28 T.C. 579 (1957)

The interest deduction on indebtedness is disallowed when the indebtedness is incurred to purchase or carry obligations, the interest on which is exempt from taxation, even if the proceeds are commingled with other funds.

Summary

The U.S. Tax Court addressed the issue of whether taxpayers could deduct interest payments on bank loans used to purchase tax-exempt securities. The court held that the interest deduction was not allowable because the indebtedness was incurred to purchase tax-exempt obligations, as per Section 23(b) of the 1939 Internal Revenue Code. The court focused on the direct correlation between the loans and the purchase of tax-exempt securities. The court rejected the taxpayers' argument that only a portion of the indebtedness was used to purchase tax-exempts due to available funds in their accounts, ruling that the loans were, in substance, for the purpose of acquiring the tax-exempt securities.

Facts

Bernard and Blanche Jacobson, husband and wife, filed a joint federal income tax return. They used their stock in Food Machinery and Chemical Corporation as collateral for bank loans. They borrowed money from several banks and, on the same day or within a few days, purchased tax-exempt West Virginia Veterans Bonus Bonds. The amounts of the loans and bond purchases were nearly identical. The proceeds of the loans were deposited into their custodian accounts, which were also used for various personal and business transactions. They claimed interest deductions for the loan payments, which the Commissioner disallowed.

Procedural History

The Commissioner of Internal Revenue disallowed the interest deduction claimed by the Jacobsons. The Jacobsons challenged the disallowance, and the case was brought before the United States Tax Court.

Issue(s)

1. Whether the interest deductions paid on the bank loans were properly disallowed under Section 23(b) of the 1939 Internal Revenue Code because the indebtedness was incurred to purchase tax-exempt obligations.

2. Whether the presence of other funds in the taxpayers' accounts at the time of the purchases, and prior to the loans, meant that the indebtedness was not entirely used to purchase tax-exempt securities.

Holding

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1. Yes, because the indebtedness was incurred to purchase tax-exempt securities, and the interest payments related to the indebtedness were not deductible.

2. No, because the other funds in the accounts did not alter the fact that the indebtedness was incurred for the purpose of purchasing the tax-exempt securities.

Court’s Reasoning

The court relied on Section 23(b) of the 1939 Internal Revenue Code, which disallows interest deductions on indebtedness incurred to purchase or carry tax-exempt obligations. The court noted that the

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