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Recovery of Accrued but Unpaid Interest on War-Lost
Investments Taxed as Capital Gain to Extent
It Exceeds Basis—*Horst v. United States**

Prior to the United States entry into World War II, taxpayer acquired certain Japanese bonds. In December 1941, pursuant to section 127(a) of the Internal Revenue Code of 1939,¹ he suffered a war loss with respect to these investments and took the proper deduction. When trading restrictions on Japanese bonds were lifted in 1950, taxpayer enjoyed a war loss recovery. At that time, bonds of this type were being traded flat, the quoted price reflecting both principal and accrued but unpaid interest thereon to the date of recovery.² As the defaulted interest coupons were paid on their extended maturity dates, in accordance with an agreement with the Japanese government, taxpayer reported the amounts received as ordinary income. Later, in an action by the taxpayer for a refund relating to these payments, *held*, judgment for plaintiff. Since recovery of war-lost bonds of a type which are being traded flat on the recovery date is analogous to a purchase of bonds flat, delayed payments of accrued but unpaid interest on such bonds are returns of capital to the extent of basis, and capital gains to the extent that they exceed basis.

In order to obviate the confusion and uncertainty inherent in establishing the loss of property destroyed or seized by the enemy during World War II,³ Congress enacted section 127 of the Internal Revenue Code of 1939.⁴ By virtue of section 127(a), property located in enemy countries was presumed lost on the date war was declared by the United States, and the taxpayer was entitled to a loss deduction to the extent that such a deduction would be of benefit to him in the year of the loss. In computing this deduction, the taxpayer was not required to consider the possibility of recovery

* 331 F.2d 879 (Ct. Cl. 1964).

1. Int. Rev. Code of 1939, § 127, added by ch. 619, 56 Stat. 852 (1942), as amended, ch. 521, §§ 341(a)-(b), 65 Stat. 511 (1951). Sections 127(a) and 127(b) dealing with losses were deleted from the 1954 Code. The recovery portions of the 1939 Code were carried over. The present war loss recovery provisions appear in INT. REV. CODE OF 1954, §§ 1331-37.

2. The price of a bond that is in default is usually quoted "flat." The purchase price includes not only the title to the securities but also the right to receive previously defaulted interest. See PRIME, INVESTMENT ANALYSIS 105 (2d ed. 1952).

3. See also *United States v. S. S. White Dental Mfg. Co.*, 274 U.S. 398 (1927), for a judicial effort to ascertain a World War I loss; S. REP. NO. 1931, 77th Cong., 2d Sess. 127 (1942).

4. For a discussion of the operation of the war loss provisions, see generally Carrol, *Tax Relief for War Losses*, 21 TAXES 491 (1943); Simon, *The Presumptions of Section 127*, 27 TAXES 791 (1949); Note, *War Losses—Revenue Act of 1942*, 20 N.Y.U.L.Q. REV. 112 (1944). For critical analysis and suggested improvements of the recovery provisions, see generally Kramer, *War Losses, Their Continuing Effect Under Section 127*, 30 TAXES 376 (1952); Tarleau, *Recovery of War Losses—Tax Effects*, 80 J. ACCOUNTANCY 168 (1945).

of the property at a future date.⁵ However, the mere restoration of the value of a war-lost investment, such as by acknowledgment of liability by the debtor, was treated as a "recovery" of the investment which had been considered as destroyed or seized.⁶ With respect to such a subsequent recovery, initially the taxpayer would be entitled to tax-free recovery up to the amount of his unused war loss, that is, that portion of his original loss that did not reduce his tax in the year of loss.⁷ That portion of his war loss which did result in a prior tax benefit would be taxed as ordinary income,⁸ and that portion of the recovery which exceeded the taxpayer's basis for all property involved in his prior war losses would be treated as gain on an involuntary conversion and taxed at capital gain rates, if at all.⁹ The unadjusted basis of the recovered property would be an amount equal to the fair market value of such property determined as of the date of the recovery¹⁰ unless the taxpayer elected the statutory option available to him under the 1951 amendment to the recovery provisions.¹¹ As can readily be seen, the primary purpose of the recovery provisions was to insure that war losses which had resulted in prior tax savings would be included in ordinary income when that which had been lost was eventually recovered.¹²

Although the war loss provisions provide for the tax treatment of war-lost property both in the year of loss and in the year of the recovery, they contain no explicit provision for the treatment of interest accruing between the date of loss and the date of recovery. As a result, the courts have been called upon to determine the appropriate designation of accrued but unpaid interest on the date of recovery and to determine the proper tax treatment of payments of such defaulted interest subsequent to the date of recovery. In *Shafer v. United States*,¹³ *Afia Finance Corp.*,¹⁴ and Revenue Ruling 58-275,¹⁵ it has been held that these delayed payments of defaulted interest are taxable as ordinary income. On the other hand, the

5. Int. Rev. Code of 1939, § 127(b), added by ch. 619, 56 Stat. 852 (1942); *Shahmoon v. Commissioner*, 185 F.2d 384 (2d Cir. 1950). See S. REP. No. 1631, 77th Cong., 2d Sess. 127 (1942).

