a result, the Committee included in its tax reform bill a generally applicable limitation on the deduction of personal interest, which in addition would further restrict the deduction allowed for investment interest.\textsuperscript{29}

\textit{The Limitation}

Under present law an individual may not deduct investment interest for a taxable year to the extent it is greater than the sum of $25,000, his net investment income, his net long-term capital gains on investment property, his out-of-pocket losses on net leased property, and one-half the amount of his investment interest in excess of these other amounts.\textsuperscript{30}

The Ways and Means Committee's tax reform bill would revise this limitation and extend it to personal interest in the following manner: \textsuperscript{31} First, it would limit an individual taxpayer's deduction for personal interest to $12,000 a year. Personal interest in excess of that amount could not be offset against any other type of income including investment income and could not be deducted in any other taxable year. In the case of an individual taxpayer's investment interest, his deduction would be limited to the excess of $12,000 over the amount

10-percent minimum tax on tax preferences (sec. 56) for taxable years beginning before 1972.

\textsuperscript{28} H. Rep. No. 94-658, 102.

\textsuperscript{29} H.R. 10612, § 206, amending sec. 163(d). The new and revised limitation would apply with respect to taxable years beginning after December 31, 1975, except in the case of certain loans incurred prior to September 11, 1975. See proposed sec. 164(d)(7), H.R. 10612, § 206(a).

\textsuperscript{30} Sec. 163(d)(1). The $25,000 amount is reduced to $12,500 in the case of a married individual filing a separate return and to zero in the case of a trust.

\textsuperscript{31} H.R. 10612, § 206. The $12,000 amount is reduced to $6,000 in the case of a married individual filing a separate return and to zero in the case of a trust. It
of his personal interest, plus the sum of his net investment income, his net long-term capital gains on investment property, and his out-of-pocket losses on net leased property. Investment interest in excess of the sum of these amounts could not be deducted currently but could be carried over to subsequent taxable years.

Under both present law and the proposed limitation on nonbusiness interest, if a taxpayer's investment interest is in excess of the specified dollar amount ($25,000 or $12,000 minus the amount of the taxpayer's personal interest, respectively) plus the amount of his net investment income and his out-of-pocket losses on net leased property, he is considered to have used his excess investment interest to offset his long-term capital gains on investment property. To the extent this occurs, the capital gains lose their character as such and instead are treated as ordinary income for purposes of the alternative capital gains tax, the 50-percent capital gains deduction, and the 10-percent minimum tax.\textsuperscript{82}

The limitation imposed under present law on investment interest is of relatively narrow application since it allows taxpayers to deduct up to $25,000 per year of this type of interest even if they do not have any investment income or capital gains. It, thus, is obvious that before the limitation becomes applicable the taxpayer must have a very large loan for investment purposes. In addition, a taxpayer with the ability to secure a loan of this magnitude often will have substantial amounts of investment income, which further protects the taxpayer's investment interest deduction. The nonbusiness interest limitation which would be imposed under the Ways and Means Committee's tax reform bill, however, would have a substantially broader application because of the reduced amount of the dollar limitation on the deduction and because of the inclusion of personal interest within the limitation.

\textit{Personal Interest}

"Personal interest" is defined for purposes of the proposed nonbusiness interest limitation as any interest other than investment interest...
and interest which is related to the taxpayer's trade or business. Personal interest, thus, would include interest on installment purchases of consumer goods or services, on vacation loans and on student educational loans. It also would include interest on home mortgage loans, home mortgage prepayment penalties, and points paid in connection with a home mortgage loan. Points paid with respect to a mortgage loan on the taxpayer's principal residence which are excepted from the application of the proposed prepaid interest limitation discussed above nevertheless would be treated as personal interest subject to the proposed nonbusiness interest limitation.

Personal interest also would include interest paid on tax deficiencies. Since in this type of situation the amount paid by the taxpayer during the year could represent interest for a number of years during which period the taxpayer had been contesting the deficiency, the application of the nonbusiness interest limitation to the interest could be particularly onerous, especially in view of the fact that no carryover would be allowed for any personal interest in excess of the limitation. Assuming a limitation on the deduction of personal interest is sound from a tax policy standpoint, it is questionable whether interest on tax deficiencies should be subject to the limitation. This type of interest does not involve a tax shelter potential or the "problem" of taxpayers deducting interest on credit purchases of luxury items which was the focus of the Committee's concern with the personal interest deduction. Accordingly, it would appear that interest on tax deficiencies should be excluded from the scope of the limitation, as was done in the case of interest imposed on installment payments of Federal estate tax.

