Corporate Borrowing for Investment in Equity Securities: Tax Advantages via the Interest Deduction and Dividends Received Deduction

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NOTES

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I. The Nature and Scope of the Benefit

Assume that *XYZ* Corporation earns $1,000,000 before taxes, that it can borrow at an interest rate of ten percent, and that it can purchase the preferred stock of a variety of the largest American corporations and so achieve a portfolio with an average dividend yield of ten percent. Under current rates,[1] *XYZ* will incur a tax of $440,750 on its pretax profit of $1,000,000. If, however, *XYZ* borrows $1,000,000 and uses this money to purchase a portfolio of preferred stocks, its tax liability will decrease to $401,650 despite the fact that preferred dividends are applied directly to pay the interest on the debt. Thus, *XYZ* will have reduced its tax liability by $39,100 without sustaining any other cash flow consequences.

Such a use of borrowed funds to purchase equity securities produces benefits because of the interplay between sections 163 and 243(a)(1) of the Internal Revenue Code. Under section 163, the general rule is that all interest on indebtedness paid or accrued within the taxable year is deductible.[2] The restrictions that apply to an individual's ability to deduct interest—the requirement of itemized deductions in excess of the zero bracket amount[3] and the limitation upon the deductibility of interest on investment indebtedness[4]—are not imposed on corporations.

Sections 243 through 246 contain the rules governing deductibility of dividends received by corporations. Whereas individuals generally are taxed fully on amounts received as dividends,[5] corpo-

1. I.R.C. § 11(b).
2. I.R.C. § 163(a). The limitations upon this general rule of interest deductibility applicable to corporations, including § 267 (related parties) and § 279 (debt-financed corporate acquisitions), are discussed in Part II, Section B of this Note *infra*.
3. I.R.C. § 63(c).
4. I.R.C. § 163(d).
5. I.R.C. §§ 301(c), 316. Individuals do receive an exclusion from gross income of $200

rations can deduct a substantial portion of the dividends they receive. The general rule is that 85% of dividends received from domestic corporations subject to federal income taxes are deductible by corporations,[6] with 100% of the dividends received deductible if the recipient corporation is a small investment company[7] or the member of an affiliated group with the paying corporation.[8] Dividends received on the preferred stock of public utilities are deductible to a more limited extent if the public utility received the benefits of section 247, whereby a percentage of such dividends paid is deductible if the utility had taxable income during the year.[9] At current rates, 59.13% of most public utility preferred dividends are deductible by recipient corporations.[10] Dividends received by corporations from foreign corporations are, in general, eligible for the 85% or 100% deduction only to the extent that the dividends are derived from income that has been subject to the federal income tax.[11]

The rationale for the dividends received deduction is that multiple full taxation of dividends at the corporate level would severely disadvantage the shareholders of the recipient corporation. Since individuals are the ultimate beneficial owners of all corporations, the minimization of taxes upon intercorporate distributions has been deemed vital since the inception of the federal income tax system.[12] Because distributed corporate earnings are taxed at the

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($100 prior to January 1, 1981) on dividends received from most domestic corporations. I.R.C. § 116.

6. I.R.C. § 243(a)(1).

7. I.R.C. § 243(a)(2).

8. I.R.C. § 243(a)(3), (b)(1).

9. I.R.C. §§ 244(a), 247(a).

10. Under I.R.C. § 244, the percentage is derived as 32/46 of the dividend received times the 85% deduction. *See generally* Curran, *Preferred Stock in Public Utility Finance—A Reconsideration,* FINANCIAL ANALYSTS J., Mar.-Apr. 1972, at 71.

11. More specifically, the foreign corporation must have been engaged in trade or business within the United States for at least 36 consecutive months (or the life of the corporation, if shorter), must have derived at least 50% of its gross income from sources "effectively connected" with the conduct of a trade or business within the United States, and must not be a foreign personal holding company. Dividends from such a foreign corporation are then subject to the dividends received deduction of § 243 to the extent of the proportion that gross income derived within the United States bears to the gross income of the foreign corporation as a whole. I.R.C. § 245(a).

12. From 1917 to 1935, dividends received by corporations were not subject to federal income taxation. In 1935 the dividends received deduction was reduced to 90% to discourage the use of multiple entities for tax avoidance and to encourage simplification of elaborate corporate structures. Revenue Act of 1935, ch. 829, § 102(h), 49 Stat. 1016. The benefit was lowered to an 85% "credit" in the language of the new Internal Revenue Code passed the next year. Revenue Act of 1936, ch. 690, § 26(b), 49 Stat. 1664.

corporate level and again to the shareholders at their marginal brackets,[13] the imposition of an additional full tax each time such earnings pass between corporate entities has been deemed inequitable. This rationale is not weakened by the existence of corporations that are profitable yet do not pay dividends, for their shareholders are not receiving the present benefit of those earnings.[14] Indeed, the value of an ownership interest in a corporation is often defined as the present value of the expected stream of distributions to the individual;[15] the value of the shares of stock in a profitable company currently paying no dividends therefore depends on the expectation that the firm's reinvestment of earnings will enable it to pay much greater dividends in the future (or to distribute substantial amounts in liquidation). Because under classic economic theory a corporation's primary goal is the maximization of the wealth of its shareholders,[16] the corporation should distribute its earnings to the shareholders—whether corporate or individual—if the rates of return available to the corporation upon reinvestment of the earnings are inferior to the rates of return attainable by the shareholders on projects available to them individually.[17] Thus, taxation that inhibits this optimal allocation of capital by restricting the flow of money in the economy not only is inequitable to the individual receiving earnings taxed more times simply because they passed through more entities, but also is contrary to public policy.

The legitimate objective of avoiding multiple taxation of earnings at the corporate level, however, leads to a substantial potential benefit to a corporation if a high-yield stock is merely viewed as one type of marketable security with a substantial portion of its return free from federal taxation. The dividends received deduction primarily seeks to avoid multiple taxation of earnings in the case of related firms or at least those with a substantial interest in each other. Obviously, the ownership interest involved when a

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13. *See generally* C. McLure, Must Corporate Income be Taxed Twice? (1979); Surrey, *Reflections on "Integration" of Corporation and Individual Income Taxes,* 28 Nat'l Tax J. 335 (1975).

14. If the shareholder of such a company wishes to receive current income, he may sell a portion of his stock and receive capital gains treatment. In doing so, however, he not only would incur transactions costs, but also would reduce his ownership interest and thus his claim upon future dividend payments.

15. *See* F. Weston & E. Brigham, Managerial Finance 553 (5th ed. 1975).

16. *See, e.g.,* R. Lipsey & P. Steiner, Economics 170-71, 314-17 (3d ed. 1972); J. Weston & E. Brigham, *supra* note 15, at 9-13.

17. *See generally* P. Samuelson, Economics 92 (8th ed. 1970).

small local cannery purchases one thousand shares of A.T. & T. or Exxon is trivial at best, yet the cannery receives the same dividends received deduction that it would receive if it had invested in the shares of a local food producer or another cannery.

