

1939

TAXATION - INCOME TAX - WHETHER PURCHASE AND RETIREMENT BY CORPORATION OF OWN BONDS AT LESS THAN AMOUNT OF ISSUE CONSTITUTES A TAXABLE GAIN WHERE CORPORATION IS INSOLVENT

S. R. Stroud
University of Michigan Law School

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Bankruptcy Law Commons](#), and the [Tax Law Commons](#)

Recommended Citation

S. R. Stroud, *TAXATION - INCOME TAX - WHETHER PURCHASE AND RETIREMENT BY CORPORATION OF OWN BONDS AT LESS THAN AMOUNT OF ISSUE CONSTITUTES A TAXABLE GAIN WHERE CORPORATION IS INSOLVENT*, 37 MICH. L. REV. 1353 (1939).

Available at: <https://repository.law.umich.edu/mlr/vol37/iss8/36>

This Regular Feature is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

TAXATION — INCOME TAX — WHETHER PURCHASE AND RETIREMENT BY CORPORATION OF OWN BONDS AT LESS THAN AMOUNT OF ISSUE CONSTITUTES A TAXABLE GAIN WHERE CORPORATION IS INSOLVENT — Petitioner, a railway corporation, in 1906 leased all its property to an operating company for a term of fifty years. At the same time petitioner issued \$434,000 in first mortgage bonds which were used to refund a prior issue of \$350,000 and to provide for certain improvements on the road. Interest on the bonds was to be met by lessee's payment of the greater part of the rental directly to the trustee of the mortgage bonds, but no provision for a sinking fund was made. In October, 1932, petitioner purchased \$19,000 par value of aforesaid mortgage bonds for \$4,750, and has since held them in order to collect the interest as it falls due. Because of changed conditions the property leased by petitioner has become practically valueless. The Commissioner of Internal Revenue taxed the difference between issuing price and repurchase price as income for the year 1932. The Board of Tax Appeals supported the Commissioner. *Held*, the board's decision should be reversed. *Transylvania Railroad v. Commissioner of Internal Revenue*, (C. C. A. 4th, 1938) 99 F. (2d) 69.

Relying on *Bowers v. Kerbaugh-Empire Co.*¹ a long line of cases held no

¹ 271 U. S. 170, 46 S. Ct. 449 (1926), affg. *Kerbaugh-Empire Co. v. Bowers*, (D. C. N. Y., 1924) 300 F. 938; 34 YALE L. J. 334 (1925); 25 COL. L. REV. 110 (1925); 6 UNIV. CIN. L. REV. 357 (1932); 40 YALE L. J. 960 (1931).

taxable gain was realized by a corporation's repurchase of its own bonds below par or issuing price,² in spite of the explicit language of the treasury regulations throughout this period.³ However, *United States v. Kirby Lumber Co.*⁴ substantially limited the *Kerbaugh-Empire Co.* case, holding the saving realized by a corporation's repurchase of its own bonds below face value in the year of issue to be taxable as income for that year.⁵ The *Kerbaugh-Empire Co.* case was distinguished on the ground that there "The result of the whole transaction was a loss."⁶ While in the *Kirby* case there "was no shrinkage of assets and the taxpayer made a clear gain."⁷ The *Kerbaugh-Empire Co.* case has been severely criticized.⁸ It allows a double deduction for losses in that a taxpayer may deduct losses as they occur in any given year and then at the completion of the whole transaction again take into account these losses in determining whether any taxable gain has been realized by repurchase of its own obligations below face or issuing price.⁹ Also the theory of the *Kerbaugh-Empire Co.*

² *Independent Brewing Co. of Pittsburgh*, 4 B. T. A. 870 (1926); *New Orleans, T. & M. Ry. v. Commr.*, 6 B. T. A. 436 (1927); *Indianapolis Street Ry. v. Commr.*, 7 B. T. A. 397 (1927); *National Sugar Mfg. Co. v. Commr.*, 7 B. T. A. 577 (1927); *General Manifold & Printing Co. v. Commr.*, 12 B. T. A. 436 (1928); *Douglas County Light & Water Co. v. Commr.*, 14 B. T. A. 1052 (1929); *North American Mortgage Co. v. Commr.*, 18 B. T. A. 418 (1929); *American Tobacco Co. v. Commr.*, 20 B. T. A. 586 (1930); *Boulevard Bldg. Co. v. Commr.*, 21 B. T. A. 864 (1930); *Norfolk Southern Ry. v. Commr.*, 22 B. T. A. 1407 (1931); *Terre Haute, Indianapolis & Eastern Traction Co. v. Commr.*, 24 B. T. A. 197 (1931).