Investment Interest

Under present law the investment interest limitation is imposed on "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." Thus, to be considered investment interest, the borrowing must be for the proscribed purpose and the property purchased or carried with the loan must be investment property. To determine whether a loan has the proscribed purpose, the proposed regulations essentially adopt a direct tracing test. A loan will be considered as made for business or personal, rather

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33 Proposed sec. 163 (d) (4) (A), H.R. 10612, § 206.
34 H. Rep. No. 94-658, 103.
35 Mortgage prepayment penalties are considered by the Revenue Service to constitute deductible interest. Rev. Rul. 57-198, 1957-1 C.B. 94. See also Rev. Rul. 73-137, 1973-1 C.B. 68, which holds that prepayment charges imposed pursuant to a retail installment contract constitute deductible interest.
37 Proposed sec. 163 (d) (5) (D), H.R. 10612, § 206.
38 Sec. 163 (d) (3) (D).
39 Prop. Reg. § 1.57-2 (b) (1) (iii). Since the definitional provisions of section 163 (d), under which regulations have not as yet been proposed, are in most
than investment, purposes if the proceeds of the loan can be directly traced to a particular business or personal activity or property. The use of the proceeds of a loan as payment for a particular activity or property, or the simultaneous borrowing and expending of substantially identical amounts by the taxpayer, can be used to establish the required tracing.

It is further provided that a loan is to be presumed incurred or continued for the proscribed purpose (i.e., to acquire or carry investment property) if the loan proceeds cannot be directly traced to a particular business or personal activity or property. In addition, a "substance over form" exception to the direct tracing rule is provided in the proposed regulations. Under this exception, a loan is considered to have the proscribed purpose if "it is clear that in substance such indebtedness was incurred to purchase or carry investment property," even though the loan is directly traceable to specific non-investment property, such as purchase money mortgage on the taxpayer's home.40

The second aspect of the present definition of investment interest is whether the property for which the loan was incurred or continued constitutes investment property. Whether property is investment property is to be determined by the type of income received from the property and also the type of activity in which the property is used.41 First, the property must be held for the production of passive income, such as dividends, interest, rents, royalties, or capital gains. Second, property will not be considered investment property to the extent it is used in a trade or business activity even though it produces passive income. For this purpose the active use of passive income-producing property in a trade or business is required rather than the mere holding of the property in the trade or business. For example, even though a portfolio investment is held in a trade or business, it will be considered to be investment property. In addition, investment property generally includes corporate stock even if it represents a controlling interest.

Although the present (and the proposed) limitation on investment interest is not generally directed to interest arising in a business context, there is one exception to this general rule in the case of net leased property.42 Even though property which is leased would otherwise be

respects identical to those contained in section 57 regarding investment interest, under which regulations have been proposed, the proposed section 57 regulations are referred to herein.

40 The proposed regulations also provide that the purpose of a borrowing may change with the passage of time, such as from a loan incurred to acquire business property to a loan continued to carry (i.e., avoid the liquidation of) investment property.

41 Prop. Reg. § 1.57-2(b) (2).

treated as used in a trade or business, it is considered to be investment property if it is leased by the taxpayer under a net lease. For this purpose, a lease is considered to be a net lease if the taxpayer's section 162 business expenses in connection with the lease are a small portion (less than 15 percent) of the gross rental income from the leased property or if the taxpayer-lessee is guaranteed a specified return or is guaranteed in whole or in part against loss of income under the lease.

As indicated above, the general approach of present law is to consider interest paid or accrued by a taxpayer as investment interest subject to the limitation of present law unless the loan in question can be directly related to a personal or business activity. Although the definition of investment interest would remain unchanged under the Ways and Means Committee's tax reform bill, this emphasis would be changed and, as a result, difficult questions may arise. Presumably because a stricter limitation would be imposed under the bill on personal interest than on investment interest, it is provided that a taxpayer's interest is presumed to be personal interest unless the taxpayer can establish that it is either business interest or investment interest. Thus, interest on a home mortgage loan would be presumed to be personal interest. This presumption could be overcome, however, if the taxpayer could establish that the loan proceeds were used by him for an investment or business purpose. The Ways and Means Committee indicated that this could occur, for example, where a taxpayer who was unable to obtain a loan for use in his business without providing additional security took out a second mortgage on his house to obtain the necessary funds.

