Russon v. Commissioner, 107 T. C. 263 (1996)

Interest paid on indebtedness to purchase stock in a C corporation is classified as investment interest, subject to limitations, even if the stock has never paid dividends.

Summary

Scott Russon, a full-time employee and stockholder in Russon Brothers Mortuary, a C corporation, sought to deduct interest paid on a loan used to purchase the company's stock. The Tax Court ruled against him, holding that such interest is investment interest under IRC section 163(d), limited to the taxpayer's investment income, because stock is property that normally produces dividends. This decision was based on the statutory definition expanded by the 1986 Tax Reform Act, which categorizes stock as investment property regardless of whether dividends were actually paid.

Facts

Scott Russon, along with his brother and two cousins, all employed as funeral directors by Russon Brothers Mortuary, purchased all the stock of the company from their fathers in 1985. The purchase was financed through loans, with the stock serving as the collateral. Russon Brothers was a C corporation, and no dividends had been paid on its stock during its 26-year history. The sons purchased the stock to continue operating the family business full-time and earn a living, not primarily as an investment.

Procedural History

The Commissioner of Internal Revenue disallowed Russon's deduction of the interest paid on the loan as business interest and instead classified it as investment interest subject to limitations. Russon petitioned the United States Tax Court for relief. The Tax Court upheld the Commissioner's position, ruling that the interest was investment interest under IRC section 163(d).

Issue(s)

1. Whether interest paid on indebtedness incurred to purchase stock in a C corporation is deductible as business interest or is subject to the investment interest limitations of IRC section 163(d).

Holding

1. No, because the interest is classified as investment interest under IRC section 163(d), limited to the taxpayer's investment income, as stock is property that normally produces dividends.

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Court’s Reasoning

The Tax Court’s decision hinged on the interpretation of IRC section 163(d), as modified by the Tax Reform Act of 1986. The court found that stock generally produces dividends, thus falling under the definition of “property held for investment” in section 163(d)(5)(A)(i), which includes property producing income of a type described in section 469(e)(1), i. e. , portfolio income. The court rejected Russon’s argument that the stock must have actually produced dividends to be classified as investment property, citing legislative history indicating that Congress intended to include property that “normally” produces dividends. The court also noted that the possibility of dividends was contemplated in the stock purchase agreement, further supporting its classification as investment property. The court distinguished this case from situations involving S corporations or partnerships, where the owners could directly deduct the interest as business expense.

Practical Implications

This decision impacts how taxpayers analyze the deductibility of interest paid on loans used to purchase stock in C corporations. It clarifies that such interest is subject to the investment interest limitations of IRC section 163(d), regardless of whether dividends have been paid. Practitioners must advise clients that owning stock in a C corporation, even if actively involved in the business, does not allow them to deduct related interest as a business expense. This ruling influences tax planning for closely held C corporations, as it may affect the choice of entity and financing strategies. Subsequent cases and IRS guidance have followed this precedent, reinforcing the treatment of stock in C corporations as investment property for interest deduction purposes.

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