

1 *Attorney Info*

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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

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CAPTION

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CASE NO. CV-S-88-12345

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PLAINTIFF TAMPAKALOGOS' TRIAL MEMORANDUM

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Plaintiff, SPIRO TAMPAKALOGOS, (hereinafter "Taxpayer") has commenced this action to recover THREE HUNDRED FORTY-ONE THOUSAND SEVEN HUNDRED SIXTY-EIGHT DOLLARS AND NO CENTS (\$341,768.00) representing overpayment of income tax and interest and penalties assessed by the UNITED STATES OF AMERICA (hereinafter "Government") for the taxable years 1985 and 1986. Plaintiff maintains that he did not owe the tax and that the interest and penalties are spurious.

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I.

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PRELIMINARY STATEMENT

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Taxpayer borrowed money to pay interest obligations for the taxable year 1985 and 1986. The Government alleges that Taxpayer cannot deduct the interest obligations as a regular item of interest

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1 expense pursuant to I.R.C § 163(a) of the 1954 Code as amended 1984, (hereinafter “The Code”),
2 since the interest obligation was postponed, not paid.

3 On March 25, 1988, Taxpayer received a Deficiency Notice from the Internal Revenue
4 Service. Taxpayer promptly paid the assessment. Pursuant to § 7422 of The Code, Taxpayer filed
5 a Claim of Refund on April 10, 1988. On August 21, 1988, Taxpayer filed a Waiver of Statutory
6 Notification of Claim of Disallowance. Subsequently, this suit was timely filed on December 3,
7 1988.

8 **II.**

9 **STATEMENT OF RELEVANT FACTS**

10 Taxpayer is an individual cash-basis taxpayer and a resident of the City and County of San
11 Francisco. Taxpayer is president of Spiro Shipping Corporation, a San Francisco based corporation
12 which trades its stock over the counter.

13 In 1984, Taxpayer purchased stock in Spiro Shipping Corporation with funds obtained from
14 Bank of America (hereinafter Bank “A”). Taxpayer was able to borrow these funds by delivering to
15 Bank A a nonrecourse note, using as collateral the stock purchased. The terms of the nonrecourse
16 note were as follows:

17 Dated: January 10, 1984
18 Terms: Matures in Five Years, Interest Only, Payable at 15%
19 First Interest Due: January 31, 1985

20 Although Taxpayer has extensive real estate holding throughout California, he found himself
21 “cash poor” toward the end of 1984. In December 1984, Taxpayer negotiated a loan with Bakersfield
22 Farmers Bank (hereinafter “Bank B”). Taxpayer was able to borrow \$150,000.00 from Bank B, using
23 as collateral his real estate. Unknown to Taxpayer, Bank B is eighty percent owned by Bank A.

24 Taxpayer promptly deposited the funds obtained from Bank B in his regular checking account
25 at Bank of California (hereinafter “Bank C”). Taxpayer uses this regular checking account to pay
26 utilities, insurance and other items of expense.

27 In January 1985, Taxpayer withdrew \$150,000 to pay his interest expense to Bank A.
28 Taxpayer then deducted his interest expense from his Federal income tax return for the taxable year
ending December 31, 1985.

1 the time of loan negotiations, is eighty percent owned by Bank A and (2) Taxpayer used the funds
2 from Bank B to pay the interest obligation to Bank A, that Taxpayer borrowed funds from the same
3 lender and, therefore, an interest obligation is not appropriate. However, to say that Bank B is the
4 same lender as Bank A because Bank B shares eighty percent of its ownership with Bank A flies in
5 the face of reality.

6 Since the Great Depression of the 1930s, the banking industry has been a highly regulated
7 industry. Even though Bank B shares eighty percent of its ownership with Bank A, each bank is an
8 individually licensed entity. It would be highly unlikely, given consumer safeguards placed on the
9 banking industry, that both banks would share the same members on their loan committees and,
10 indeed, Taxpayer will show that the loan committees of each bank are comprised of different
11 individuals.

12 Further, Taxpayer will show that the loan officers of each bank are completely autonomous
13 from the other. This is evidenced by the fact that Bank B required separate collateral for its loans to
14 Taxpayer. Had the second loan been a mere postponement of a loan obligation to Bank A, the
15 collateral would have remained the same. Thus, it is inconsequential that Bank A and Bank B share
16 common ownership since each bank operates as separate entities.