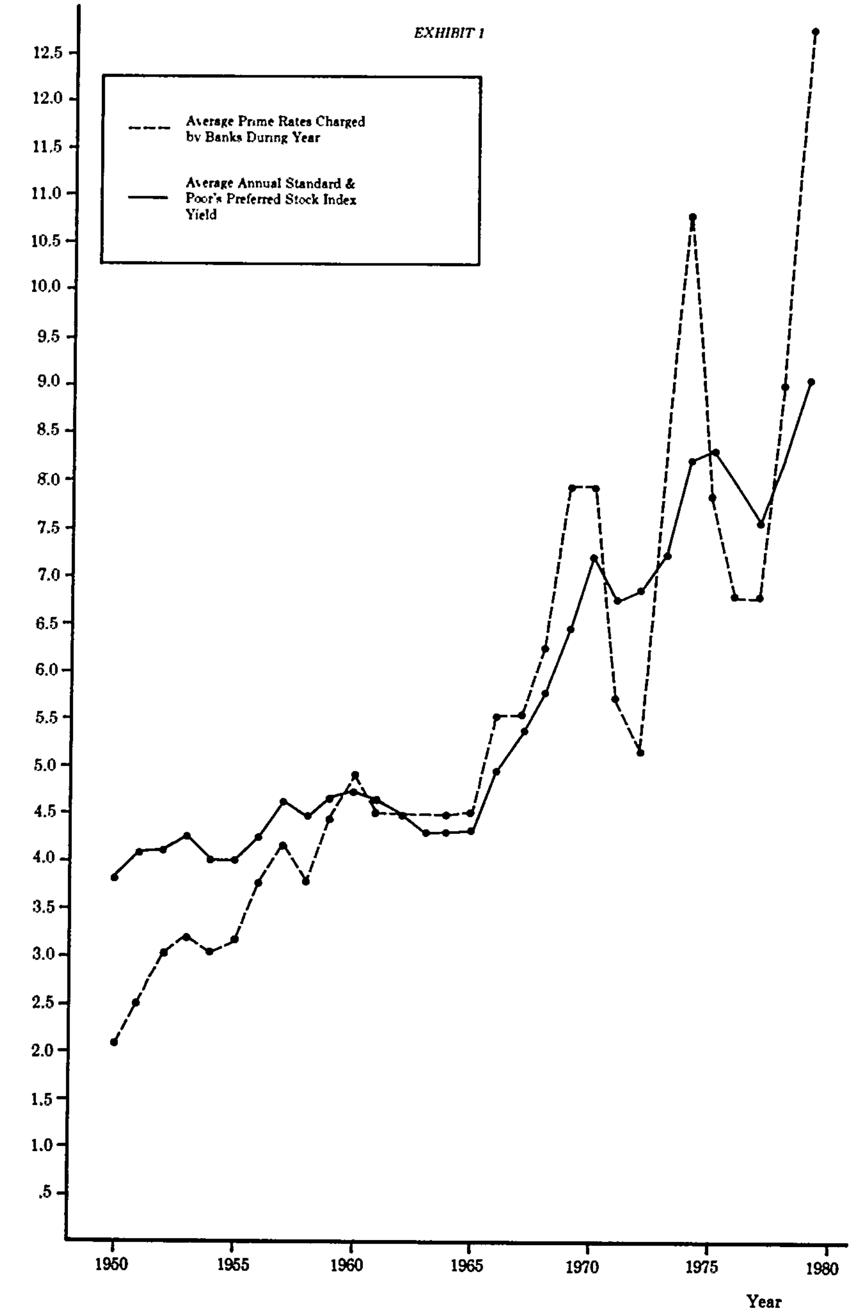
The potential benefit of pairing the dividends received deduction with the deductibility of interest on debt used to carry the equity investment is enormous. At any given time a corporation may not be able to borrow at some interest rate and receive an exactly equivalent yield on a diversified portfolio of stable equity securities, as did the hypothetical *XYZ* Corporation above.[18] Yet Exhibit 1, which displays the annual averages of the prime rate charged by banks and the Standard and Poor's index of preferred stock yields, reveals that there have been numerous occasions since 1950 when preferred yields equalled or exceeded the rate at which major corporations could borrow.[19] The prime rate is only available to the strongest corporations, and many companies must deal with debt limitations imposed by indentures or in effect created as the cost of debt rises with leverage. Nevertheless, the prime rate is more than a figure at which the most soundly based corporations can borrow. Combined with margins over prime according to risk, it also indicates the rates at which other corporations can obtain debt. Similarly, the preferred stock yield index is valid only as to the yields available on a limited number of the most stable equity issues. If there were a large influx of buyers for such securities, prices would tend to rise substantially (most preferred issues being rather thinly traded), and available yields would fall correspondingly. Hence, a comparison of the prime rate and the preferred stock yield index is not indicative of the profit potential for all corporations investing in equity securities with borrowed funds. Such a comparison is entirely valid only for the hypothetical firm capable of borrowing the amount it chooses at the prime rate (without affecting its capital structure) and investing that amount in preferred stocks of the highest quality (without depressing their yield).

It is important to recognize, however, that leveraged investment in equities can be advantageous even if the available divi-

18. *See* text preceding note 1 *supra*.

19. Exhibit 1 reveals a trend of increasing volatility, particularly for interest rates. Data for 1980 indicate a continuation of this trend: while the prime rate has averaged 14.78% for January through September (ranging from 11.00% to 20.00%) the Standard and Poor's index of preferred stock yields has averaged 10.33% (ranging in monthly averages from 9.78% to 11.26%).

dend yield does not equal or exceed the cost of borrowing. Such an investment will produce a positive net present value to the firm as long as the dividend yield is greater than 58% of the cost of the



debt,[20] assuming that the borrowing has no other impact upon the firm. From 1950 through 1979, the Standard and Poor's index of preferred stock yields was well above 58% of the prime rate charged by banks in each year, and over the period it averaged 109% of the prime rate.[21] Given this prevailing relationship between prime preferred yields and prime interest rates, many corporations (not just those that can borrow at the prime rate) could avail themselves of the benefits of financing high yield equities with debt. Even in 1979, a year of unprecedented prime rate levels, the index's preferred stock yield averaged 71.6% of the prime rate.[22] Hence, despite such adverse market conditions, many firms could theoretically reap the benefits of leveraged investment in equity securities although transaction costs would probably exceed benefits for firms not able to borrow at or near the prime rate.

While the dividends received deduction applies to most equity investments,[23] the benefits of this Internal Revenue Code provision are greatest with certain types of stock. Preferred stocks are generally more suitable for corporate investment fund purposes than are common stocks because they offer greater stability and, in most cases, higher yields. Preferred stocks also have priority over common shares as to payment of dividends and as to proceeds of liquidation, and they do not share in the profitability of the firm be-

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20. This percentage is derived as follows: the benefit of fully leveraged investment in equities equals the amount of the dividend less the cost of the debt plus the net tax effect, which consists of the tax on the 15% of the dividends remaining after the deduction and the value of the deduction for the interest expense.

$$B = d(P) - i(P) - [.15(d)(P) - i(P)].46$$

where B = the benefit

P = the principal amount borrowed and invested

d = the dividend yield

i = the interest rate on the debt

$.46$ = the maximum corporate tax rate under I.R.C. § 11(b)

$$B = P[d - i - (.15d - i).46]$$
$$= P(d - i - .069d + .46i)$$
$$= P(.931d - .54i)$$

To determine the breakeven point, the amount of the benefit is set equal to zero.

$$0 = P(.931d - .54i)$$
$$.54i = .931d$$
$$d/i = .54/.931 = 58\%$$

21. *See* Exhibit 1. Within this period, the averages were 132% for the decade of the 1950s, 95% for the 1960s, and 100% for the 1970s.

22. This relationship, a ratio of the 1979 average preferred yield of 9.07% and the 1979 average prime rate of 12.67%, represents the smallest percentage during the years covered. The previous low was 76.2% in 1974. The 1979 trend has thus far continued in 1980. *See* note 19 *supra*.

23. *See* notes 5-11 *supra* and accompanying text.

yond the scheduled dividend payments. Therefore, values of preferred shares that are nonparticipating and nonconvertible move primarily according to changes in interest rates. Changes in investor perceptions of the issuing corporation tend not to affect the value of such shares unless those perceptions touch upon the ability of the firm to pay the preferred dividends or the likelihood of insolvency. When a corporate investor purchases publicly traded equity securities, it seeks to minimize the price variations associated with the performances of individual firms unless it has what it believes to be advantageous knowledge about a specific company. Therefore, the equities purchased not only are likely to be preferred stock, but also will probably consist of a diversified portfolio to reduce the risk of the insolvency of any particular firm.

Corporations clearly perceive the benefits of investment in equities under the dividends received deduction. Financial publications have explained the deduction and its effective use and have noted the increasing dominance of corporate investors in the market for "straight" preferred stock.[24] In particular, financial managers have tended increasingly to utilize preferred stock in their large short-term investment accounts as, in effect, a form of money market security;[25] previously, corporate investment in preferred stock was largely confined to long-term portfolio investments, such as those of insurance companies.[26] The primary difference between preferred stock investments and standard debt instruments, other than the difference in taxability of the return, is the absence of a maturity date on the preferred. This feature renders preferred stock much more susceptible than debt instruments to fluctuations in value caused by changes in the prevailing interest rate.[27] The

24. *E.g., Markets and Investments: The Profits in Collecting Preferred Dividends*, BUS. WEEK, Oct. 17, 1977, at 118; *Preferred Stocks Interest Private and Large Corporate Investors*, MAGAZINE OF WALL STREET, Aug. 29, 1970, at 9; *Research Notes: Using Preferred Securities to Generate Greater Cash Flow*, FINANCIAL EXECUTIVE, Dec. 1970, at 10.

