

## ***Bradford v. Commissioner, 58 T. C. 665 (1972)***

Interest expense deductions may be disallowed if indebtedness is incurred or continued to purchase or carry tax-exempt securities, even if funds are commingled.

### **Summary**

Bradford, a securities broker and dealer, challenged the IRS's disallowance of a portion of its interest expense deductions, arguing that its indebtedness was not specifically for tax-exempt bonds. The Tax Court held that a portion of Bradford's interest expense was disallowed under IRC § 265(2) because the firm's indebtedness was incurred or continued to purchase or carry tax-exempt securities. The court rejected Bradford's argument that its commingled funds and general business borrowings negated the purpose requirement of § 265(2), affirming the Second Circuit's approach in *Leslie*. The decision clarified the application of the allocation method for disallowed interest and included partners' capital in the calculation formula.

### **Facts**

Bradford, a partnership operating as a broker and dealer in securities, purchased tax-exempt bonds solely as a dealer for resale, never intending to hold them as investments. Bradford's business involved buying and selling securities, underwriting new issues, providing margin loans, and financial counseling. The firm commingled all cash receipts and disbursements in general-purpose checking accounts, including proceeds from bank borrowings and sales of securities. Bradford borrowed daily based on its cash needs without specifically accounting for tax-exempt bond purchases. The IRS disallowed a portion of Bradford's interest expense deductions under IRC § 265(2), arguing that the indebtedness was incurred to purchase or carry tax-exempt bonds.

### **Procedural History**

The IRS determined deficiencies in Bradford's income tax for 1964, 1965, and 1966 due to disallowed interest expense deductions. Bradford challenged these determinations before the Tax Court, which reviewed the case in light of the Second Circuit's decision in *Leslie v. Commissioner*. The Tax Court upheld the IRS's disallowance of a portion of the interest expense and modified the allocation formula to include partners' capital in the denominator.

### **Issue(s)**

1. Whether a portion of Bradford's interest expense deductions should be disallowed under IRC § 265(2) because the indebtedness was incurred or continued to purchase or carry tax-exempt securities.
2. Whether the allocation formula for disallowed interest expense should include partners' capital in the denominator.

## **Holding**

1. Yes, because Bradford's indebtedness was incurred or continued to purchase or carry tax-exempt securities, even though funds were commingled and borrowed for general business purposes.
2. Yes, because Rev. Proc. 72-18 specifies that the denominator should include the taxpayer's total assets, which includes partners' capital contributions.

## **Court's Reasoning**

The court adopted the Second Circuit's approach from *Leslie*, inferring the proscribed purpose of § 265(2) from Bradford's continuous course of conduct involving borrowings and the acquisition of tax-exempt securities. The court rejected Bradford's argument that commingled funds negated the purpose requirement, stating that the purpose could be inferred even when funds were not directly traceable to tax-exempt bond purchases. The court emphasized that the allocation method was appropriate when direct tracing was not possible. Regarding the allocation formula, the court found that Rev. Proc. 72-18, issued after the deficiency notice, should be applied to include partners' capital in the denominator, despite the IRS's initial exclusion of these accounts. The court reasoned that the IRS's decision-making process likely considered policy and administrative convenience rather than strictly the value versus basis of assets.

## **Practical Implications**

This decision impacts how securities firms and other taxpayers with commingled funds must analyze their interest expense deductions under IRC § 265(2). It clarifies that the purpose of indebtedness can be inferred from a taxpayer's overall business activities, even without direct tracing of funds. Legal practitioners must carefully review their clients' business operations to determine if any indebtedness could be seen as incurred or continued to purchase or carry tax-exempt securities. The inclusion of partners' capital in the allocation formula, as per Rev. Proc. 72-18, affects how these deductions are calculated. This ruling may influence future cases involving similar tax issues, particularly in the securities and financial services sectors, by setting a precedent for how the IRS and courts should approach the allocation of disallowed interest expenses.