1 T.C. 804 (1943)

When installment obligations are satisfied at less than face value, the "income which would be returnable" for calculating the basis of the obligations refers to the entire profit that would have resulted from full satisfaction, not just the percentage of profit considered when computing net income under capital gains provisions.

Summary

Lockhart v. Commissioner addresses how to calculate taxable gain when installment obligations, arising from the sale of stock, are satisfied for less than their face value. The Tax Court held that the "income which would be returnable" under Section 44(d) of the Internal Revenue Code, for purposes of determining the basis of the obligations, refers to the total profit that would have been realized if the obligations were fully satisfied. This calculation is made before applying any capital gains provisions that might reduce the amount of gain included in net income.

Facts

The Lockharts sold stock in 1937 for cash and promissory notes payable over ten years. They elected to report the profit on the installment basis. In 1939, the buyer, American Liberty Oil Co., exercised its option to cease payments on the notes and transfer certain assets to the noteholders, including the Lockharts. The face value of the remaining notes held by the Lockharts was $26,694, but the assets received in satisfaction were worth only $18,967.25. Had the notes been paid in full, the basis would have been $2,072.49.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Lockharts' income taxes for 1939. The Lockharts petitioned the Tax Court, contesting the Commissioner's calculation of the gain realized when the installment obligations were satisfied at less than face value. The cases were consolidated due to the returns being filed on a community property basis and the deficiencies arising from the same transaction.

Issue(s)

Whether, in calculating the gain from satisfying installment obligations at less than face value, the "income which would be returnable" under Section 44(d) of the Internal Revenue Code should be reduced by the capital gains provisions of Section 117(b) before determining the basis of the obligations.

Holding

No, because the phrase "income which would be returnable" means the entire profit that would result if the obligations were satisfied in full, without regard to any percentage limitations applied in computing net income under Section 117(b).

Court's Reasoning

The Tax Court reasoned that "returnable" refers to the gain or profit a taxpayer is required to report on their return, which isn't restricted to amounts included in net income. Section 51(a) of the Internal Revenue Code directs taxpayers to report their gross income, including gains from sales, as defined in Section 111. The court stated, "This cursory statement of the pertinent statutory provisions indicates that a taxpayer upon making a sale is required to report the entire gain therefrom in his return. Having done this, the taxpayer is then accorded the benefit of Section 117…" The court rejected the Lockharts' argument that Section 117 should be factored in before calculating the basis of the obligations. The court also noted that the Lockharts' approach would lead to an illogical result: the promissory notes would somehow acquire a basis significantly higher than the original property's basis. The court cited a Senate Finance Committee report illustrating that the profit should be calculated before applying capital gains percentages. The court concluded that the Commissioner's method, consistent with Treasury Regulations, correctly interpreted the law.

Practical Implications

Lockhart v. Commissioner clarifies the proper method for calculating taxable gain when installment obligations are satisfied for less than their face value. This case instructs tax practitioners to first determine the total profit that would have been realized from full satisfaction of the obligations. Only then should any applicable capital gains provisions be applied to determine the amount of gain included in net income. This ensures that the basis of the obligations is calculated correctly, preventing an artificial inflation of the basis and a corresponding reduction in taxable gain. This case has been consistently followed to calculate the basis of installment obligations when they are disposed of at other than face value.