25. Fischer & Wilt, *Non-Convertible Preferred Stock as a Financing Instrument 1950-1965*, 23 J. FINANCE 611, 622-23 (1968); Merjos, *Investor's Choice: Preferred Stocks Have Suddenly Returned to Favor*, BARRON'S, Nov. 3, 1975, at 5.

26. *See* Merjos, *supra* note 25.

27. As the maturity of a debt instrument draws near, the price will inevitably approach the surrender value, no matter how large the gap between the prevailing interest rate and the stated rate on the debt. Preferred stocks, lacking such a fixed maturity, will vary in value in direct relation to prevailing interest rates, much as will the perpetuity form of debt, unless the preferred has some limiting features such as callability or convertibility or unless the ultimate factor of value upon liquidation—which can at most equal the par value—comes into consideration. Thus, pure preferred stock theoretically has the value of a perpetuity: the stated payout divided by the current interest rate. In reality, the paying firm's solvency is always a consideration; hence, the price of a share of preferred steck dif-

higher market risk of preferred must be balanced against the tax-exempt character of a portion of the return according to the investor's risk-return preference curve in order for the corporate investor to determine whether particular debt or preferred equity investments are more desirable.[28]

Thus, while corporations definitely are availing themselves of the dividends received deduction on equities unrelated to their own lines of business, there is no evidence that corporations are leveraging fully such equity investments as part of a tax reduction plan. To the extent that the corporations taking the deduction are capitalized with a mixture of debt and equity, the equity investments are in effect partially leveraged. The resulting tax reduction, however, is incidental.

There are several potential explanations for the apparent failure by corporations to utilize fully leveraged equity investments. First, the market risk may well deter a number of corporate financial managers. As demonstrated above, preferred equity investments are especially sensitive to interest rate fluctuations[29] and tend to lose value more rapidly than debt instruments in a period of rising interest rates. Given the uncertainty and volatility characterizing interest rates since 1965,[30] conservatism on the part of corporate financial managers is understandable.

Second, corporations may not have been able to tie the financing debt to the equities in an adequate fashion. Most firms would not wish to constrain the amount or cost of debt available to finance corporate purposes in order to undertake investments in unrelated equities. Hence, corporations would seek to use the equity investment as collateral for the debt and to arrange the maturity of the debt accordingly. Collateralization probably would not pose too great a problem, although the lender would likely require recourse against the corporation because of the market volatility of the equities. Obtaining debt of sufficient duration for such purposes, however, would pose a more formidable problem. Nominal application of long-term debt to other projects and use of available cash to finance the equities would achieve the goal but would risk

fers from the perpetuity value by an amount reflecting the risk the market associates with the likelihood that the corporation will be liquidated voluntarily or involuntarily and that an amount less than the par value will be realized by the investors.

28. *See* Curran, *supra* note 10, at 74-75.

29. *See* note 27 *supra*.

30. *See* Exhibit 1 *supra*.

violation of the accumulated earnings provisions.[31] The availability of bank debt of sufficient length to allow for the weathering of an interest rate cycle prior to refinancing is questionable. Smaller firms have perhaps the best opportunity to secure loans of sufficient duration by dealing with individuals, such as major shareholders, but such firms must guard against running afoul of the "related parties" or capital structure restrictions on interest deductibility.[32]

Last, corporations may be failing to avail themselves of the benefits of fully leveraged investment in equities because of simple lack of sophistication and lack of desire for profit maximization. A preference for conservatism, not necessarily based upon reason, was noted recently in regard to a similar plan of "dividend rollovers" desigued to take maximal advantage of the dividends received deduction in the context of money balances.[33] While fully leveraged equity investment is not complicated, it is likely that many corporate financial officers, bound by tradition, have not even considered it and would not seek to take advantage of such a strategy, even were it clearly available with substantial benefits, unless they were aware of its attempted use by a substantial number of their peers.

II. Potential Limitations

The benefits of pairing the interest deduction with the dividends received deduction in a fully leveraged equities investment plan are not impaired by the provisions of the two deduction sections themselves; those benefits are in theory of substantial net present value and should be available to corporations that either have access to long-term loans from individuals or are agressive enough to assume the market risk over the term for which institutional lenders are willing to supply the capital. Sections 163 and 243(a)(1) do not exist in a vacuum, however, and corporations are subject to several other tax provisions that either limit the applica-

31. *See* text accompanying notes 40-43 *infra.*

32. *See* text accompanying notes 57-67 *infra.*

33. *Markets and Investments, supra* note 24. These dividend rollovers involve buying preferred stock shortly before the ex-dividend date and selling it soon thereafter. (Certain lags are necessary to prevent technical corrections from negating the benefits.) The process is then repeated with another stock that is approaching its ex-dividend date. Some financial officers regarded the plan as too wild ("too much swinging for me"); others expressed a desire that it not become widely understood in order to keep the benefits for themselves ("we've got a good thing going"). *Id.* at 119-20.

bility of these sections or interact with them. This section of this Note investigates these potential limitations by analyzing two penalty taxes on corporations that seek to shield their shareholders from taxation, by looking at the various limitations on interest deductibility by corporations, and by examining the restrictions placed upon the dividends received deduction.

A. *Corporate Penalty Taxes*

1. The Accumulated Earnings Tax

Internal Revenue Code sections 531 through 537 impose a special tax on earnings of a corporation that are held in corporate solution but are not required for a corporate purpose. This tax is designed to penalize corporations that seek to maximize the shareholders' wealth by retaining earnings and thus avoiding a second taxation of that income.[34] The penalty is so severe[35] that there is substantial incentive to avoid even the risk of imposition of the tax. The general rule is couched in terms of "the purpose of avoiding" the income tax at the shareholder level.[36] The taxpayer has the burden of proving the absence of such a purpose if earnings and profits have been accumulated "beyond the reasonable needs of the business."[37] The tax is generally imposed on the amount by which undistributed earnings exceed the portion retained for the reasonable needs of the business,[38] although each corporation is allowed an accumulation of at least $150,000 of earnings and profits.[39]

Investment in unrelated equities is one of the standard indicators used by the government to identify corporations that are accumulating earnings beyond their reasonable needs.[40] The focus of this criterion is the way the purchased stock relates to the "business of the corporation."[41] Under the regulations, whether the

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34. The theory underlying such a practice is that the substantial earnings will increase the value of the firm's shares, and the shareholder may reap the benefits of the corporate profits at capital gains rates when he sells the shares.

35. The tax ranges from 27.5% to 38.5% upon the amount deemed "accumulated taxable income." I.R.C. § 531. This penalty tax is imposed in addition to the standard income tax liability at the corporate and individual levels.

36. I.R.C. § 532(a).

37. I.R.C. § 533(a). The fact that the corporation is a holding or investment company is prima facie evidence of the forbidden purpose. I.R.C. § 533(b).

38. I.R.C. § 535.

39. I.R.C. § 535(c)(2).

40. Treas. Reg. §§ 1.533-1(a)(2)(ii) (1960), 1.537-3(b) (1960).

41. Treas. Reg. § 1.537-3(b) (1960).

ownership of less than 80% of the stock of another corporation constitutes the use of funds in the business of the owning corporation, rather than as an investment, "depend[s] upon the particular circumstances of the case."[42] Decisional authority establishes that, unless there is some overriding long-range purpose for the accumulation of a liquid reserve, the acquisition of the stocks of public corporations unrelated to the acquiring corporation, even in a diversified portfolio, provides clear evidence of an intent to avoid the imposition of tax at the shareholder level.[43] Based upon these principles the purpose of minimization of corporate income taxes, as by a corporation fully leveraging its equity investments, is not likely to be treated as an acceptable purpose to allow acquisition of unrelated equities as part of the "business of the corporation." Nevertheless, there are several rationales by which a corporation seeking to benefit from leveraged equity investments can evade the noose of the accumulated earnings tax.