³ TREAS. REG. 45, art. 544 (1) (1918); REG. 62, art. 545 (1) (1921); REG. 69, art. 545 (1) (1926); REG. 74, art. 68 (1) (1928); REG. 77, art. 68 (1932): "Sale and retirement by corporation of its bonds.—(1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (b) If the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year." But see TREAS. REG. 86, art. 22 (a)—18 (1934), which is the same as the above except for the omission of the words "and retires" in (c).

⁴ 284 U. S. 1, 52 S. Ct. 4 (1931), reversing (Ct. Cl. 1930) 44 F. (2d) 885.

⁵ The *Kirby* case was followed by *Consolidated Gas Co. of Pittsburgh v. Commr.*, 24 B. T. A. 901 (1931); *Woodward Iron Co. v. Commr.*, 24 B. T. A. 1050 (1931); *Suncrest Lumber Co. v. Commr.*, 25 B. T. A. 375 (1932); *Norfolk Southern R. R. v. Commr.*, 25 B. T. A. 925 (1932); *Twin Ports Bridge Co. v. Commr.*, 27 B. T. A. 346 (1932); *Garland Coal & Mining Co. v. Commr.*, 28 B. T. A. 348 (1933). See 20 CAL. L. REV. 441 (1932) as to conflict between the *Kerbaugh-Empire* and *Kirby* cases.

⁶ *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170 at 175, 46 S. Ct. 449 (1926).

⁷ *United States v. Kirby Lumber Co.*, 284 U. S. 1 at 3, 52 S. Ct. 4 (1931).

⁸ Periodicals cited, *supra*, note 1, and also Rottschaefer, "The Concept of Income in Federal Taxation," 13 MINN. L. REV. 637 at 660 (1929); 40 YALE L. J. 960 (1931). The concept of income as set forth in the case of *Eisner v. Macomber*, 252 U. S. 189, 40 S. Ct. 189 (1920), and relied on in the *Kerbaugh-Empire* case has also been modified. See 45 HARV. L. REV. 1072 at 1075 (1932).

⁹ Under the *Kerbaugh-Empire Co.* case theory, this double deduction possibility would occur only in the case of realized losses involved in the same transaction, though

case makes dependent two independent factors, namely the repurchase of the obligations below par and the outcome of a business venture.¹⁰ The problem revolves largely around what the base period for taxation is to be. According to *Burnet v. Sanford & Brooks*,¹¹ a given year is the basis for determining whether a taxable gain has been realized and a loss resulting in a previous year from the same transaction is not to be considered.¹² Where the obligation is incurred or bonds are issued for property, the question arises, on attempting to determine whether there has been a taxable gain realized in a later year by cancellation of part of the indebtedness or repurchase of bonds below par, whether or not the value of the property is to be taken into account and, if so, as of what date.¹³ If the *Kerbaugh* case has been completely overruled, then "unrealized" losses will not be taken into account.¹⁴ Where, however, at the time of the cancellation of indebtedness, or the analogous case of repurchase of bonds below par, the debtor or purchaser, as the case may be, is insolvent and remains insolvent after such event, it has been consistently held that no taxable gain is realized.¹⁵ The

the case would seem also to stand for the proposition that unrealized losses involved in the same transaction can be taken into account.

¹⁰ If no gain is realized because the transaction as a whole results in a loss, or if a gain is offset by a "corresponding loss," the question of what constitutes a "corresponding loss" is raised. As indicated by note 9, *supra*, both realized and unrealized losses might be included and this would involve a revaluation of property received for or purchased by means of the original obligation.

¹¹ 282 U. S. 359, 51 S. Ct. 150 (1931), reversing (C. C. A. 4th, 1929) 35 F. (2d) 312, noted 43 HARV. L. REV. 962 (1930).

