DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Associate Chief Counsel (Income Tax & Accounting) CC:ITA

SUBJECT:

This Field Service Advice responds to your memorandum dated October 4, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Parent	=	
Sub 1	=	
Sub 2	=	
Sub 3	=	
Sub 4	=	
A	=	
B	=	
C	=	
D	=	
E	=	
F	=	
G	=	
H	=	
J	=	
K	=	
Year 1	=	
Year 2	=	
Year 3	=	

ISSUES

1. Whether a portion of the interest expense incurred by Parent was incurred to purchase or carry tax-exempt securities under I.R.C. § 265(a)(2), where the purpose of the loan was to provide its insurance subsidiary, whose business involved the holding of tax-exempt securities, with additional capital.

2. Whether I.R.C. § 265(a)(2) applies to disallow interest expenses to the consolidated group where Parent incurs the debt and a subsidiary holds the tax-exempt securities.

CONCLUSIONS

1. Parent may deduct the interest expense only if Parent can substantiate that it needed additional capital for a valid business purpose (i.e., a purpose other than meeting ordinary and recurring business expenses), rather than to purchase or carry tax-exempt securities.

2. Although regulations have not been issued under section 7701(f), section 265(a)(2) can apply in appropriate situations, including situations such as this, where one member of a consolidated group

incurs or continues debt and another member acquires or holds tax-exempt obligations.

FACTS

Parent is the common parent of an affiliated group that files consolidated returns. Parent is a holding company and, through its subsidiaries, operates a specialty insurance group. The group's two main lines of businesses are , headed by one of Parent's subsidiary, Sub 1, and reinsurance, headed by another subsidiary, Sub 2. This advice focuses on the relationship between Parent and Sub 2.

Sub 2 is a reinsurance company whose primary business is reinsurance of A% of the lines of coverage underwritten by Sub 1 and reinsurance of accounts produced by independent sources, such as ceding insurance companies. Sub 2 is a wholly owned subsidiary of Parent; Sub 2 in turn wholly owns Sub 3. Sub 3 wholly owns Sub 4.

In Year 1, Parent obtained a bank loan in the amount of $B. The loan was increased to $C in Year 2. Shortly after obtaining each loan, Parent made capital contributions to Sub 2, which in turn made small contributions to Sub 3, which contributed to Sub 4. At the end of Year 2, Parent contributed a total amount of $D, of which $E went to Sub 2 and $F went to Sub 4. During Year 2 and Year 3, Parent claimed interest expenses of $G and $H, respectively.

In Year 1 and 2, Sub 2 apparently held tax-exempt bond portfolios in the amounts of $J in cost and $K, respectively. The tax-exempt assets exceeded more than two percent of the group's and Sub 2's total assets. Sub 4 did not own tax-exempt securities. The loan incurred by Parent was not collateralized by the tax-exempt securities, nor are the loan proceeds directly traceable to the acquisition of the tax-exempt assets.

The issue is whether Parent's interest expense should be disallowed under section 265(a)(2).

LAW AND ANALYSIS

ISSUE ONE

Section 163(a) generally allows a deduction for all interest paid or accrued on indebtedness within the taxable year. Section 265(a)(2), however, disallows interest deductions on indebtedness incurred or continued to purchase or carry tax-exempt obligations. The statute has been interpreted to disallow interest deductions based on the purpose of the borrowing. The purpose for incurring or continuing indebtedness is determined based on all the facts and circumstances and may be established either by direct or indirect evidence. See Indian Trading Post, Inc. v. Commissioner, 60 TC 497, 500 (1973), aff'd, 503 F.2d 102 (6th Cir. 1974); Section 3.01 of Rev. Proc. 72-18, 1972-1 C.B. 740. Direct evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of indebtedness are used for and are directly traceable to the purchase of tax-exempt obligations. Section 3.02. Except in the case of dealers in tax-exempt obligations, direct evidence of a purpose to carry tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness. Section 3.03. In the absence of direct evidence, section 265(a)(2) applies only if the totality of facts and circumstances support a reasonable inference that a purpose to purchase or carry tax-exempt obligations exists.[1] Section 3.04.

The revenue procedure provides for a de minimus exception when a taxpayer's investment in tax-exempt obligations is insubstantial. In such a situation, the purpose to purchase or carry tax-exempt obligations will not ordinarily be inferred in the absence of direct evidence. For a corporation that is not a dealer in tax-exempt obligations, an investment in tax-exempt obligations is presumed insubstantial only if during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2 percent of the average total assets (valued at their adjusted basis) held in the active conduct of the trade or business. Section 3.05.