6. Treas. Reg. § 1.1334-1 (1957).

7. INT. REV. CODE OF 1954, § 1332(b)(1).

8. INT. REV. CODE OF 1954, § 1332(b)(2).

9. INT. REV. CODE OF 1954, § 1332(b)(3). "If property . . . is compulsorily or involuntarily converted . . . into property similar or related in service or use to the property so converted, no gain shall be recognized." INT. REV. CODE OF 1954, § 1033(a). See INT. REV. CODE OF 1954, § 1231.

10. INT. REV. CODE OF 1954, § 1336(a). See INT. REV. CODE OF 1954, § 1332(a).

11. See INT. REV. CODE OF 1954, § 1333 and text accompanying notes 28-30 *infra*.

12. *George C. Dix*, 34 T.C. 837, 841 (1960).

13. 204 F. Supp. 473 (S.D. Ohio 1962), *aff'd on opinion below*, 312 F.2d 747 (6th Cir. 1963).

14. 41 T.C. 255 (1963).

15. Rev. Rul. 58-275, 1958-1 CUM. BULL. 22.

Horst case is the first to be decided in the taxpayer's favor. In *Horst* the court pointed out that war-lost property is nonexistent for tax purposes and concluded that the payments received were not interest income because it is not possible to recover payments for the use of nonexistent property.¹⁶ In addition, since bonds of the type in question were being traded flat on the recovery date, the court held that the recovery was equivalent to a "purchase" of bonds flat. Therefore, it applied the flat purchase rule, which permits a taxpayer who acquires defaulted bonds flat to treat subsequent payments of interest then in default as partial returns of capital rather than as ordinary income.¹⁷

The decision in *Horst* is subject to forceful criticism for the way in which it employed the commonly cited fiction¹⁸ that war-lost property ceases to exist for tax purposes until a recovery is made. Revenue Ruling 58-275 and the *Shafer* and *Afia* cases take the position that despite the war loss, the debtor-creditor relationship continues and the delayed payments are interest income received for the use of the taxpayer's money.¹⁹ The contrary position taken by the *Horst* court seems untenable. War-lost property is deemed to be nonexistent for deduction purposes. Since the taxpayer is given a loss deduction when war is declared without regard to any possibility of a future recovery, courts have felt obliged to deny additional deductions and have done so by resorting to this fiction of nonexistence. Thus, courts have disallowed subsequent deductions for fire losses²⁰ and depreciation²¹ with respect to war-lost property. The *Horst* court is in error in attempting to employ the fiction of nonexistence, however, as a justification for treating the "loss" and the "recovery" as totally independent events. In fact, the recovery provisions necessarily treat these events as correlative by providing for the inclusion in taxable income of recoveries to the extent they resulted in a tax saving in the year of loss. This treatment is much more closely related to treating the taxpayer as if his recovered

16. *Horst v. United States*, 331 F.2d 879, 882-83 (Ct. Cl. 1964). Interest on indebtedness has generally been defined as "the compensation allowed by law or fixed by the parties for the use, or forbearance, or detention of money." *Fall River Elec. Light Co.*, 23 B.T.A. 168, 171 (1931); *Deputy v. DuPont*, 308 U.S. 488 (1940). See MERTENS, *FEDERAL INCOME TAXATION* § 6.01 (1962).

17. *Horst v. United States*, *supra* note 16, at 882-83. To the extent it exceeds basis, it is treated as capital gain.

18. *Weinmann v. United States*, 278 F.2d 474 (2d Cir. 1960); *Kenmore v. Commissioner*, 205 F.2d 90 (2d Cir. 1953); *Shahmoon v. Commissioner*, 185 F.2d 384 (2d Cir. 1950); *George C. Dix*, 34 T.C. 837, 841 (1960). See *Treas. Reg. § 1.334-1* (1957).