The situation posed by the Committee, however, is a relatively clear one. The troublesome questions that will arise as a result of the shift in emphasis from investment interest to personal interest will occur in those cases where the taxpayer has mixed motives for a borrowing, which is not infrequently the case. A typical situation would be that of a taxpayer with a substantial investment portfolio who needs funds for a personal purpose, such as purchasing a boat or a summer cottage. Rather than liquidating a portion of his investments, the taxpayer obtains a personal loan. In this type of situation, the taxpayer has dual motives: He wishes to obtain funds for a personal purpose and he also desires to continue to hold his investment assets. Under present law, it is likely that the taxpayer would be considered to have obtained the loan in order to carry his investments and, accordingly, the interest on the loan would be treated as investment interest subject to the limitation of section 163(d). Similarly, if the taxpayer held a substantial amount of tax-exempt municipal bonds in his investment portfolio, it is likely that he would be treated under section 265(2) as

43 Proposed sec. 164(d) (4) (A) (ii), H.R. 10612, § 206.
having obtained the loan to carry the tax-exempt bonds and, ac-
correspondingly, would not be allowed to deduct the interest on the loan.\textsuperscript{45} Under the proposed nonbusiness interest limitation, however, the interest would be presumed to be personal interest rather than investment interest. Would the rules developed under present law (sections 163(d) and 265(2)) be sufficient to overcome the presumption so the interest would be treated as investment interest? If the loan were secured by the taxpayer's investments, it clearly would be treated as incurred to continue the investments under the principles of section 265(2) and presumably also under the present rules of section 163(d). Would the presumption be overcome in this type of situation so the loan would be treated as incurred for investment purposes? If, because more stringent limitations are imposed on personal interest than on investment interest under the proposed nonbusiness interest limitation, it is decided that the presumption is not overcome in these examples, then taxpayers will be faced with conflicting and contradictory rules under section 163(d) and section 265(2). It is even possible that a given loan might be treated as a personal loan under the nonbusiness interest limitation of section 163(d) and also as a loan incurred to carry tax-exempt bonds under section 265(2). On the other hand, given the circumstances of the taxpayer, it may well be that the rules developed under one of these provisions will be useful to the taxpayer in avoiding the application of the other provision.

\textit{Net Investment Income}

As previously indicated, a taxpayer's \textit{investment interest} in excess of the dollar limitation (of present law or of the proposed nonbusiness interest limitation) nevertheless is currently deductible by the taxpayer to the extent of his net investment income. For this purpose, net investment income generally means the taxpayer's passive income from property held for investment\textsuperscript{46} less his investment expenses. Passive income which is derived in a trade or business, such as royalties received by a manufacturer or dividends received by a securities dealer, is not considered investment income. On the other hand, income which is derived from the temporary or incidental use of property in a trade

\textsuperscript{45}See text, \textit{infra}, under "Interest on Indebtedness Incurred or Continued to Purchase or Carry Tax-Exempt Bonds."

\textsuperscript{46}Passive income for this purpose means dividends, interest, rents, royalties, net short-term capital gains on the disposition of investment property, and amounts which are treated as ordinary income upon the disposition of investment property under the depreciation recapture provisions of sections 1245 and 1250. Under the proposed nonbusiness interest deduction limitation, investment income also would include ordinary income amounts arising under the proposed recapture rule for intangible drilling and development costs (proposed secs. 164(d)(4)(C)(iii) and proposed sec. 1254, H.R. 10612, § 202).
or business will nevertheless be considered investment income if the
property is held primarily for investment purposes.\textsuperscript{47}

The expenses which are taken into account in determining the
amount of the taxpayer’s net investment income are his trade or
business expenses, real and personal property taxes, bad debt deductions,
depreciation and depletion, amortizable bond premium and his section
212 expenses.\textsuperscript{48} These types of expenses, however, are taken into ac-
count only to the extent they are directly connected with the pro-
duction of investment income. Under present law, even though a
taxpayer claims accelerated depreciation or percentage depletion, he
is allowed to take into account only straight line depreciation or cost
depletion in determining the amount of his net investment income.\textsuperscript{49}
This special rule would not apply under the Ways and Means Com-
mittee’s proposed nonbusiness interest limitation and, accordingly, a
taxpayer would be required in determining his net investment income
to reduce his gross investment income by the actual amount of the
accelerated depreciation or percentage depletion deductions claimed
by him.\textsuperscript{50}

\textbf{Out-of-Pocket Losses}

Under both present law and the proposed nonbusiness interest limita-
tion, investment interest is and would continue to be deductible to
the extent of any actual out-of-pocket economic loss suffered by a
taxpayer in connection with net leased property if the taxpayer is
actually receiving rents from the lessee.\textsuperscript{51} His out-of-pocket loss for
this purpose is the excess of the amount of the taxpayer’s trade or
business expenses, investment expenses, interest, and deductible real
or personal property taxes attributable to the net leased property over
the amount of rents received by the taxpayer from the property. This
rule recognizes that where a taxpayer is actually renting property but
nevertheless incurs an economic loss, the loss is not an artificial one
incurred for tax shelter purposes, and, therefore, to that extent it is
inappropriate to deny the interest deduction.