Section 6.01 of the revenue procedure provides that in general, the purpose to purchase or carry tax-exempt obligations will not be inferred with respect to indebtedness incurred or continued to provide funds for carrying on an active trade or business, not involving the holding of tax-exempt obligations, unless it is determined that the borrowing was in excess of business needs. Thus, the prohibited purpose may be inferred where the borrowings exceed the reasonable needs of business or provide funds for portfolio investments. Further, section 6.02 provides that the purpose to carry tax-exempt obligations will be inferred unless rebutted by other evidence where the taxpayer could have reasonably foreseen

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[1]Section 5 (guidelines for dealers in tax-exempt obligations) and section 7 (procedures) of Rev. Proc. 72-18 discuss additional circumstances in which interest incurred by dealers in tax-exempt obligations will be disallowed. These circumstances will not be discussed here since the request for assistance does not indicate that Parent or Sub 2 was a dealer in tax-exempt obligations.

when purchasing the tax-exempt assets that indebtedness probably would have to be incurred to meet future needs of the corporation of an ordinary, recurrent nature.

Section 6.03 of Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669, provides that the required relationship (i.e., the purpose to use borrowed funds to purchase or carry tax-exempt obligations) will generally not be present when the taxpayer is unable to sell holdings of tax-exempt obligations acquired in the ordinary course of business in payment for services performed for, or goods supplied to, state or local governments.

Here, there is no direct evidence of the prohibited purpose. Further, neither the “insignificant” exception of section 3.05 or “unable-to-sell” exception of section 6.03 apply to Sub 2. Thus, the determination of whether the prohibited purpose existed at the time of the loans depends on the totality of the circumstances.

This case, as so far developed, appears to be factually similar to Letter Ruling 8438003, where the taxpayer was a holding company and was the parent company of an affiliated group of insurance corporations.[2] The subsidiaries were approaching the limit of policies that they could issue based on their then-existing surplus levels. Accordingly, the taxpayer issued long-term debentures and a portion of the proceeds were contributed to the capital of the subsidiaries to increase their surplus levels. The ruling determined that the totality of the circumstances did not establish a sufficiently direct relationship between the borrowing and the investment in tax-exempt securities to justify disallowing the interest expense.[3]

Similarly, in Letter Ruling 8745024, the interest expense of a loan was not disallowed where a capital contribution was made to a subsidiary in order to raise a surplus. The taxpayer was a holding company that held all the outstanding stock of two property and casualty insurance companies. The insurance companies had to maintain certain surplus levels to prevent lower rating and/or loss of the licenses necessary to conduct insurance in a given state. Neither the holding company nor the subsidiaries used tax-exempt investments as security or collateral for any

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[2]Letter rulings may not be used or cited as precedent. See section 6110(k). The rulings cited herein are discussed merely for the purpose of analysis.

[3]The ruling also determined that under separate entity taxable income computations prescribed by the consolidated return regulations, section 265(a)(2) would not apply to match borrowing by one member of the consolidated group to another member’s tax-exempt securities. The ruling was issued before Congress enacted section 7701(f).

borrowing. The ruling determined that the debt was for a valid and vital business purpose and not for the prohibited purpose under section 265(a)(2).

Here, if Sub 2 can substantiate its contention than an increased surplus level was critical to its business and/or state licensing needs, section 265 would not apply to disallow Parent's interest expense deduction.

ISSUE TWO

Section 53(c) of the Deficit Reduction Act of 1984, 1984-3 (Vol. 1) C.B. 75, added section 7701(f) to the Internal Revenue Code. Under section 7701(f), the Secretary is authorized to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those Code provisions that deal with the linking of borrowing to investment through the use of related persons, passthrough entities, or other intermediaries.[4]

No regulations have been promulgated on the basis of this authority but the Conference Report states that Congress intended this section to authorize regulations under section 265(2) (now section 265(a)(2). H. Rep. No. 861, 98th Cong., 2d Sess. 1041-42 (1984), 1984-3 (Vol. 2) C.B. 295. However, Congress did not intend this authority to be used to adopt regulations under section 265(a)(2) that would "cause interest on borrowings by and affiliated company to be disallowed in any case where such interest would not be disallowed under present law if the operations of the corporations were carried on as separate divisions of a single corporation." Id. Therefore, a deduction would not be disallowed merely because one corporation borrows in the ordinary course of business operations and an affiliated bank, insurance company, or similar business holds tax-exempt obligations. See 130 Cong. Rec. S4511 (April 12, 1984) (colloquy between Sen. Percy and Sen. Dole).

The Conference Report also indicates that the application of section 265(a)(2) to related parties is unclear. Nevertheless, the Conference Report states that "[n]o inference is intended that any particular provision under present law or as amended by the conference agreement (e.g., sec. 265(2)...), by its own terms, is not

[4]Section 7701(f) is effective for term loans made after July 18, 1984, and demand loans outstanding on July 18, 1984 (and not repaid before September 18, 1984). See section 1804(b)(2) of PL 99-514, 100 Stat. 2085, 2798.

applicable in the case of related parties, pass-through entities, or other intermediaries." H. Rep. No. 861, at 1042.[5]

In H Enterprises International, Inc. and Subsidiaries v. Commissioner, 105 TC 71 (1995), the taxpayer filed a motion for summary judgment that section 265(a)(2) does not apply where a subsidiary borrows funds for use by its parent to acquire tax-exempt obligations. Because there was an issue of material fact, the Tax Court denied the motion. Nonetheless, the court concluded there is nothing in section 265(a)(2) that, as a matter of law, renders the section inapplicable to a subsidiary's borrowings of funds for a parent's use. The court concluded that the fact that regulations have not been issued under section 7701(f) does not resolve the issue of whether the borrowing by one member of an affiliated group and the purchase of tax-exempt securities by another comes within section 265(a)(2).