19. *Shafer v. United States*, 204 F. Supp. 473, 475 (S.D. Ohio 1962), *aff'd on opinion below*, 312 F.2d 747 (6th Cir. 1963); *Afia Fin. Corp.*, 41 T.C. 255, 267 (1963); *Rev. Rul. 58-275*, 1958-1 CUM. BULL. 2. See *Horst v. United States*, 331 F.2d 879, 885 (1964) (dissenting opinion).

20. *Kenmore v. Commissioner*, 205 F.2d 90 (2d Cir. 1953).

21. *Shahmoon v. Commissioner*, 185 F.2d 384 (2d Cir. 1950).

property had never been lost than it is to treating him as if the same property were newly acquired. This position is supported by the Senate Finance Committee's report accompanying the 1951 amendment to the recovery provisions, which makes it clear that it is "appropriate to treat the taxpayer as nearly as possible as if he had held the property throughout the entire period and received no deduction for the temporary loss."²²

The validity of the decision in *Horst* is also questionable because of the court's application of the flat purchase rule. In the *Afia* case, faced with a claim similar to the one presented in *Horst*, the court refused to apply the flat purchase rule because it felt the taxpayer had been the owner of the indebtedness at all relevant times and that his receipt of new bonds to replace his war-lost bonds did not qualify as a purchase of bonds flat.²³ Although the *Afia* case can be distinguished from *Horst* because the bonds of the type in question were not being traded flat on the recovery date, the fact remains that the taxpayer in *Horst* did not actually purchase bonds on the recovery date. Instead, he enjoyed a war loss recovery which by judicial definition is merely a "kind of constructive acquisition" of temporarily lost property.²⁴ Although the flat purchase rule is commonly stated in terms of the acquisition of defaulted bonds, the rule has been applied almost without exception only in cases in which there has been an actual purchase.²⁵ Such a requirement is more consistent with the theory behind the rule. In a typical flat purchase, in return for a fixed sum of money the buyer obtains title to defaulted interest coupons as well as to the bond itself, the fair market value of both these elements being reflected in the basis of the acquired property.²⁶ Thus, when a defaulted interest coupon is paid,

22. S. REP. No. 781, 82d Cong., 1st Sess. 53, 54 (1951). (Emphasis added.)

23. *Afia Fin. Corp.*, 41 T.C. 255, 268 (1963). *But see* Rev. Rul. 54-501, 1954-2 CUM. BULL. 197, in which the Commissioner ruled that the right to collect accrued but unpaid interest would be considered as part of the new bonds received. In effect, it seems the Commissioner included accrued interest in the recovery basis.

24. See *George C. Dix*, 34 T.C. 837, 841 (1960). The statute itself does not define "recovery."

25. *E.g.*, *Carman v. Commissioner*, 189 F.2d 363 (2d Cir. 1951); *Hamilton C. Rickaby*, 27 T.C. 886 (1957). *Shattuck v. Commissioner*, 25 T.C. 416 (1955). *Contra*, *Ann T. Simpson*, 11 P-H Tax Ct. Mem. ¶ 42059 (1942) (beneficiary of estate received notes with defaulted interest coupons attached).

26. *United States v. Langston*, 308 F.2d 729 (5th Cir. 1962); *Hamilton C. Rickaby*, 27 T.C. 886 (1957); *R. O. Holton & Co.*, 44 B.T.A. 202 (1941). However, the interest must have actually accrued as of the date of purchase. *First Ky. Co. v. Gray*, 309 F.2d 845 (6th Cir. 1962). *Contra*, *Campbell v. Sailor*, 224 F.2d 641 (5th Cir. 1955).

27. The flat purchase rule does not apply to interest defaulted after the taxpayer acquires the bonds. *Fisher v. Commissioner*, 209 F.2d 513 (6th Cir. 1954). *National City Lines, Inc. v. United States*, 197 F.2d 754 (3d Cir. 1952); *Warner A. Shattuck*, 25 T.C. 416 (1955). *Erskine Hewitt*, 30 B.T.A. 962 (1934). See generally *Hellawell, Capital Gains Problems in Particular Areas—Dispositions of Evidences of Indebtedness*, 12 W. RES. L. REV. 350, 362-63; 34 CHL-KENT L. REV. 157 (1956); 1 MERTENS, FEDERAL INCOME TAXATION § 5.06 (1962).

a part of the buyer's initial investment is being returned to him. He is not receiving a payment of interest for the use of his money. In the *Horst* case, the flat purchase rule should not have been applied because the taxpayer did not purchase defaulted coupons from the Japanese government. As a result, when the defaulted interest coupons were paid, it could not be said that a part of taxpayer's investment in defaulted coupons was being returned to him, because he had never made such an investment. In reality, he was receiving interest income for the use of his property.²⁷