\textbf{Carryover of Disallowed Interest}

The present limitation on the deduction of investment interest pro-
vides a carryover for interest which is not currently deductible under
the limitation.\textsuperscript{52} Under this carryover, which is unlimited in time,
excess investment interest paid or accrued in a taxable year may be
deducted by the taxpayer in a subsequent taxable year to the extent

\begin{itemize}
\item \textsuperscript{47} Prop. Reg. § 1.57-2(b)(4).
\item \textsuperscript{48} Sec. 163(d)(3)(C) and proposed sec. 163(d)(4)(D), H.R. 10612, § 206.
\item \textsuperscript{49} Sec. 164(d)(3)(C).
\item \textsuperscript{50} Proposed sec. 163(d)(4)(D).
\item \textsuperscript{51} Sec. 163(d)(1)(B) and proposed sec. 163(d)(2)(B), H.R. 10612, § 206.
\item \textsuperscript{52} Sec. 163(d)(2).
\end{itemize}
of one-half the amount of the taxpayer's net investment income in the subsequent year which is not offset by that year's investment interest. A taxpayer's net investment income in a subsequent year for this purpose is considered to have been offset by that year's investment interest only to the extent the investment interest exceeds $25,000. Apparently, the 50-percent-of-net-income limitation on the use of a carryover of disallowed interest was adopted to produce the same total amount of investment interest deduction under the carryover rule as would have been allowable if the taxable year in which the interest was paid or accrued and the carryover year were treated as only one taxable period. Stated differently, the rule produces the same total deduction that would have resulted if the investment income in the carryover year which is not offset by that year's investment interest had arisen in the earlier year in which the investment interest being carried over was paid or incurred.

In addition, under present law a special rule applicable in the carryover year correlates the amount of a taxpayer's excess investment interest carryover with the amount of the long-term capital gains deduction allowed the taxpayer for that carryover year.

Under the Ways and Means Committee's proposed nonbusiness interest limitation, a simpler and more liberal carryover for excess investment interest would be allowed. The bill would simply provide that investment interest which is not currently deductible solely because of the investment interest limitation is to be treated as investment interest paid or incurred in the following taxable year. Accordingly, this disallowed investment interest would simply be aggregated under the carryover rule with the amount of investment interest paid or incurred by the taxpayer in the carryover year and would be deductible to the extent permitted under the nonbusiness interest limitation in that subsequent year. Because there would be no time limit on the carryover of excess investment interest, it is not necessary to distinguish in a carryover year between the investment interest paid or incurred by the taxpayer in that year and the excess investment interest from previous years which is being carried over to that subsequent year.

In addition to being substantially simpler, the proposed excess investment interest carryover rule is also more liberal than the carryover rule contained in present law. Under the proposed rule, excess investment interest which is carried over to a subsequent year may be offset against any portion of the taxpayer's $12,000 allowance in the carryover year which is not used up by that year's personal or investment interest. Under present law, this is not the case. Even though a taxpayer has no investment interest in the carryover year, excess investment interest...
from a prior taxable year may not be offset in a carryover year against the taxpayer's $25,000 allowance for that year.\textsuperscript{56}

**Subchapter S Corporations and Partnerships**

In the case of partnerships and subchapter S corporations, the present limitation on the deduction of investment interest and the proposed nonbusiness interest deduction limitation is applied at the partner and shareholder level rather than at the partnership or corporation level.\textsuperscript{57} A partner or a subchapter S corporation shareholder separately takes into account his distributive share of the entity's relevant income and expense items (i.e., the entity's investment interest, investment income and expenses and other items pertinent to the application of the limitation). The individual then aggregates his distributive share of these items with his own investment interest income and expense for purposes of the limitation. In this regard, it is not clear what happens in the situation in which the partner or shareholder is allowed to deduct some, but not all, of his share of the partnership or corporation's loss for the year because the loss exceeds the basis of his partnership interest or of his stock and debt in the corporation.\textsuperscript{58} The question in this situation is whether the partner or shareholder in fact would otherwise be receiving a deduction for all or a portion of the entity's investment interest. In other words, is the amount of the loss which the taxpayer is not allowed to deduct composed in whole or in part of the entity's investment interest or does it represent some other item of expense?

**Interest on Indebtedness Incurred or Continued to Purchase or Carry Tax-Exempt Bonds**

Since the mid-1960's a number of cases have been decided construing the rule found for over 50 years in section 265(2) and its predecessors that no deduction is to be allowed for interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds.\textsuperscript{59} In general, the courts have held that the interest deduction is to be disallowed under section 265(2) only if the borrowing in question was made or continued for the proscribed purpose or has a sufficiently direct relationship to the purchasing or carrying of tax-exempts. In determining whether the proscribed purpose-relationship exists in a given factual situation,

\textsuperscript{56}Sec. 164(d) (2).

\textsuperscript{57}Sec. 163 (d) (4) (B) and (C), and proposed sec. 164(d) (5) (B) and (C), H.R. 10612, § 206.