The facts in H Enterprises were as follows: In 1985, H Enterprises International, Inc., (HEI) acquired a paper-products business (Waldorf) for $100 million,[6] using $80 million borrowed from the General Electric Credit Corporation (GECC). Waldorf proved so successful that by 1987 it was appraised at $210 million and the GECC debt had been reduced to under $30 million. That same year, HEI's board adopted a plan of restructuring under which HEI would form a subsidiary and contribute Waldorf in exchange for the subsidiary's stock. Afterwards, the subsidiary would refinance the GECC indebtedness for a larger sum and use the excess proceeds to make a distribution to HEI. In connection with the restructuring plan, HEI's stockholders entered into a shareholder agreement requiring HEI to be split into four divisions. Two of these divisions would be formed specifically to invest the anticipated distribution from the subsidiary. As planned, in mid-December 1987, the subsidiary's board resolved to borrow additional money from GECC and declared a 92 million dividend payable to HEI. In less than a week, the subsidiary borrowed $113 million and made a distribution to HEI in satisfaction of the dividend. This distribution included a $73 million cash payment, which came from the borrowed funds. Most of the cash payment, $64 million, went into the two

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[5]GCM 39667, I-077-86 (September 30, 1987), provides that section 265(2) may be applied to related parties. However, in view of the enactment of section 7701(f) and the Conference report statement that present law was unclear, the GCM recommends limiting the application of section 265(2) for years prior to the effective date of section 7701(f) to situations where the proceeds of indebtedness are used for and are directly traceable to the purchase of tax-exempt obligations, or where tax-exempt obligations are used as collateral for indebtedness. See sections 3.02 and3.03 of Rev. Proc. 72-18.

[6]All figures are approximate.

investment divisions and, other than investment returns, the divisions had no other significant source of funds. By February 1988, the investment divisions began making investments and soon had 22.7 percent of the funds in tax-exempt obligations. For the tax years at issue – 1989, 1990, and 1991, they held an average of 35.3 percent of their funds in tax-exempt obligations.

The Tax Court's second opinion in the case, wherein the court considered the facts of the case as well as the law, was H Enterprises International, Inc., and Subsidiaries v. Commissioner, 75 T.C.M. 1948 (1998), aff'd 183 F.3d 907 (8th Cir. 1999). There, the court held that the subsidiary's purpose for borrowing was, in part, the purchase of tax-exempt obligations. The court held that the purpose to incur or continue indebtedness to purchase or carry tax-exempt obligations may be determined not only from the member's conduct but also from the surrounding circumstances, including the use of the borrowed proceeds by another group member. The court further held that the restructuring plan and the shareholder agreement, as well as HEI's investment of the borrowed proceeds in tax-exempt obligations, directly evidenced that the dominant purpose for incurring the GECC debt was the purchase of tax-exempt obligations. As a result, the court held that section 265(a)(2) disallowed interest on the portion of that debt used directly to purchase tax-exempt obligations. The court also stated, however, that "in a less clear-cut case we would be substantially aided in reaching a decision by the regulations called for by section 7701(f)." 75 T.C.M. at 1953. Thus, in the absence of regulations under section 7701(f), the Tax Court may be reluctant to apply section 265(a)(2) to a member of a consolidated group based on circumstantial evidence related to the conduct of another group member, unless such circumstantial evidence is compelling.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted] If the group fails to thoroughly substantiate its business purposes and needs as described above, the group cannot avoid disallowance under section 265.

After the factual development above, if it is determined that the prohibited purpose exists, the next issue is whether the disallowance can be applied to one member of the consolidated group where another member holds the tax-exempt securities. In H Enterprises, the Tax Court indicates that, in applying section 265(a)(2) to a member of a consolidated group, the member's purpose for borrowing may be determined not only from the member's conduct but also from the conduct of another group member. The court's memorandum opinion arguably also indicates that the purpose of borrowing could be established not only by directly tracing the proceeds of the borrowing to the second group member's purchase of tax-exempt obligations, but also by circumstantial evidence relevant to the conduct of the other group member. Although the opinions do not discuss what circumstantial evidence would be sufficient to establish that the purpose for borrowing was to purchase tax-exempt obligations, certain language in the memorandum opinion suggests that the evidence would have to meet a high standard in order to establish such a purpose. 75 T.C.M. at 1953.

The request for advice does not discuss what circumstantial evidence exists in the instant case. Therefore, it remains unclear whether this is an appropriate case for applying section 265(a)(2) to disallow part of Parent's interest deduction.

Please call if you have any further questions.

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