The strongest argument for not applying the accumulated earnings tax to corporations that borrow for investment in equity securities is that the penalty tax provisions challenge the investment of *earnings and profits* in unrelated equities. The regulations state that "investment by a corporation of its earnings and profits in stock and securities of another corporation is not, of itself, to be regarded as employment of the earnings and profits in its business."[44] If the government wished to use ownership of, rather than investment of earnings and profits in, unrelated equities as an indicator of the forbidden purpose, that distinction could easily have been accomplished by a different drafting of the regulations. As the regulations now stand, however, there is a clear indication that tracing of the invested funds back to the status of earnings and profits is necessary. The need for such tracing has never been addressed in the reported cases under the unrelated equities criterion for imposition of the accumulated earnings tax, but the issue of the source of the funds for the investment has never been raised.[45] If

42. *Id.*

43. *E.g.*, Helvering v. National Grocery Co., 304 U.S. 282 (1938); Cataphote Corp. v. United States, 535 F.2d 1225 (Ct. Cl. 1976).

44. Treas. Reg. § 1.537-3(b) (1960).

45. Rather, the challenged corporations have litigated under the theory that there was a valid business purpose for the acquisition of the steck. *See, e.g.*, United States v. Donruss Co., 393 U.S. 297 (1969) (contending that purchase of stock of major distributor was desirable for control purposes); Cataphote Corp. v. United States, 535 F.2d 1225 (Ct. Cl. 1976) (contending that the investment was part of a contingency fund for possible acquisition of a fleet of trucks and a service department should the firm's current middleman leasing prac-

equity investments were fully leveraged, the funds used to purchase the stock would not be earnings and profits but rather loan proceeds. Documentation of this nexus between the loan and the purchase would be quite easy, especially if the loan were collateralized by the equities. While a corporation undertaking this course of action would still be subject to the restrictions of the accumulated earnings tax, such an investment, if well documented, would not in itself lead to liability under this penalty tax provision as it is now construed.

Other arguments that can be made for the proposition that leveraged investments in equity securities should not trigger imposition of the accumulated earnings tax stem from the limited application of the tax. Although the benefits of leveraged investments are theoretically available to all corporations subject to the federal income tax,[46] the accumulated earnings tax appears to be applicable only to those corporations that are dominated by a few large shareholders who can exercise control over the corporate dividend policy.[47] Also, in order for the accumulated earnings tax to be applicable, the avoidance of tax *at the shareholder level* must be one of the purposes of the accumulation (though it need not be the sole, dominant, or controlling motive).[48] Although tax avoidance is clearly a dominant motive of fully leveraged equity investments, such investment activity is directed toward avoidance of the corporate rather than the individual income tax.

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tice become unprofitable).

In GPD, Inc. v. Commissioner, 508 F.2d 1076 (6th Cir. 1974), the court did find that the accumulated earnings tax imposition need not be based on an accumulation of "earnings and profits" in the taxable year. *Id.* at 1086-87. The court, however, stressed that two factors must be present before the tax could be imposed: "1) the proscribed purpose of avoiding the income tax for its shareholders, and 2) the proscribed conduct of permitting earnings and profits to accumulate instead of being divided or distributed." *Id.* at 1079. Thus, while it is unnecessary to trace the accumulated earnings to the taxable year under question, it is necessary to locate an improper accumulation of earnings and profits before the penalty tax can be imposed.

Note, however, that if the equity securities funded by debt appreciated, the amount of appreciation would properly be regarded as accumulated earnings and profits for the purposes of imposition of the accumulated earnings tax. *See* Ivan Allen Co. v. United States, 422 U.S. 617 (1975).

46. In practice, however, large public corporations would probably be unable to obtain the necessary loans and to purchase enough preferred stock at sufficient yield (given the limited market depth for such shares) to render such investment activity useful to them.

47. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 8.02, at 8-6 to -7 (4th ed. 1979).

48. United States v. Donruss Co., 393 U.S. 297 (1969).

2. The Personal Holding Company Tax

The other tax designed to penalize use of the corporate structure to shield shareholders from full income taxation at the high individual rates applicable to income not related to personal services is the personal holding company tax imposed by sections 541 through 547. If a corporation meets the necessary qualifications of a personal holding company—the adjusted ordinary gross income requirement and the stock ownership requirement[49]—it will be subject to a tax amounting to 70% of its "personal holding company income" (generally, passive income) that is not currently distributed.[50] Briefly, under the adjusted ordinary gross income requirement[51] at least 60% of the adjusted ordinary gross income (gross income excluding gains treated as capital, with certain further adjustments relating to passive income)[52] must be personal holding company income, which consists of passive income such as dividends, rents, and royalties, compensation for the use of corporate property by shareholders, and income from personal service contracts.[53] The stock ownership requirement is that at some point within the last half of the taxable year more than 50% in value of the outstanding stock of the corporation must have been owned by five or fewer individuals.[54]

The personal holding company tax relates to fully leveraged equity investments insofar as receipt of the dividends pushes a corporation over the threshold of the adjusted ordinary gross income requirement. If a corporation meets the stock ownership test of a personal holding company, use of fully leveraged equity investments could trigger imposition of the personal holding company tax. This potential problem results from the inclusion of the dividends in "adjusted ordinary gross income" as well as "personal holding company income," neither of which is reduced by the dividends received deduction or the interest deduction.[55] Ordinarily,

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49. I.R.C. § 542(a).

50. I.R.C. § 541. Note that this percentage equals the maximum rate applicable to individuals under I.R.C. § 1.

51. I.R.C. § 542(a)(1).

52. I.R.C. § 543(b).

53. I.R.C. § 543(a). There are various exceptions and further requirements for most of the types of passive income. The examination of those provisions, however, is beyond the scope of this Note. *See generally* B. BITTKER & J. EUSTICE, *supra* note 47, at ¶ 8.22.

54. I.R.C. § 542(a)(2). The ownership attribution rules applicable to this requirement are located in I.R.C. § 544.

55. Interest expense relating to rents and mineral royalties is deductible in reaching adjusted ordinary gross income and personal holding company income, but there are no

fully leveraged equity investments would be made by a firm with substantial nonpassive taxable income; therefore, the incremental adjusted ordinary gross income provided by the dividends would pose no problem. Should the company face a decline in operating earnings, however, the unaffected dividend receipts, in combination with any other passive income, could become the dominant component of the firm's income. There is no "escape hatch" provision, as in the case of rents and royalties,[56] for a company that derives a majority of its income from dividend sources. Hence, the corporation would have to foresee the problem and liquidate a sufficient portion of the equities or else face the rigors of the penalty tax provision. The option of liquidation might be unpalatable if the firm's earnings decline has coincided with a general economic slump, particularly if, as has happened in the past decade, the business cycle downturn is accompanied by high interest rates that in turn depress preferred stock prices. The statutory means of avoiding imposition of the personal holding company tax—distributing the personal holding company income to the shareholders—would offer no help to the firm fully leveraging its equity investments because the income to be distributed—the dividends—would already be utilized to pay the interest on the debt. Thus, the firm unfortunate enough to have its fully leveraged equity dividends push it into personal holding company status would be thrust into a thoroughly untenable position. This predicament clearly would be a risk for a corporation with the appropriate stock ownership characteristics to result in personal holding company status, and any such firm would have to assess that risk carefully in deciding whether to undertake fully leveraged equity investments.

B. Restrictions on Deductibility of Corporate Interest Expense

1. Related Parties

Interest deductions that arise with respect to related parties, provided that the interest is accrued rather than paid currently, are disallowed under Internal Revenue Code section 267.[57] Such relationships include that between a corporation and an individual who owns more than 50% in value of its outstanding stock,[58] and

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commensurate provisions for interest expense relating to dividends. I.R.C. § 543(b)(2)(A)(iii), (B)(iii).

56. I.R.C. § 543(a)(2)-(5).

57. I.R.C. § 267(a)(2).

58. I.R.C. § 267(b)(2). Note that attribution rules apply te the individual's percentage

that between two corporations, both of which are owned, to the extent of 50% or more of the value of outstanding stock, by the same individual.[59] This provision does not affect the fully leveraged purchase of equity securities by a corporation as long as the debt is obtained from unrelated sources. If, however, the corporation borrows from a related party, as when a close corporation cannot obtain additional bank debt (or does not wish to tie up its limited unsubordinated debt capacity for such purposes) and must turn to members of the controlling family, the company must pay interest currently[60] in order to obtain the full benefits of leveraging the equity investments.