\textsuperscript{58}A partner may not currently deduct his share of a partnership loss to the extent it exceeds the adjusted basis of his partnership interest. Sec. 704(d). A similar rule is applicable in the case of a shareholder of a subchapter S corporation. Sec. 1374(c) (2).

\textsuperscript{59}The Revenue Act of 1918 contained the original predecessor of section 265(2).
the courts have in essence employed two principles to establish the proscribed purpose-relationship: a direct tracing principle and a lack of reasonable business or economic justification principle.

The proscribed purpose-relationship has been found to exist where there is a direct tracing between the borrowing and the tax-exempt obligations. Such a direct tracing exists where the tax-exempts are purchased with the proceeds of the loan, are pledged as collateral for the loan, or where the tax-exempt obligations and the loan proceeds are held in the same account and the amount of the borrowing is directly related to the amount of the tax-exempt bonds.

If the loan proceeds are not directly traceable to the tax-exempts in the manner described above, then it generally has been held that the interest deduction is to be disallowed under section 265(2) if the taxpayer does not have a reasonable business or economic justification for concurrently holding the tax-exempts and also having the loan outstanding. For example, in Illinois Terminal Railroad Company, the taxpayer-railroad purchased the assets of another railroad entirely with borrowed funds. After approximately two years, the taxpayer sold the most substantial of the acquired assets to a municipality for cash and tax-exempt bonds of the municipality. The taxpayer used the cash to reduce the outstanding balance on its original loan but then continued for a number of years to hold most of the tax-exempt bonds and to keep most of the balance of the original loan outstanding to provide it with working capital. The court, however, concluded that the taxpayer did not have a reasonable justification for holding the tax-exempts and at the same time continuing the bank loan because it could have sold the tax-exempt bonds and used the proceeds to pay off its debt without impairing its capital needs.

Similarly, in Indian Trail Trading Post, Inc., it was found that the taxpayer did not have a reasonable business justification for acquiring tax-exempts while continuing to have a loan outstanding. In this case, the taxpayer obtained permanent financing for a new store in a shopping center owned by the taxpayer and used a portion of the loan to pay off the interim construction loan on the store. It placed the balance of the borrowing in its general funds and 8 months later purchased tax-exempt bonds. At the time the tax-exempt bonds were purchased, the taxpayer had an amount of cash in excess of its current business needs. Although the taxpayer noted some possible future business needs that might require funds, the Court concluded there was not a reason-

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60 Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420 (7th Cir. 1968).
63 Indian Trail Trading Post, Inc., 60 T.C. 497 (1973) aff’d 503 F.2d 102 (6th Cir. 1974).
able business justification for the concurrent existence of the loan and the tax-exempts, and, accordingly, found the proscribed purpose to be present.

On the other hand, taxpayers have been found to have a reasonable justification for the concurrent existence of a loan and the holding of tax-exempts, and, thus, the proscribed purpose-relationship has not been found to be present, in situations where the taxpayer while holding tax-exempts obtained a loan to finance a major nonrecurring expenditure, such as a mortgage loan obtained in order to build a new plant. In another situation in which a reasonable justification was found to exist, the taxpayer was required to borrow funds to meet an unanticipated and immediate need, which had arisen because of circumstances beyond its control, for cash to carry on its normal business operations. Liquidation of its holdings of tax-exempt obligations would not have been a feasible method of obtaining the needed funds since the amount of the tax-exempts was substantially less than the amount of funds needed by the taxpayer and about one-half of the tax-exempts were otherwise pledged with the Federal Reserve Bank.

In two recent cases, the Tax Court evidenced a more liberal attitude than prior cases in finding that the taxpayers had a reasonable business justification for the concurrent existence of loans and tax-exempt bonds. In one case, the two principal shareholder-executives of the taxpayer corporation were at odds with each other and also pursued an extremely conservative fiscal policy of no debt financing and comparatively small expenditures for necessary extensive plant and equipment modernization and expansion. Because of these factors, the business needs of the corporation could not be met and for many years it accumulated its excess funds in substantial amounts of taxable and tax-exempt securities. Then, to resolve the shareholder disputes, the corporation redeemed the stock of one of the principal shareholders and paid a substantial part of the redemption price in 6-year installment notes. Subsequently, the corporation's tax-exempt bonds were sold or matured and the proceeds used for the needed plant modernization. The Tax Court held that in these circumstances the corporation had a reasonable business justification for concurrently holding the tax-exempt bonds and having the installment notes outstanding.