The *Horst* decision can also be challenged on the ground that under its interpretation cases turn upon whether the taxpayer exercises the statutory election made available to him by the 1951 amendment to the recovery provisions. That amendment was enacted in an attempt to alleviate the harsh treatment afforded taxpayers who took war-loss deductions as to several pieces of property only some of which were recovered.²⁸ When the election is availed of, the taxpayer may exclude the value of the recovered property from income in the year of recovery and give such property a basis equal to its adjusted basis on the date of loss.²⁹ His deduction in the year of loss must then be reduced by the amount of the adjusted basis of the recovered property on the date of loss and the tax in that year must be recomputed. The resulting increase in the tax in the year of loss must then be added to the tax for the year of recovery.³⁰ In this way, any appreciation in the value of the specific property recovered is protected from taxation at ordinary income rates. Without the election, such protection would not have been afforded if the total tax benefits from all war-lost property exceeded the original basis of the property actually recovered.

The *Horst* court distinguished the decision in *Shafer* on the ground that the taxpayer there had elected, according to the statutory option, to retain the basis of his property as of the date of loss. Since that basis did not reflect the value of defaulted interest, the *Horst* court argued that later payments in *Shafer* were properly designated as interest income rather than as returns of capital.³¹ By virtue of

28. S. REP. 781, 82d Cong., 1st Sess. 53-54 (1951). For example, assume a taxpayer took a war loss deduction of \$20,000 due to the loss of two pieces of property, each having an adjusted basis of \$10,000 on the date of loss. Further, assume that the taxpayer recovered only one of the two pieces of lost property and that on the date of recovery that piece of property had appreciated to a value of \$15,000. Without the statutory election, the entire \$15,000 recovery would be taxed as ordinary income. On the other hand, with the statutory election, only the original \$10,000 basis would be used in computing the tax on recovery and appreciation in value would not be subjected to taxation at ordinary income rates. If the taxpayer had lost only one piece of property, appreciation in value could not have been taxed at ordinary income rates because his original deduction could not have exceeded the basis of the lost property on the date of loss.

29. INT. REV. CODE OF 1954, § 1333(1).

30. INT. REV. CODE OF 1954, § 1333(2).

31. *Horst v. United States*, 331 F.2d 879, 884 (1964).

the distinction drawn by the court in the principal case, payments of accrued but unpaid interest to a taxpayer who exercised the statutory option in order to protect the appreciation in the value of his property would be taxed as ordinary income; but, a taxpayer who did not find it necessary to exercise the option would not be so taxed. Thus, by drawing this attenuated distinction, the *Horst* court has seemingly impaired the congressional effort to protect appreciation in the value of war-lost investments for every taxpayer. Furthermore, it seems implausible that Congress would have intended this election process to be determinative of the tax on accrued but unpaid interest.

By adding defaulted interest as a part of the basis of the "recovery," the *Horst* court created for itself a dilemma. It then had to strain to conclude that that same interest would not also be taxed as income or there would be double taxation. Had the accrued interest not been treated as part of the basis of the recovered property, the court would have been able to tax it as income. Realistically, there can be no loss suffered as to that which had not been acquired as of the date of loss,³² and no recovery as to that which had not been lost initially. Thus, the most consistent policy would be to treat as a "war loss recovery" only the principal of the investment which had been originally deducted as a war loss, treating later payments of accrued interest separately as normal interest income rather than as part of basis.³³ An exception to this policy should not be made simply because bonds of the type in question were being traded flat on the recovery date. The problem of determining that portion of the market value on the recovery date which is attributable to the value of the defaulted interest could be easily solved. Such a determination could be made by taking that portion of the market value of the bonds on the recovery date which is equal to the ratio of the amount of the interest defaulted to the sum of the original war loss plus the amount of defaulted interest.³⁴ Although the possible ramifications and limitations of the *Horst* decision are unclear, its obvious defects make it questionable authority and indicate that the position of the previous authorities is more justified.

32. See, e.g., *Warner Bros. Co. v. United States*, 214 F.2d 429, 431 (2d Cir. 1954).

33. Such interest should be taxed at ordinary rates under INT. REV. CODE OF 1954, § 61.

34. The Supreme Court has already treated a tax problem related to interest coupons on bonds owned by Mr. Horst. See *Helvering v. Horst*, 311 U.S. 112 (1940).