2. Capital Structure

If a close corporation is financed substantially by debt owed its shareholders, the government frequently will challenge the characterization of the investment as debt, arguing instead that it is part of the corporation's equity capital.[61] The owners can obtain significant benefits by characterizing a large portion of their investment as debt,[62] and the government has sought to limit these benefits. In addressing the characterization issue, courts have tended to look beyond the form of the instrument and instead have generated several criteria to distinguish between debt and equity capital.[63] Although Congress chose not to attempt a definition of the difference between stock and debt in the 1954 Internal Revenue Code,[64] it decided in 1969 to place the burden on the Treasury Department to delineate the distinctions by means of regulations.[65] To date, however, these regulations do not exist, even in proposed

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of ownership.

59. I.R.C. § 267(b)(3).

60. The corporation must pay tbe interest to a related party within the taxable year or two and one half months thereafter in order for it to be deductible. I.R.C. § 267(a)(2)(A).

61. *See, e.g.,* Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968); J.S. Biritz Constr. Co. v. Commissioner, 387 F.2d 451 (8th Cir. 1967).

62. *See* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,* 26 TAX L. REV. 369, 371-404 (1971).

63. The primary criteria are as follows: whether there is a pro rata holding of stock and debt among the shareholders; whether the debt-equity ratio is so high as to run afoul of the thin corporation doctrine; whether the debt was issued for "essential" assets; and whether the parties intended an actual debtor-creditor relationship. For a discussion of these criteria and the cases applying them, see B. BITTKER & J. EUSTICE, *supra* note 47, at ¶ 4.04.

64. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 42 (1954).

65. I.R.C. § 385.

form.

The danger of disallowance of interest deductibility because of recharacterization of debt as equity would not generally arise in the debt-financed purchase of unrelated equities. Application of this disallowance presupposes that the loans come from shareholders of the close corporation. Furthermore, even if the funds derive from this source, application of the judicial criteria for distinguishing between debt and equity capital may assure characterization of the capital as debt. First, there is no reason why the loans would be obtained in a pro rata manner. Second, the loans would not be for "essential" assets. Last, an actual debtor-creditor relationship would be intended.[66] Hence, only if the loans pushed the debt-equity ratio to a level regarded as excessive by the courts[67] would there be any apparent danger of disallowance of the interest deduction. Segregation of the loan proceeds and direct collateralization of the loans with the equities would greatly diminish that risk.

3. Debt-Financed Corporate Acquisitions

In 1969 Congress responded to the wave of corporate acquisitions during the 1960s by limiting the amount of interest any corporation could deduct on certain debt issued to finance such acquisitions.[68] Under section 279, a corporation acquiring the stock of another corporation[69] or at least two-thirds of a corporation's productive assets[70] generally is restricted to $5,000,000 in interest deductions[71] on debt used to acquire the stock or assets if three conditions are met: first, the debt is subordinated to the issuing

66. *See* note 63 *supra.*

67. Whereas a three to one ratio of debt to equity is generally considered safe, B. BITTKER & J. EUSTICE, *supra* note 47, ¶ 4.04, at 4-13, courts have accepted much higher ratios when they have found a valid business purpose for the debt. *E.g.,* Byerlite Corp. v. Williams, 286 F.2d 285 (6th Cir. 1960) (advances of over $550,000 from parent to wholly-owned subsidiary in order to take advantage of exporting opportunity accepted as debt although only $30 of equity capital present); Lots, Inc. v. Commissioner, 49 T.C. 541 (1968) ("loans" by sole shareholder to his corporation of over $50,000 to finance development of real estate purchased from him accepted as debt even though only $10,000 of capital had been contributed); Baker Commodities, Inc. v. Commissioner, 48 T.C. 374 (1967) (debt of roughly $3,500,000 issued in incorporation of established family partnership in rendering business accepted as debt despite capital being set at $5,000—a debt-equity ratio of approximately 700 to 1).

68. Tax Reform Act of 1969, Pub. L. No. 91-172, § 411(a), 83 Stat. 604 (enacting I.R.C. § 279). *See generally* Eustice, *Corporations and Corporate Investors,* 25 TAX L. REV. 509, 512-27 (1970).

69. I.R.C. § 279(b)(1)(A).

70. I.R.C. § 279(b)(1)(B).

71. I.R.C. § 279(a)(1).

corporation's trade or other secured creditors;[72] second, the debt is convertible (or includes an option to purchase shares);[73] and third, the debt is part of the indebtedness of a corporation that fails one of two leverage tests.[74] There is no minimum percentage test with respect to the amount of stock acquired, although there is such a test with respect to the purchase of assets; all stock purchased by a corporation is covered by the provision. An important limitation, however, is that the debt will be considered "corporate acquisition indebtedness" only if the issuing corporation owns before the close of the taxable year five percent or more of the total voting power of the company whose stock was purchased.[75]

Section 279 would rarely affect the corporation fully leveraging its equity investments. Only a large corporation heavily investing in the stock or assets of other corporations would have $5,000,000 in acquisition-related interest. Even such a corporation would still have to run afoul of each of the three tests of subordination, equity participation, and leverage in order for its debt to be characterized as "corporate acquisition indebtedness." Most importantly, the acquisition of a diversified portfolio of preferred stock by a corporation leveraging its equity investments would virtually guarantee application of the five percent stock rule. Not only would the diversification minimize the chance of owning enough of any single company's stock to meet the percentage test, but the stock used—preferred—usually does not carry a vote, so that even a concentrated ownership[76] would not exceed the required five percent of combined voting power of all classes of stock.[77]

4. Holding Tax-Exempt Securities

Section 265, which relates to the deductibility of interest paid in connection with the purchase or continued holding of tax-exempt investments, applies equally to corporations and individuals.

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72. I.R.C. § 279(b)(2).

73. I.R.C. § 279(b)(3).

74. These leverage tests are as follows: the corporation must either exceed a two to one debt-equity ratio or must have projected earnings less than three times its annual interest expense. I.R.C. § 279(b)(4).

75. I.R.C. § 279(d)(5).

76. Such a concentration could occur if the issuing corporation were using a dividend rollover strategy in combination with full leverage. *See* note 33 *supra*.

77. I.R.C. § 279(d)(5). Although the regulations under this subsection, Treas. Reg. § 1.279-4(b) (1973), do not specifically address the matter, preferred stock with voting rights contingent on the occurrence of particular events presumably would not be considered part of the combined voting power unless those triggering events had already occurred.

No interest deduction is allowed on "indebtedness incurred or continued to purchase or carry" tax-exempt investments.[78] A similar provision applies to indebtedness incurred to refinance the acquisition of shares of a regulated investment company, the dividends on which are exempt from federal taxation.[79] Income effectively exempt from federal taxation under the dividends received deduction is not covered by section 265; hence, this provision does not impair the usefulness of fully leveraged equity investments. The analogy between interest on debt used to carry tax-exempt securities and interest paid by a corporation holding fully leveraged equities, however, is substantial. The ramifications of this analogy, particularly as to the difficulty of applying section 265(2), will be explored in Part III of this Note.