In the second case, the taxpayer-corporation, because of business reversals, extended the term of 40-year bonds it had issued to its organizers at incorporation in exchange for land they transferred to it. Approximately five years after the extension, shareholders who owned 49½ percent of the stock in the corporation made detailed and con-

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64 Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420 (7th Cir. 1968).
crete proposals for an expansion of the corporation's business. The corporation had followed a conservative business pattern in the past in that it had maintained very substantial reserves to meet the working capital needs of its seasonal business and also had accumulated funds for the retirement of its bonds. These funds had been maintained in a very liquid portfolio of taxable securities. Shortly before the expansion proposal was made, the portfolio was largely converted into liquid tax-exempt securities maturing within a year in order to obtain higher after-tax yields. This portfolio was maintained and expanded through investment of surplus funds during the period the expansion proposals were under consideration. The corporation continued its indebtedness during this period to provide funds both to meet its working capital needs, consistent with its past practices, and also to provide the possible additional funds required if the proposed expansion plan were adopted. After serious consideration of the expansion proposals, they were rejected and on the next prepayment date the corporation prepaid a substantial portion of its outstanding indebtedness. These circumstances were considered by the Tax Court to evidence a reasonable business justification for the concurrent existence of the tax-exempts and the indebtedness and, accordingly, the proscribed purpose-relationship was not found to be present.

Where the taxpayer is an individual rather than a corporation, however, it generally is more difficult to establish that the proscribed purpose-relationship is not present, especially if the taxpayer is engaged in investment, rather than trade or business, activities. For example, in one recent case a doctor and his wife undertook an investment program which included the purchase of tax-exempt bonds during a period of substantially rising income. During this period, the taxpayers purchased a new home for cash, maintained substantial liquid balances (approximately $100,000) in their checking and savings accounts, and then subsequently obtained a $37,200 mortgage loan on their new home. The business and economic reasons offered by the taxpayers for obtaining the home mortgage loan was that it was needed to pay the balance of their prior years' federal income tax liability in approximately the same amount and to finance the purchase of certain X-ray equipment. The Tax Court in denying the deduction for the interest on the mortgage loan concluded that in reality the purpose of the loan was to assist the taxpayers in their investment program which included the acquisition and carrying of tax-exempt bonds.

Similarly, in Israelson v. United States, a taxpayer who held a large amount of tax-exempt obligations and at the same time continued a bank loan, the bulk of the proceeds of which were used for making stock and bond investments, was found to not have a reasonable justifi-

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68 Amedeo Louis Mariorenzi, 32 T.C.M. 681 (1973), aff'd per curiam, 490 F.2d 92 (1st Cir. 1974).
cation for the concurrent existence of the tax-exempt bonds and the loan. At most points during the period in question, the amount of the tax exempt bonds held by the taxpayer was substantially in excess of the amount of his bank loan.

Another type of investment program involving concurrent borrowings and the holding and acquisition of tax-exempt bonds was found in *Levitt v. United States* ⁷⁰ to be lacking in any reasonable business or economic justification. In this case, the taxpayer, during a period in which tax-exempt obligations were held and additional obligations acquired, borrowed to purchase U. S. obligations which were redeemable at face to pay estate taxes. The additional tax-exempt bonds were purchased with income of the taxpayer from other sources and then the borrowings were made to acquire the U. S. bonds. The court found that the only benefit to the taxpayer was the overall tax savings it would achieve and did not consider this a reasonable economic justification for the taxpayer's activity.

On the other hand, where an individual taxpayer incurs debts in connection with business ventures such as investments in real estate projects or joint ventures, ranches, and oil drilling ventures, and at the same time has a relatively insignificant amount of tax-exempt bonds in his investment portfolio, the courts generally have found that the taxpayer had a reasonable economic and business justification for incurring these debts and at the same time holding the tax-exempt obligations.⁷¹ It is important to note, however, that in the cases where the interest deduction was allowed because of the existence of a reasonable business or economic justification, there was no direct tracing between the loans in question and the tax-exempt obligations. That such a direct tracing will overcome an otherwise reasonable business justification is illustrated in the *Levitt* case. There, the District Court allowed the taxpayer to deduct the interest he incurred on loans obtained in connection with long-term real estate investments and a nonrecurring major business investment.⁷² On appeal, however, the Eighth Circuit focused on the fact that the taxpayer had pledged his tax-exempt obligations as part of the collateral for the loans in question, and, to this extent, the court found the requisite direct tracing to exist. Accordingly, it held that, notwithstanding the apparently reasonable business justification, a proportionate part of the interest on the loans was to be disallowed.⁷⁸