¹² In the *Sanford & Brooks* case a judgment recovered in 1920 compensating the taxpayer in part for losses in the years 1913 to 1916 was taxed as income for 1920 though clearly the "whole transaction" resulted in a loss to the taxpayer. See Altman, "Net Losses and the Taxable Year," 28 ILL. L. REV. 525 at 528 (1933).

¹³ *Helvering v. American Chicle Co.*, 291 U. S. 426, 54 S. Ct. 460 (1934) [taxing gain realized by repurchase below par, reversing (C. C. A. 2d, 1933) 65 F. (2d) 454, which held the difference between par and purchasing price merely effected a change in the price of the property purchased with the bonds]; *Commissioner of Internal Revenue v. Coastwise Transp. Corp.*, (C. C. A. 1st, 1934) 71 F. (2d) 104 (tax on gain by repurchase of serial notes below face value upheld, reversing the Board of Tax Appeals, which had allocated the difference to a change in purchase price of the property purchased with the notes). But see *Commissioner of Internal Revenue v. Rail Joint Co.*, (C. C. A. 2d, 1932) 61 F. (2d) 751.

¹⁴ That is, decreases in the value of property purchased with the bond or evidence of indebtedness being retired or repurchased below issuing or face value will not constitute a deductible loss as against the gain realized by such retirement or repurchase unless the loss is actually realized, and then the deduction will be allowed only in the year in which the loss is realized or as permitted by the act in force at the time.

¹⁵ *Meyer Jewelry Co.*, 3 B. T. A. 1319 (1926); *Eastside Mfg. Co. v. Commr.*, 18 B. T. A. 461 (1929); *Progress Paper Co. v. Commr.*, 20 B. T. A. 234 (1930); *Commissioner v. Simmons Gin Co.*, (C. C. A. 10th, 1930) 43 F. (2d) 327; *Burnet v. J. F. Campbell Co.*, (D. C. App. 1931) 50 F. (2d) 487; *Towers & Sullivan Mfg. Co. v. Commr.*, 25 B. T. A. 922 (1932); *Dallas Transfer & Terminal Warehouse Co. v. Commr.*, (C. C. A. 5th, 1934) 70 F. (2d) 95; *Quinn v. Commr.*, 31 B. T. A. 142 (1934); *Madison Rys. Co. v. Commr.*, 36 B. T. A. 1106 (1937).

principal case would seem to fall within this category since it was found that the leased assets and franchise rights of the petitioner had become practically valueless and no provision had been made for repayment of their bonded indebtedness of \$434,000.¹⁶ There was the additional fact in the principal case that the bonds had been repurchased in order to hold and receive the interest on them as paid by the lessee of petitioner. Since the federal treasury regulations read "purchases and retires," the court had grounds for holding purchase for retirement to be a condition precedent to tax.¹⁷

S. R. Stroud

But where after the forgiveness of indebtedness the insolvent debtor is solvent, there is a taxable gain. *Lakeland Grocery Co. v. Commr.*, 36 B. T. A. 289 (1937). Under some circumstances forgiveness of indebtedness may constitute a contribution to capital rather than income. *United States v. Oregon-Washington Ry. & Nav. Co.*, (C. C. A. 2d, 1918) 251 F. 211 (corporation cancelled indebtedness of subsidiary of which it owned all the stock). See Harvey, "Some Indicia of Capital Transfers Under the Federal Income Tax Laws," 37 MICH. L. REV. 745 at 750 (1939).

¹⁶ Stated in its simplest terms, one who, by reason of owing more than he has, is insolvent receives nothing of which he can avail himself by a cancellation or retirement of a part of the indebtedness as long as he remains insolvent afterward.

¹⁷ It has been suggested that the distinction between purchase for retirement and purchase for investment is not a valid one. 40 YALE L. J. 960 (1931). And TREAS. REG. 86, art. 22 (a)-18 (1934). REG. 94, art. 22 (a)-18 (1936), and REG. 101, art. 22 (a)-18 (1938), omit the words "and retires" so that as far as the Treasury Regulations are concerned the distinction no longer exists.