C. Restrictions on the Dividends Received Deduction

There are no Internal Revenue Code provisions that specifically restrict a corporation's use of the dividends received deduction as the four provisions above limit interest deductions by corporations. Section 269, however, allows the government to limit all deductions relating to certain acquisitions if "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which [the taxpayer] would not otherwise enjoy."[80] This provision covers a corporation's acquisition of another corporation's property if the latter firm is not controlled by the acquiring corporation or its shareholders and the acquiring corporation's basis in the property is determined by reference to the basis in the hands of the transferor firm.[81] Individuals are subject to disallowance of deductions under section 269 if the principal purpose of their acquisition of a corporation was tax evasion or avoidance.[82] While thus far no court has upheld disallowance of the dividends received deduction under section 269,[83] application of that provision could, in theory, be directed either at the individual who created or acquired a corporation in order to avail himself of the dividends received deduction or at the corporation that acquired stock for the prohibited tax avoidance purpose. While courts have not

78. I.R.C. § 265(2).
79. I.R.C. § 265(4).
80. I.R.C. § 269(a).
81. I.R.C. § 269(a)(2).
82. I.R.C. § 269(a).
83. B. BITTKER & J. EUSTICE, *supra* note 47, ¶ 16.21, at 16-38.

directly questioned the applicability of section 269 to the dividends received deduction, they have avoided application of the section in this context by closely examining the facts of each case. Specifically, these courts have allowed the deduction by finding that tax avoidance was not the overriding purpose of the acquisition[84] or that an alternative structuring of the deal would have achieved the same tax avoidance result.[85]

The full leveraging of equity investments does not appear likely to subject the investing corporation to section 269 disallowance of the dividends received deduction. Although the principal purpose of financing equities with debt is clearly the avoidance of federal income tax, the property acquired—the stock—would not have a basis determined by the basis in the hands of a transferor corporation, as is required for imposition of section 269. Furthermore, assuming that the corporation purchasing the fully leveraged equities is a profitable, operating business merely seeking to reduce its tax liability, neither would the corporation's shareholders be subject to section 269 because of the acquisition—the principal purpose for the corporation's existence, and hence for the acquisition of shares in it by individuals, would not be tax avoidance.

III. Policy Implications of the Benefit: Comparison with the Holding of Tax-Exempt Securities

The corporate taxpayer receives a clear benefit if it can both receive 85% of dividends free of tax and deduct the interest on the debt funding the stock. This benefit is quite analogous to the one that is inhibited by section 265(2)—the deduction of interest on debt used to carry tax-exempt securities. The rationale for the different treatment accorded the two benefits is that intercorporate dividends are shifts of earnings (already taxed once to their producer) among entities prior to the second taxation at the shareholder level and thus serve as a method of allocating those earnings to ultimate shareholder beneficiaries. Overuse of this means of allocation is discouraged by the taxation of 15% of distributions among nonaffiliated corporations. Tax-exempt securities, on the other hand, are in general neither claims upon the *income* of the payor nor claims upon proceeds previously taxed. Most issuers of

84. Geoli Inv. Co. v. Commissioner, 29 T.C.M. (CCH) 349 (1970); Arutunoff v. Commissioner, 22 T.C.M. (CCH) 931 (1963); Commodores Point Terminal Corp. v. Commissioner, 11 T.C. 411 (1948).

85. Cromwell Corp. v. Commissioner, 43 T.C. 313 (1964).

tax-exempt securities are not themselves taxed, and the securities are legal claims enforceable regardless of whether the entity can generate sufficient revenues to fund its payments.

The distinction breaks down from the perspective of a corporation that seeks maximum return on its liquid reserves. Tax-exempt securities and preferred stocks[86] have substantially similar characteristics from the corporate investor's perspective. Both investments represent claims on fixed income streams that are impaired only when the payor faces severe constraints.[87] The values of both types of instrument vary primarily according to shifts in the prevailing interest rate, unless the solvency of the payor becomes suspect.[88] Both types may contain features giving the issuer the right to call in the security, either at the issuer's option (should market rates fall substantially below those at which the obligations were issued) or in accordance with sinking fund requirements. Also, both types of investment are quite easily marketable, although the market for particular issues is likely to be so shallow that there will be a significant difference between tbe bid and asked prices at any given time. Similarly, block sales of any single issue probably will require a discount below the current bid price.

Except for any requirements based on the corporation's gross income,[89] the rates of return available to a corporation on preferred stocks and on tax-exempt securities are directly comparable. The after-tax rate of return to the corporate investor in tax-exempt securities is simply the market yield, with an adjustment for any capital gains or losses upon disposition. The comparable rate of return on preferred stock, unadjusted for any gain or loss upon disposition, is 93.1% of the market yield.[90] Regarding the possibil-

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86. The term "preferred stocks" is here limited to large corporations' nonparticipating and nonconvertible issues lacking callability features that heavily influence their value.

87. Preferred dividends are theoretically payable at the discretion of the board of directors, but in reality such distributions are reduced only when the scheduled payment would pose a serious threat to the firm's solvency. This distinction between discretionary payment of preferred dividends and mandatory payment of interest on debt is further diminished if the preferred stock carries a cumulative right to dividends.

88. *See* note 27 *supra* and accompanying text.

89. Such requirements could originate from external sources such as the Internal Revenue Service or from the corporation's own agreements, such as bond indentures. One requirement with important tax implications involves the definition of the personal holding company. *See* notes 55-56 *supra* and accompanying text.

90. This percentage assumes 85% deductibility and the maximum marginal corporate tax rate:

$$\text{Yield} = \frac{\text{Dividend} - [(\text{Dividend} - \text{Deduction})\ \text{Tax Rate}]}{\text{Stock Price}}$$

ity of such gains or losses, changes in the market values of botb types of investment are basically correlated with market interest rate shifts. There are several other external factors that determine the relative values of these two types of investment, but the probable overall impact of these factors is essentially neutral.[91]

To evaluate the market forces that set the prices of these two investment vehicles, assume that preferred stock *P* and tax-exempt security *T* are equally risky. Financial theory indicates that the market should then value the two investments so that their after-tax rates of return are equal.[92] If the annual dividends per share of *P* equalled the annual interest per unit of *T*, the corporate investor would be indifferent between them if the price of *P* were 93.1% of tbat of *T*.[93] Individual investors, however, have a far different point of reference for relative valuation, since they would be taxed fully on the dividends of *P*.[94] Individual investors in the marketplace would tend to bid up the price, and hence drive down the yield, of *T* relative to *P*, making *P* more attractive to the rational corporate investor. Hence, any corporate investor willing to purchase tax-exempt securities should be able to find preferred stock of equivalent riskiness that will produce a higher return than tax-exempt securities. It is therefore inconsistent for the government to prohibit corporations from improving their rate of return on tax-exempt securities by leveraging them and deducting the interest while it allows this same technique for preferred stocks, which already have a higher rate of return to corporations. In both cases a double benefit is present.

Should Congress determine that there is insufficient reason to retain the current treatment of interest on debt used to finance

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91. Tax-exempt securities are more favorable investments tban preferred stock because they are not dependent on the good will of a board of directors for their return and often are backed by the taxing power of the state. Preferred stocks are advantageous in that better information is often available to evaluate the riskiness of the payor and that markets are more structured. The absence of a maturity date on preferred stecks renders them theoretically more volatile than debt obligations. *See* note 25 *supra*. This volatility would operate to the investor's advantage in times of falling interest rates and to his disadvantage when rates are rising.

92. For discussions of the capital asset pricing model, see STUDIES IN THE THEORY OF CAPITAL MARKETS (M. Jensen ed. 1972); F. WESTON & E. BRIGHAM, *supra* note 15, at 636-86.

93. Actually this percentage is a bit simplistic; such other factors as the frequency of periodic payments, the length of time until maturity or recall, and the anticipated proceeds upon recall or maturity are also determinants of the market value. As long as the maturity date is distant, however, the effect of these factors is minor and can he disregarded for purposes of theoretical comparison.

94. This statement ignores for the sake of simplicity the dividend exclusion available to individuals. *See* note 5 *supra*.

equity investments by corporations, the most obvious means of limitation would be a provision analogous to section 265(2): "No deduction shall be allowed for . . . [i]nterest on indebtedness incurred or continued to purchase or carry *stock, the dividends on which are wholly or partially deductible under sections 243 through 245, to the extent of the deductions provided under those sections.*"[95] Unlike debt used to finance tax-exempt securities, indebtedness that funds equity investments can generate interest expense exceeding the amount of dividends and yet have a very legitimate nontax motivation. Hence, disallowance of interest deductions in excess of the dividends received deduction would penalize borrowing for control-related purposes and could even affect a borrower who received no benefit from the dividends received deduction.[96]

There may well be a rationale for treating preferred stock differently from common stock in this regard; hence, the disallowance provision discussed above might be made applicable only to preferred stock. Nonconvertible and nonparticipating preferred stock is an investment with characteristics quite close to those of long-term debt instruments: limited appreciation potential, periodic payments of cash, and preference as to proceeds upon liquidation. Importantly, preferred shareholders usually do not participate in the control of the firm; typically they can vote, if at all, only in some default situation. Common stock is generally a much riskier investment than preferred stock, and the "upside potential" that accompanies such greater risk is substantially related to the "ability to control" element of ownership. There is therefore some appeal in the notion of treating the two types of stock differently with respect to interest deductibility, but such a distinction would probably be difficult to apply. There are many hybrid varieties of equity securities—multiple classes of common, convertible preferred, participating preferred, voting preferred, and others—and categorization of these into the two classical equity types would be nearly impossible. Whether such a stock more closely resembles common or preferred often depends on the current market condi-

95. This proposed statute is derived from I.R.C. § 265(2). The italicized material is supplied by the author.

96. Such a situation could occur if the company whose stock was purchased with funds provided by debt paid no dividends. Under these circumstances, there is no reason to penalize corporate acquisitions of stock funded by debt, given the provisions of § 279, *see* notes 68-77 *supra* and accompany text, unless a double benefit is provided by the interest and dividends received deductions.

tions. Additionally, even the theoretical distinction is arbitrary. There are common stocks of large corporations in stable industries that have high yields and long records of dividend payments without a decrease. Corporations can view such common issues as quite comparable to preferred stocks and, in the face of disallowance of the interest deduction on debt funding preferred shares, could merely shift over into the common if they wished to continue to receive the benefits of such an investment strategy.

