

THE M&A TAX REPORT

The Monthly Review of Taxes, Trends & Techniques

Volume 5, Number 5

December 1996



TAX INSTITUTE

Editor-in-Chief

Robert W. Wood
Robert W. Wood, P.C.
San Francisco

Associate Editor

Vaughne Sprowls
Tax Institute
San Francisco

Advisory Board

Gilbert D. Bloom
KPMG Peat Marwick
Washington

Lawrence B. Gibbs
Miller & Chevalier
Washington

Richard M. Lipton
Sonnenschein, Nath
& Rosenthal
Chicago

Steven K. Matthias
Deloitte & Touche
San Francisco

Mark A. Muntean
The Fremont Group
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate,
Meagher & Flom
New York

Joseph L. Schiffhauer
Federal Express Corp.
Memphis

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

Investment Interest Restrictions Can't be Buried

by Robert W. Wood • San Francisco

To savvy investors who make leveraged purchases of stock in a corporation as an investment, and incur interest expenses in connection with the debt to purchase that stock, it may seem self-evident that the rules

Continued on Page 6

ALSO IN THIS ISSUE:

- New Fort Howard Opinion 7
- Tax Profile of BT/MCI Transaction 7
- And a Few More Spins... 8

INVESTMENT INTEREST Continued from Page 1

of Section 163 concerning investment interest would apply. Nonetheless, it bears repeating that investment activity, even by employee/owners, can be considered investment interest subject to these rules.

A case in point recently decided by the Tax Court is *Scott C. Russon, et ux. v. Commissioner*, 107 T.C. No. 15 (Nov. 6, 1996). There, Scott Russon, his brother, and two cousins were employed by Russon Brothers Mortuary, a C corporation operated by the Russon family. As Scott Russon's father and uncles

neared retirement age, Russon and his brother agreed to buy the company. They paid \$999,000 for the stock, each paying 1/4 of the total, payable 10% down with the balance plus interest in 180 monthly installments.

The company never paid interest or dividends, but the purchase agreement specified that the buyers could not declare or pay dividends relating to the stock until the full purchase price had been paid. After the sale, the taxpayer and the other buyers elected themselves officers and directors. The sellers then retired.

Scott Russon deducted the interest he paid on the purchase price and, when the interest was disallowed, went to Tax Court. The IRS' argument was that because stock *generally* produces dividends, the stock Russon bought was covered by Section 163(d)(5)(A)(i). This was the case, said the IRS, notwithstanding the fact that the mortuary had never in fact paid a dividend. The taxpayer, on the other hand, argued that the phrase "property which produces income" in Section 163(d)(5)(A)(i) was limited to property that had *actually produced* one of the types of income described in Section 469(e)(1)(A).

An Investment's an Investment

The Tax Court concluded that the definition of "investment interest" was broad enough to include property that "normally" produces interest, dividend or royalty income, even if in a particular case it proves not to. Indeed, the Tax Court pointed out that the Russon brothers owned the company, and that the Russon brothers and relatives were employees. Consequently, said the Tax Court, the taxpayer was not entitled to deduct the interest on the debt incurred to purchase the stock as trade or business interest.

This conclusion should not seem too surprising. Revenue Ruling 93-68, 1993-2 C.B. 72, considered a factual situation similar to that of the *Russon* case. In Revenue Ruling 93-68, the specific question was how the interest on indebtedness should be treated where the debt was incurred by a person to purchase stock in a C corporation by which he was employed. Moreover, the specific reason for the stock purchase was to protect his employment.

The ruling concludes that, notwithstanding the need to purchase stock to protect the purchaser's

ALSO AVAILABLE FROM TAX INSTITUTE:

TAXATION OF INTANGIBLE ASSETS, by Mark A. Muntean *[NEW!]*

Taxation of Compensation and Benefits, by David J. Cartano

Taxation of Damage Awards and Settlement Payments, by Robert W. Wood *[1996 Supplement!]*

Tax Guide for Church & Clergy, by Mark A. Muntean

The Home Office Tax Guide, by Robert W. Wood
For more information, call or write today:



TAX INSTITUTE

235 Montgomery Street #972

San Francisco, CA 94104

e-mail: info@taxinstitute.com

(800) 852-5515

Fax (415) 834-1888

Continued on Page 7

INVESTMENT INTEREST Continued from Page 6

employment with the company, the interest on the debt is still investment interest. The ruling does carve out the notion that a dealer or a trader in the stock or securities involved would not be subject to this investment interest treatment. Interestingly, though, this ruling notes that if the interest attributable to the purchase of the stock were not characterized as investment interest, that interest would be non-deductible personal interest under Section 163(h)(1).

The ruling notes that personal interest includes interest paid or accrued on indebtedness properly allocable to the trade or business of performing services as an employee, unless one of the other exceptions in Section 163(h)(2) applies. In the ruling, the pertinent investment interest exception was that contained in Section 163(h)(2)(B). ■

WHERE DO YOU KEEP YOUR *M&A TAX REPORT*?

If you do not have an *M&A Tax Report* binder, or if the one you have is full, please write or call and we will be happy to send you one **at no charge!**

**TAX INSTITUTE**

235 Montgomery Street #972

San Francisco, CA 94104

e-mail: info@taxinstitute.com

(800) 852-5515

Fax (415) 834-1888