17 **B. TAXPAYER MAY DEDUCT AN INTEREST PAYMENT WHERE TAXPAYER**
18 **BORROWS FUNDS TO PAY AN INTEREST OBLIGATION FROM THE**
19 **ORIGINAL LENDER IF TAXPAYER HAS UNRESTRICTED CONTROL OVER**
20 **THE FUNDS.**

21 Even if it should be found that Bank B is not an autonomous entity from Bank A, Taxpayer
22 may still deduct his interest payment to Bank A on his Federal income tax returns. Under the
23 controversial Burgess Rule, a taxpayer who commingles funds with an existing account demonstrates
24 that he has unrestricted control over the funds and may deduct an interest payment made with funds
25 obtained from the original lender. Burgess, 8 T.C. 47, 50 (1947). In Burgess, the Tax Court reasoned
26 that where funds are not specifically earmarked to pay the interest expense due the lender, *i.e.*, the
27 taxpayer pays many expenses with funds from the same account, the commingled funds have lost
28 their identity and the taxpayer may do with them as he please. Id.

Subsequently, the Tax Court refined the Burgess Rule. In Burch, 63 T.C. 556 (1975), the Tax

1 Court found that unrestricted control may be further demonstrated where loan proceeds are not
2 absolutely required for the taxpayer to make interest payments since the taxpayer maintains
3 ownership of substantial assets which could have been made available to make interest payments.
4 Id. at 560. This test is one where the taxpayer makes a purely economic decision to borrow funds and
5 does not seek Federal income tax avoidance.

6 In the instant matter, Taxpayer placed the funds obtained from Bank B into his regular
7 checking account, which was at a separate bank, Bank C. These funds were commingled with
8 existing funds in Taxpayer's regular checking account and were available to Taxpayer to pay other
9 items of expense as well as his interest obligation to Bank A. Further, Taxpayer has extensive real
10 estate holdings. Had Taxpayer not borrowed the funds from Bank B, he would have been able to
11 make his interest payments through the sale of any one of his real estate assets. Thus, under the
12 Burgess Rule, with its Burch refinement, Taxpayer has met the unrestricted control test and a
13 deduction of his interest expense obligation on his Federal income tax returns is proper.

14 Of late, the unrestricted control test has met with zealous opposition. In our own Ninth
15 Circuit, the United States Court of Appeals considers the primary purpose of borrowing paramount
16 to the application of the unrestricted control test. Wilkerson v. C.I.R., 655 F.2d 980 (9th Cir. 1981).
17 Apparently, this is the position taken by the Government in the instant case.

18 In Wilkerson, the court found that there was no payment of interest if funds are borrowed
19 from the same lender for the "primary purpose" of financing interest on a prior loan, regardless of
20 whether the taxpayer had unrestricted control over the funds. Id. However, the facts of Wilkerson
21 are distinguishable from those here. In Wilkerson, the taxpayer did not have any other available
22 assets to meet the loan obligation. As stated above, Taxpayer has vast real estate holdings at his
23 disposal. Thus, even if the Government were to follow Wilkerson, the facts are distinguishable and,
24 therefore, Wilkerson does not apply.

25 IV.

26 CONCLUSION

27 There can be no serious dispute that Taxpayer has demonstrated that the deduction of interest
28 expense for the taxable years 1985 and 1986 was proper. The Government's argument that Taxpayer

1 should not have taken the deduction since Taxpayer borrowed funds from the “same” lending
2 institution and had no control over the borrowed funds does not comport with the facts.

3 Taxpayer borrowed funds from a separate lending institution from which he owned an
4 interest obligation, using as collateral his real estate. The decision to borrow funds from the second
5 lending institution was made by Taxpayer solely on economic facts. Had Taxpayer intended to
6 merely postpone the payments of interest expense by negotiating a transaction with a lending
7 institution which, by its common ownership, was essentially the same lending institution as the one
8 which was owed the interest expense obligation, the collateral would have remained the same, the
9 shares in Spiro Shipping Corporation

10 As further proof that the loan from the second lending institution was not part of the original
11 transaction, it was Taxpayer who placed the funds in his regular checking account at the third
12 banking institution, not the lender. Equally important, it was Taxpayer who decided how those funds
13 were to be used. There is no evidence to show otherwise. Thus, the borrowing of funds from the
14 second lending institution was an independent transaction from the interest obligation owed the first
15 lending institution. The interest expense was not postponed, it was paid.

16 WHEREFORE, the income taxes and interest and penalties were erroneously assessed.
17 Taxpayer properly took a deduction for payment of his interest expense obligation on his Federal
18 income tax returns of 1985 and 1986. Plaintiff is entitled to a refund of THREE HUNDRED
19 FORTY-ONE THOUSAND SEVEN HUNDRED SIXTY-EIGHT DOLLARS AND NO CENTS
20 (\$341,768.00) which represents overpayment of income tax, interest and penalties.

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22 DATED:

Respectfully submitted,

LEGAL LAW FIRM, P.C.

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26 By: _____
27 ARTHUR M. ATTORNEY, ESQ.
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