Fundamentally, the experience under section 265(2) indicates tbat there are substantial problems in determining when the indebtedness has a sufficient relation to the investment to warrant disallowance of the interest deduction. The cases under the antecedents of section 265(2)[97] are divisible into two groups. First, courts addressed the position of the municipal bond dealer who had to borrow to finance his inventory of securities. These courts held tbat there is no statutory exception to the disallowance of interest on debt used to purchase or carry tax-exempt securities and that no such exception is constitutionally mandated.[98] Second, courts bad to determine whether particular instruments constituted tax-exempt securities within the meaning of the section when these obligations were directly tied to indebtedness by the taxpayer. While one court did disallow the deduction of interest on joint-stock land bank bonds used to finance tax-exempt farmers' notes and mortgages,[99] another allowed the interest deduction on bank loans collateralized by state, county, and municipal deficiency warrants tbat bore tax-exempt interest.[100] These cases embody the first judicial struggles to ascertain what quantum of connection between the debt and the tax-exempt securities was sufficient to mandate disallowance of the interest deduction.

The period from 1954 to 1972 witnessed a rising tide of litigation on this nexus question. Leaving aside the continuing unsuccessful challenge by securities dealers who had municipals in their

97. Revenue Act of 1934, § 23(b), 48 Stat. 688; Revenue Act of 1921, § 214(a)(2), 42 Stat. 239; Revenue Act of 1918, § 214(a)(2), 40 Stat. 1066-67.

98. Denman v. Slaytor, 282 U.S. 514 (1931); Clyde C. Pierce Corp. v. Commissioner, 120 F.2d 206 (5th Cir. 1941); Prudden v. Commissioner, 2 B.T.A. 14 (1925). For later cases on this issue, see note 101 *infra*.

99. First Nat'l Bank v. United States, 38 F.2d 925 (Ct. Cl. 1930), *aff'd*, 283 U.S. 142 (1931).

100. Sioux Falls Metal Culvert Co. v. Commissioner, 26 B.T.A. 1324 (1932); R.B. George Mach. Co. v. Commissioner, 26 B.T.A. 594 (1932). These cases turned on the court's finding that there was no intent to carry the tax-exempt obligations and that the loans were for the purpose of continued operation of the businesses.

inventories,[101] taxpayers made great headway during this period in securing the formulation of judicial criteria that the government must meet in order to establish the requisite tie between the indebtedness and the tax-exempt securities. The Tax Court, in three cases disallowing the interest deduction, indicated that something more than mere coexistence within an investor's portfolio was required.[102] Dictum in a 1965 Supreme Court opinion concerning the treatment of tax-exempt securities in determining life insurance reserve requirements is ambiguous as to the importance of a connection between the debt and the tax-exempt securities in applying section 265(2).[103] In 1967 the Court of Claims took the first step in describing the required connection, holding that there must be a sufficiently direct relationship[104] as well as a forbidden tax

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101. Leslie v. Commissioner, 413 F.2d 636 (2d Cir. 1969), *cert. denied,* 396 U.S. 1007 (1970) (reversing Tax Court holding for taxpayer under theory that municipals were too small a portion of dealer inventory to warrant disallowance of interest deduction and requiring allocation of interest among dealer's securities); Wynn v. United States, 288 F. Supp. 797 (E.D. Pa. 1968), *aff'd per curiam,* 411 F.2d 614 (3d Cir. 1969), *cert. denied,* 396 U.S. 1008 (1970) (distinguishing the Tax Court's *Leslie* holding in disallowing the interest deduction); Kirchner, Moore & Co. v. Commissioner, 54 T.C. 940 (1970), *aff'd,* 448 F.2d 1281 (10th Cir. 1971) (rejecting taxpayer argument that purpose of deht was to allow resale within a business cycle under the "sufficiently direct relationship" test). *See also* note 98 *supra* and accompanying text. The case law applying § 265(2) to securities dealers was carried forward intact into Rev. Proc. 72-18 § 5, 1972-1 C.B. 742. In the most recent case in this area, Bradford v. Commissioner, 60 T.C. 253 (1973), the Tax Court specifically endorsed the Second Circuit's result in *Leslie* in reaching the same conclusion on indistinguishable facts. Thus, no securities dealer has yet avoided disallowance of interest under § 265(2), even though no direct connection hetween the debt and the tax-exempt security has been established.

102. Drybrough v. Commissioner, 42 T.C. 1029 (1964), *aff'd,* 376 F.2d 350 (6th Cir. 1967) (taxpayer mortgaging investment real estate and investing proceeds in tax-exempt securities for wife); Bishop v. Commissioner, 41 T.C. 154 (1963), *aff'd,* 342 F.2d 757 (6th Cir. 1965) (taxpayer borrowing to buy securities, then selling them and buying tax-exempt securities); Jacobson v. Commissioner, 28 T.C. 579 (1957) (taxpayer running loan proceeds through bank accounts and mixing them with unborrowed money before buying tax-exempts).

103. Writing for a unanimous Court, Justice White alluded to Denman v. Slaytor, 282 U.S. 514 (1931):

> It is argued, however, that the rule of *Denman* disallowing deduction of exempt interest is limited to "but for" situations: Interest incurred on loans used to purchase exempt bonds may be disallowed only where there would have been no interest charge except for the purchase of exempt securities. . . . However this may be, we do not read *Denman* so narrowly. We think interest can be said to he incurred or continued as a cost of producing exempt income whenever a taxpayer borrows for the purpose of making investments and in fact invests funds in exempt securities.

United States v. Atlas Life Ins. Co., 381 U.S. 233, 248-49 n.17 (1965). Despite the ensuing judicial activity in this area of federal tax law, the Supreme Court bas not granted certiorari to clarify the above statement.

104. Illinois Terminal R.R. v. United States, 375 F.2d 1016 (Ct. Cl. 1967). Taxpayer had borrowed heavily to finance its largest asset, a bridge. When the bridge was sold for

avoidance purpose.[105] There followed a series of cases in which the taxpayer prevailed by proving the absence of a sufficient connection to warrant disallowance.[106] Among these cases, the leading one on the meaning of "sufficiently direct relationship" is *Wisconsin Cheeseman, Inc. v. United States*.[107] The criteria that emerged from this case are as follows: first, whether the tax-exempts are used as collateral; second, whether the debt finances a major nonrecurring expenditure, primarily long-term in nature; third, whether a reasonable person would incur the debt to avoid sacrificing liquidity and security; and fourth, whether business reasons are dominant.[108] Additionally, these judicial decisions particularly emphasize that the government must prove the intent to receive a double benefit and that each case demands a special factual inquiry rather than a mechanical application of section 265(2).[109]

In 1972 the Treasury Department responded to these taxpayer successes at creating judicial criteria by issuing Revenue Procedure 72-18. Under this promulgation "direct evidence" of the forbidden purpose is defined for "purchase" as the use of the debt proceeds to buy the tax-exempts and for "carry" as the use of the tax-exempts as collateral for the debt.[110] For an individual, the general presumption is established that a "sufficiently direct relationship" existed unless the municipals represented less than two percent of

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cash and tax-exempt securities, the cash was applied against the deht, but the tax-exempts were not. The court found that there was a sufficient relationship between the debt and the tax-exempts to warrant disallowance of the interest deduction.