⁷⁰ 75-1 U.S.T.C. ¶ 9508 (8th Cir. 1975), aff'g and remanding 368 F.Supp. 644 (S.D. Iowa 1974).
⁷⁸ Levitt v. United States, 75-1 U.S.T.C. ¶ 9508 (8th Cir. 1975). Since the taxpayer in this case had relatively large holdings of tax-exempt bonds, it is possible that the Court of Appeals might have concluded, in the absence of a direct tracing, that a reasonable justification for the concurrent existence of the loans
In applying section 265(2) the courts have consistently stated that it is not mechanical in operation and “it does not become operative merely because the taxpayer incurred or continued indebtedness at the same time it held tax-exempt securities. Rather, the Commissioner must establish a sufficiently direct relationship between the debt and the carrying of the tax-exempt bonds.” As indicated above, the proscribed relationship is considered to exist to the extent that there is a direct tracing between the indebtedness and the tax-exempts. Even where there is no direct tracing, the proscribed purpose-relationship is considered to exist, if the taxpayer does not have a reasonable business or economic justification for the concurrent holding of the tax-exempts and the existence of the indebtedness. In the Leslie and Bradford cases, partnerships engaged in the securities brokerage business borrowed and repaid funds on a day-to-day basis in connection with the carrying on of their securities businesses, which included the purchase and sale of tax-exempt bonds. The Second Circuit disallowed a deduction in Leslie for the portion of the partnership’s interest expenses that was allocable to its holdings of tax-exempts. The court found the proscribed purpose-relationship to exist because the partnership took its intended purchases of tax-exempts into account in computing its daily cash needs for borrowing purposes and presumably would have had to borrow less had it not held the tax-exempts. In Bradford, the Tax Court followed the position of the Second Circuit enunciated in Leslie.

One of the dissenting opinions in Bradford suggested that these two cases depart from the approach of the other section 265(2) cases and instead set forth the mechanical principle that section 265(2) is operative whenever a taxpayer has both tax-exempts and an indebtedness outstanding. These cases, however, do not go as far as suggested by the dissenting opinion and indeed are consistent with the other section 265(2) cases. The distinguishing factor in this regard is that in Leslie and Bradford the borrowings in question were incurred in connection with all of the activities of the brokerage businesses, including the acquisition and carrying of tax-exempt bonds. In other words, the acquisition of the tax-exempts contributed at least in part to the need for the borrowings. In the other section 265(2) cases which did not involve a direct tracing and where the courts thus proceeded to as-

and the tax-exempts did not exist. The court alluded to, but did not pass on, this question in view of the existence of direct tracing. Compare Batten and Ball (fn. 71) in which the relative holdings of tax-exempt bonds were quite small.


certain whether there was a reasonable business or economic justification for the concurrent existence of the indebtedness and the tax-exempts, the event occasioning the borrowing did not involve even in part the acquisition of tax-exempts.

Viewed in this manner, it would appear that Leslie and Bradford are in fact cases in which the proscribed purpose-relationship was established by a type of direct tracing since one of the purposes of the borrowings in these cases was to acquire tax-exempts. In view of the fact that there was a direct tracing, it was not necessary for the courts to proceed to the further inquiry whether the concurrent existence of the indebtedness and the tax-exempt obligations had a reasonable business or economic purpose. Such an inquiry is necessary only where the proscribed purpose-relationship is not established by a direct tracing. Accordingly, it does not appear that the Leslie and Bradford cases set forth a mechanical principle for the application of section 265(2); rather, the approach employed in Leslie and Bradford is consistent with that which has been developed by the courts in other section 265(2) cases. This is further demonstrated by the fact that cases subsequent to Leslie and Bradford have neither construed them as adopting such a mechanical principle nor applied such a principle.

**Tax Avoidance Transactions**

Over the years taxpayers have attempted to devise tax-saving transactions to produce a large interest deduction which is then used to shelter other unrelated income from tax. As discussed above, prepayments of interest have been used for this purpose in recent times. A more complex type of transaction which was designed to produce a substantial interest deduction, but little else, originated in the early 1950's and is known as the "Livingstone transaction." Generally, this type of transaction involves the purchase of a substantial amount of U.S. Treasury obligations, and the financing of all or almost all of the purchase price of the obligations by a loan for which the obligations are pledged as security. Often, interest on the loan is prepaid to further enhance the tax-saving potential. In one variation of the Livingstone transaction, the Treasury obligations are purchased from, and the loan is obtained from, the same person, often a promoter. In another variation of the Livingstone transaction, the loan in question is obtained from an independent financial institution.

By and large, taxpayers have been unsuccessful in securing the interest deduction intended to be produced by these tax-saving schemes. The courts have employed two basic approaches to deny the interest deduction. In cases where the obligations were purchased from, and the loan made by, the same person, the courts have concluded that the transaction was a sham and, accordingly, resulted in no valid indebtedness which could support an interest deduction. In the cases where the
loan in question was obtained from an independent financial institution and, thus, involved a valid indebtedness, the courts have disallowed the interest deduction on the basis that the transaction must have a purpose other than the obtaining of an interest deduction. In other words, it has been held that the deduction will not be allowed if, considering the facts surrounding the transaction, it is apparent that the taxpayer did not, and could not, have had any reason for entering into the transaction other than to secure the benefit of the interest deduction.

