Bowater Incorporated, f. k. a. Bowater Holdings, Inc. , and Subsidiaries, Petitioner v. Commissioner of Internal Revenue, Respondent, 101 T. C. 207 (1993); 1993 U. S. Tax Ct. LEXIS 56; 101 T. C. No. 14

A taxpayer may net interest income against interest expense in determining the interest deduction for computing combined taxable income under the DISC provisions.

Summary

Bowater Inc. sought to net interest income against interest expense when calculating the interest deduction for its DISC's combined taxable income. The Tax Court held that this netting was permissible, distinguishing the case from Dresser Industries due to the applicability of a regulation treating interest as fungible. The court reasoned that netting reflects the actual cost of borrowing, consistent with the fungibility concept in the regulation. This ruling impacts how interest deductions are calculated for DISC purposes, allowing taxpayers to more accurately reflect their borrowing costs.

Facts

Bowater Inc. , a Delaware corporation, and its subsidiaries filed consolidated federal income tax returns for 1979 and 1980. Its subsidiaries, Bowater Southern Paper Corp. and Bowater Carolina Corp. , used their wholly owned domestic international sales corporations (DISC's), Southern Export Corp. and Carolina Export Co. , to sell wood pulp and related products internationally. In computing the combined taxable income (CTI) of these entities under the 50/50 method, Bowater sought to net interest income against interest expense. This interest income primarily arose from loans to Bowater from its subsidiaries, using retained sales proceeds.

Procedural History

The Commissioner determined deficiencies in Bowater's federal income tax for 1976, 1979, and 1980, leading Bowater to file a petition with the U. S. Tax Court. The parties submitted the netting issue for decision on a fully stipulated basis, with other issues to be resolved later.

Issue(s)

1. Whether Bowater Inc. may net interest income against interest expense in determining the amount of the interest deduction to be allocated and apportioned in computing the CTI of Bowater and its DISC's under section 994(a)(2).

Holding

1. Yes, because netting interest income against interest expense is consistent with the fungibility of money concept in section 1. 861-8(e)(2) of the Income Tax

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Regulations and reflects the actual cost of borrowing.

Court’s Reasoning

The court relied on the fungibility concept in section 1. 861-8(e)(2) of the Income Tax Regulations, which treats interest as allocable to all income-producing activities due to the fungibility of money. This regulation, effective for years after 1976, was applicable to Bowater’s case but not to Dresser Industries, which dealt with earlier years. The court found that netting interest reflects the actual cost of borrowing, as supported by analogous precedents like General Portland Cement Co. v. United States and Ideal Basic Indus. , Inc. v. Commissioner. The court rejected the Commissioner’s argument that interest income is not attributable to qualified export receipts, noting that this assumes the conclusion that interest should not be netted. The court also distinguished cases where netting was not allowed due to different statutory contexts, such as Murphy v. Commissioner.

Practical Implications

This decision allows taxpayers to net interest income and expense when calculating interest deductions for DISC purposes, more accurately reflecting their actual borrowing costs. It may lead to increased DISC tax benefits for taxpayers who can demonstrate bona fide loans and interest income. The ruling clarifies that the fungibility concept applies to DISC calculations, potentially affecting how similar cases are analyzed in the future. Practitioners should consider this decision when advising clients on structuring DISC transactions and calculating CTI, ensuring compliance with the bona fide loan requirement. The case may influence future IRS guidance or regulations regarding the treatment of interest in DISC calculations.

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