105. The court stated the purpose test as whether "the total impression given by the evidence leads to the conclusion that the taxpayer had the forbidden purpose." *Id.* at 1022-23.

106. Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420 (7th Cir. 1968) (taxpayer borrowing for short-term needs of seasonal business and mortgaging a new plant while investing earnings in municipal bonds, which were in turn used for collateral in the ensuing season's borrowing; court allowing deduction of interest on mortgage but not on short-term borrowing); Batten v. United States, 322 F. Supp. 629 (E.D. Va. 1971) (taxpayer horrowing to purchase stock from uncle's estate while holding tax-exempts; court holding that "purposive connection" not established because borrowing was reasonable as part of attempt to create an independent profitable investment); Norfolk Shipbuilding & Drydock Corp. v. United States, 321 F. Supp. 222 (E.D. Va. 1971) (taxpayer undertaking short-term borrowing to sustain operations while holding tax-exempt securities; court allowing deduction because borrowing was for valid business purpose); Ball v. Commissioner, 54 T.C. 1200 (1970) (taxpayer mortgaging real estate while holding tax-exempt securities; court allowing because there was no sufficiently direct relationship).

107. 388 F.2d 420 (7th Cir. 1968).

108. *See id.* at 423; Ball v. Commissioner, 54 T.C. 1200, 1209 (1970).

109. Batten v. United States, 322 F. Supp. 629, 631-32 (E.D. Va. 1971); Norfolk Shipbuilding & Drydock Corp. v. United States, 321 F. Supp. 222, 229 (E.D. Va. 1971).

110. Rev. Proc. 72-18 § 3.02-.03, 1972-1 C.B. 740-41.

the average adjusted basis of his investment portfolio or the debt was of a personal nature (including a home mortgage) or proceeded from "the active conduct of a trade or business."[111] The two percent test for corporations is stated in terms of average total assets,[112] but a far more lenient presumption test applies to corporations: whether "it is determined that the borrowing was in excess of business needs."[113]

The disparate treatment of individuals and corporations under Revenue Procedure 72-18 has largely been reflected in the ensuing judicial record. Corporations have been quite successful in identifying business needs that justify borrowing despite the presence of large quantities of tax-exempt securities.[114] In contrast, individuals have in recent years surmounted challenges under section 265(2) only when their transactions have been structured carefully to

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111. *Id.* at §§ 3.05, 4.02-.03, 1972-1 C.B. 741. Regarding this presumption, the revenue procedure clearly challenged the application of the judicial standards:

> Generally, 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 . . . or . . . 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.
>
> Portfolio investment for the purposes of this Revenue Procedure includes transactions entered into for profit (including investment in real estate) which are not connected with the active conduct of a trade or business. . . .
>
> 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 a new portfolio investment 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 maintain a diversified portfolio. This purpose necessarily involves a decision, whether articulated hy the taxpayer or not, to incur (or continue) the indebtedness, at least in part, to purchase or carry the existing investment in tax-exempt ohligations.

Id. at § 4.04, 1972-1 C.B. 741-42.

112. *Id.* at § 3.05, 1972-1 C.B. 741.

113. *Id.* at § 6.01, 1972-1 C.B. 742-43.

114. Investors Diversified Servs., Inc. v. United States, 575 F.2d 843 (Ct. Cl. 1978) (face amount certificates necessitated by statutory requirement of "minimum certificate reserves"); Swenson Land & Cattle Co. v. Commissioner, 64 T.C. 686 (1975) (large contingency reserve necessitated by seasonal nature of business); Handy Button Mach. Co. v. Commissioner, 61 T.C. 846 (1974) (long-standing use of municipals as contingency fund justified by liquidity needs as well as purpose of being able to avoid additional horrowing). *See also* Ritholz & Tanenbaum, *Tax Court's Decision in* Handy Button: *A Hopeful Sign in the Section 265(2) Area,* 43 J. TAX. 336 (1975). Only in the blatant case of a firm that borrowed money clearly in excess of its needs and eight months later invested the proceeds in tax-exempts has there been a successful challenge under § 265(2) since the promulgation of Rev. Proc. 72-18. Indian Trail Trading Post v. Commissioner, 60 T.C. 497 (1973).

minimize any connection between debt and tax-exempts.[115] Successful individual plans have utilized independent investments for which leveraging is the standard practice (real estate and life insurance) and have avoided use of the tax-exempts as collateral.[116]

Section 265(2), which on its face applies equally to corporations and individuals, is thus used to challenge corporate interest deductibility only in the most flagrant cases. Clearly the difference in treatment as between individuals and corporations under Revenue Procedure 72-18 reflects primarily the usual complexity of the corporate financial structure in comparison to the financing used by an individual. Naturally, it is easier for the government to build a case under section 265(2) when there are fewer problems in tracing the sources and uses of funds.

Just as the government has had difficulty in denying corporations the deductibility of interest on debt used to finance the acquisition of tax-exempt securities, so it would likely find problems disallowing the deductibility of interest on borrowing used to fund high-yield equities subject to the dividends received deduction. The same difficulties that have caused the comparatively easy presumption corporations must overcome to avoid application of section 265(2) would be present should the government attempt to eliminate the benefits of fully leveraging equity investments. In fact, because of the widespread ownership of equities by corporations, the policing problem would be greater. While on its face the use of fully leveraged equity investments would appear to run afoul of the standards imposed under Revenue Procedure 72-18—borrowing in excess of business needs—it is quite conceivable that practitioners could construct arguments concerning liquidity

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115. McDonough v. Commissioner, 577 F.2d 234 (4th Cir. 1978) (requiring more justification on taxpayer's part than desire to maintain both taxable and tax-exempt securities in a portfolio and to maximize use of money invested in the taxable securities in order to overcome presumption); Phipps v. United States, 515 F.2d 1099 (Ct. Cl. 1975) (disallowing interest deduction on bank loans to partnership collateralized by partner's tax-exempts); Mariorenzi v. Commissioner, 32 T.C.M. (CCH) 681 (1973), *aff'd per curiam*, 490 F.2d 92 (1st Cir. 1974) (disallowing interest deduction on home mortgage when proceeds used to buy municipals). *See generally* Willis & Raabe, *Avoiding Disallowed Interest Deduction for Taxpayer Holding Tax-Exempt Bonds*, 56 TAXES 230 (1978); Note, *The Deductibility of Interest Costs by a Taxpayer Holding Tax-Exempt Obligations: A Neutral Principle of Allocation*, 61 VA. L. REV. 211 (1975).

116. Levitt v. United States, 517 F.2d 1339 (8th Cir. 1975) (but interest on borrowings to buy Treasury Bills for estate tax reduction disallowed when tax-exempts exceeded amount of such borrowing); Israelson v. United States, 367 F. Supp. 1104 (D. Md. 1973), *aff'd mem.*, 508 F.2d 838 (4th Cir. 1974) (but interest on bank loans used to purchase taxable securities held not deductible because taxpayer refrained from selling tax-exempts).

and contingency funds that would be analogous to those that have prevailed against section 265(2) challenges.[117]

IV. Conclusion

By borrowing money and purchasing preferred stocks with an average yield greater than 58% of the interest rate on the debt, a corporation at the maximum marginal tax rate can reduce its federal income tax liability. In evaluating the potential benefit of this practice, the corporation must consider transactions costs and its ability either to tie the debt to the equities or to have a sufficiently distant maturity on the debt to weather interest rate cycles that depress preferred stock prices. A small to medium-sized corporation probably is in a better position to obtain appropriate debt and to purchase enough equities, without depressing yields, to make the use of fully leveraged equity investments have a significant impact on its tax liability. A corporation would also have to assess the chances that the dividends would cause personal holding company tax liability in periods of low operating earnings. In securing the loans, the corporation would have to avert the danger that interest deductions might be disallowed under tax rules pertaining to related parties, capital structure, and debt-financed corporate acquisitions. An analysis of the past application of the interest deduction disallowance provision relating to the holding of tax-exempt securities indicates that the government would have difficulty in creating and applying to corporations an interest disallowance provision when high-yield equities, rather than tax-exempts, are related to the debt.

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117. *See* note 113 *supra*.