**Sham Transactions**

In *Knetsch v. United States*, the Supreme Court applied the sham transaction approach to deny the interest deduction in a tax-saving transaction. In this case, the taxpayer purchased 2 1/2 percent single premium annuity bonds from an insurance company and financed 99.9 percent of the purchase price by giving the insurance company 3 1/2 percent nonrecourse notes that were secured by the bonds. Since the taxpayer borrowed the annual increase in the cash value of the bonds attributable to the 2 1/2 percent interest factor to meet a substantial portion of the required interest payments on the notes, his equity in the bonds would never increase. The Supreme Court concluded that the transaction was a sham noting that "There was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."

In other cases in which the sham transaction approach has been employed to deny the interest deduction, the fact that the transaction is a sham has been even more apparent. Often in these cases, the bonds purchased by the taxpayer were immediately resold to the promoter and thus the transaction was viewed as involving mere paper shuffling over a short period of time without any real purchase of government obligations or any real borrowing.

**Interest Deduction Sole Purpose of Transaction**

Prior to 1966 if a taxpayer borrowed the amount necessary to finance the investment in his tax-saving scheme from an independent financial institution, the courts generally found that a valid indebtedness had been created and, accordingly, that the interest deduction was not to be disallowed under the sham transaction approach. In 1966, the Second Circuit in considering a tax-saving transaction involving a valid debt in the *Goldstein* case formulated the principle

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76 364 U.S. 361 (1960).
that the interest deduction could be denied on the basis that the trans-
action had no purpose other than the obtaining of an interest deduction.
In this case, the taxpayer used the proceeds of 4-percent loans obtained
from independent financial institutions to purchase 1\%\% percent Treas-
ury notes. The notes were pledged as security for the loans. The
interest on the loans were prepaid and a deduction for the interest
was claimed, primarily to offset a substantial amount won by the tax-
payer in the Irish Sweepstakes. The Second Circuit, noting that the
taxpayer had no prospect of sufficient appreciation to offset the eco-
nomic loss from the interest rate differential between the Treasury
notes and the loan, held that the taxpayer had no realistic expectation
of economic profit from the transactions and had entered into them
solely to secure a large interest deduction to offset her sweepstakes
winnings. On this basis, the court denied the claimed interest deduction.

This principle was reaffirmed by the Second Circuit less than two
years later when in the \textit{Lifschultz}\textsuperscript{80} case it considered a similar trans-
action which involved both an economic loss to the taxpayer on the
interest rate differential and a very remote chance of sufficient ap-
preciation resulting from the bond investment to offset that economic
loss. As in \textit{Goldstein}, the court denied the interest deduction on the
basis that the transaction was entered into without any realistic ex-
pectation of economic profit and solely as a means of securing the in-
terest deduction. The \textit{Goldstein} principle has also been considered by
the Court of Claims and has been applied by that court to deny the
interest deduction in a similar type of tax-saving transaction which
involved a valid indebtedness.\textsuperscript{81}

In the \textit{Estate of Frank Cohen}\textsuperscript{82} the Tax Court applied the \textit{Goldstein}
principle to deny the interest deduction in the case of a tax-saving trans-
action in which the interest rate differential did not produce an
economic loss to the taxpayer. Although the obligations acquired by
the taxpayer with borrowed funds had a higher interest rate than the
loan in question, the obligations were purchased at a premium. If
held to maturity and redeemed at par (as they in fact were), a loss
would be produced that would cause an overall economic loss on the
transaction. The court concluded that the taxpayer had entered into
the transaction solely to secure an interest deduction because of both
the remote possibility of an economic profit on the transaction and the
taxpayer's actual conduct in not selling the obligations prior to maturity
at a price which exceeded his purchase price.

Although the courts in discussing the \textit{Goldstein} principle have
often characterized it in broad terms as a business purpose requirement

\textsuperscript{80} \textit{Lifschultz v. Comm'r}, 393 F.2d 232 (2d Cir. 1968), \textit{aff'g} 25 T.C.M. 1146
(1966).

\textsuperscript{81} \textit{Rothschild v. United States}, 407 F.2d 404 (Ct. Cl. 1969). This case also con-
tains a lengthy review of the various tax avoidance cases.

\textsuperscript{82} 29 T.C.M. 1221 (1970).
or a purposive activity requirement, up to now the principle has been confined in application to those limited situations where the loan in question served no purpose other than the securing of an interest deduction. In other words, to date it has been applied to deny the interest deduction only in the situation where the lack of any realistic possibility of economic gain has demonstrated that the securing of an interest deduction was the only purpose of the taxpayer in entering into the transaction in question.