***4 T.C. 252 (1944)***

Real estate acquired by a bank through foreclosure, which it is legally obligated to sell and does not actively manage as a real estate business, is considered a capital asset for tax purposes, with gains or losses from its sale treated as capital gains or losses.

**Summary**

Kanawha Valley Bank acquired several properties through foreclosure as part of its loan recovery efforts. The Tax Court addressed whether gains from selling these properties and certain securities should be treated as ordinary income or capital gains. The court held that the foreclosed real estate was a capital asset because the bank was legally restricted from operating a real estate business and acquired the properties as an incident to its banking operations. Conversely, the court determined that the gains from government securities were ordinary income because the bank's practice was to subscribe and immediately sell the securities, indicating they were held for sale rather than investment. The treatment of paving certificates and stocks was also addressed.

**Facts**

Kanawha Valley Bank, operating in West Virginia, sold three parcels of real estate in 1940 that it had acquired through foreclosure. West Virginia law prevented the bank from engaging in the real estate business. The bank also engaged in transactions involving government securities, subscribing for allotments and then selling portions on an "if and when issued basis." Additionally, the bank held paving certificates and shares of stock as collateral for loans, some of which were sold at a profit.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in the bank's income taxes for 1940 and 1941, arguing that gains from real estate and securities sales should be treated as ordinary income rather than capital gains. The bank contested this assessment, leading to a hearing before the United States Tax Court.

**Issue(s)**

1. Whether real estate acquired by the bank through foreclosure constitutes a capital asset under Section 117(a)(1) of the Internal Revenue Code.
2. Whether gains from the sale of government securities, subscribed for and immediately sold by the bank, should be treated as ordinary income or capital gains.
3. Whether profits from paving certificates paid by obligors at maturity are considered gains from a sale or exchange under Section 117(f) of the Internal Revenue Code.
4. Whether shares of stock held as collateral and later sold by the bank are

capital assets.

**Holding**

1. Yes, because the bank was legally prohibited from engaging in the real estate business, and the acquisition and sale of the properties were incidental to its banking operations.
2. Yes, because the bank acquired the securities with the intent to sell them immediately, rather than hold them as investments, indicating they were held primarily for sale in the ordinary course of its business.
3. Yes, because there was no evidence the certificates carried interest coupons or were in registered form.
4. Yes, because stock can not be denied the character of capital asset merely because acquired through the enforcement of a lien as an incident of the collection of an indebtedness.

**Court's Reasoning**

The court reasoned that the real estate did not fall under the exceptions in Section 117(a)(1) for "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The court distinguished the bank's situation from that of a real estate business, emphasizing that the bank was legally restricted from operating as such. The court cited *Thompson Lumber Co., 43 B.T.A. 726*, noting that even with the power to carry on a real estate business, foreclosed properties were capital assets. As to the government securities, the court found the bank's intent was always to sell them rapidly, classifying the profits as ordinary income. Regarding the paving certificates, the court noted that the bank did not show the certificates to be of the character specified by Section 117(f), which would make the payment a sale or exchange for tax purposes. Finally, the stock was classified as a capital asset for the same reasons as the real estate.

**Practical Implications**

This case clarifies the circumstances under which foreclosed property can be considered a capital asset for financial institutions, particularly when state law restricts their ability to operate a real estate business. It highlights the importance of intent and the nature of business operations in determining whether assets are held for investment or for sale to customers. The decision emphasizes that banks passively liquidating foreclosed properties as part of debt collection, rather than actively engaging in real estate sales, can treat gains or losses as capital, offering potential tax advantages. This provides a valuable precedent for banks and other lending institutions managing foreclosed assets, and informs tax planning related to the disposition of such assets. Later cases will distinguish or follow this ruling based on the specifics of the entity's business and the nature of the asset disposition.

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