Drown News Agency v. Commissioner, 85 T. C. 86 (1985)

Interest expense deductions may be disallowed under IRC § 265(2) if it is foreseeable that loans will be needed to meet ordinary, recurrent business needs due to the purchase of tax-exempt securities.

Summary

Drown News Agency (DNA) attempted to deduct interest paid on loans from related entities, Drown Properties, Inc. and the Drown Trust, arguing these loans were not used to purchase or carry tax-exempt securities. The Tax Court disallowed these deductions, citing the foreseeability that DNA would need to borrow to meet its annual cash shortfall, despite the loans being unsecured. The court emphasized that DNA's pattern of purchasing tax-exempt bonds while knowing it would require loans to cover December payments to publishers indicated that the loans were effectively used to carry these securities.

Facts

Drown News Agency (DNA), a wholesale distributor of magazines and paperback books, had been attempting to match its cash basis income to an accrual basis since its inception in 1938. To achieve this, DNA made substantial December payments to publishers, which required borrowing from Bank of America, Drown Properties, Inc. (DPI), and the Drown Trust. DNA also invested in tax-exempt municipal bonds, with holdings increasing annually from 1971 to 1978. These bonds were not liquidated despite the annual borrowing needs. DNA deducted interest paid to DPI and the Drown Trust, but the Commissioner disallowed these deductions, asserting they were incurred to carry tax-exempt securities.

Procedural History

The Commissioner issued notices of deficiency to DNA and related entities for the tax years 1976 and 1977, disallowing interest deductions. DNA contested this determination before the Tax Court, which upheld the Commissioner's position, finding the interest expense was nondeductible under IRC § 265(2).

Issue(s)

1. Whether the interest paid by DNA to DPI and the Drown Trust was nondeductible under IRC § 265(2) as being incurred to purchase or carry tax-exempt securities?

Holding

1. Yes, because DNA could reasonably have foreseen the need for loans to meet its regular December cash shortfall due to its purchases of tax-exempt securities, establishing a direct relationship between the loans and the carrying of these securities.

Court’s Reasoning

The Tax Court’s decision was grounded in the interpretation of IRC § 265(2), which disallows interest deductions on indebtedness incurred to purchase or carry tax-exempt securities. The court relied on the foreseeability test from Wisconsin Cheeseman, Inc. v. United States, emphasizing that DNA’s regular pattern of borrowing at year-end to meet increased payments to publishers was directly related to its continued holding of tax-exempt bonds. The court noted that DNA’s failure to liquidate any of its substantial bond holdings, despite the need for cash, further supported the disallowance. The court also rejected DNA’s arguments that its business was not seasonal and that the loans were unsecured, finding these points irrelevant to the application of the foreseeability test. Key quotes from the opinion include, “In addition, * * * the deduction should not be allowed if a taxpayer could reasonably have foreseen at the time of purchasing the tax-exempts that a loan would probably be required to meet future economic needs of an ordinary, recurrent variety. “

Practical Implications

This decision informs legal practitioners that the foreseeability of needing loans to meet regular business needs can result in the disallowance of interest deductions, even if the loans are unsecured and not directly used to purchase tax-exempt securities. Businesses must carefully consider the timing and nature of their investments in tax-exempt securities relative to their borrowing needs. This ruling may influence tax planning strategies, particularly for entities using the cash method of accounting and holding significant tax-exempt investments. Subsequent cases, such as those cited by the court, have continued to apply or distinguish this ruling based on the specifics of the taxpayer’s situation and the foreseeability of their borrowing needs.

