4 T.C. 708 (1945)

r
r

Payments received on defaulted notes and coupons are treated as a return of capital, reducing the cost basis, while payments representing accrued interest after acquisition are taxed as income.

r
r

Summary

r

Adrian & James, Inc., a personal holding company, purchased defaulted gold notes of a transit company. The court addressed the tax treatment of payments received on these notes, specifically whether they constituted a return of capital or taxable interest. The court held that payments on the principal of notes and coupons acquired after default were a return of capital. However, payments on coupons acquired before default, and "post-due interest" accruing after the notes were acquired, constituted taxable interest. The court also addressed the deductibility of taxes paid for a merged corporation and the computation of dividend carry-overs.

r
r

Facts

r

Petitioner, Adrian & James, Inc., purchased Interborough Rapid Transit Co. gold notes in 1925 and additional notes between 1932 and 1937. The Transit Co. defaulted on the notes in September 1932. After the default, the Transit Co. was placed in receivership. The court overseeing the receivership issued an order dictating how payments were to be allocated between principal and interest. Petitioner sold the notes in 1939. Additionally, Adrian & James, Inc. paid federal income tax for Acee Corporation, which had merged into Adrian & James. The tax returns were filed on a cash receipts and disbursements basis.

r
r

Procedural History

r

© 2025 SCOTUSreports.com. All rights reserved.

The Commissioner of Internal Revenue determined deficiencies in petitioner's income tax and personal holding company surtax for 1939. The case was brought before the United States Tax Court to resolve the tax treatment of the payments received on the defaulted notes, the deductibility of the tax payment for the merged corporation, and the computation of dividend carry-overs.

r
r

Issue(s)

r

r

1. Whether payments received by petitioner on Transit Co. notes and coupons during the receivership, derived from interest on pledged bonds, constituted a return of capital or taxable interest for determining the cost basis upon the sale of the notes.

   r

2. Whether the payment by petitioner of the income tax liability of Acee Corporation, a merged entity, is deductible for computing petitioner's dividend carry-over from 1937 to 1939.

   r

3. Whether interest received by petitioner in 1938 on U.S. obligations should be excluded from its adjusted net income for 1938 when calculating the dividend carry-over from 1938 to 1939.

   r

r
r

Holding

r

r

1. Yes in part and no in part, because payments on notes and coupons acquired after default are a return of capital, but payments on coupons acquired before default and "post-due interest" are taxable interest.

© 2025 SCOTUSreports.com. All rights reserved.

r

2. Yes, because the merged corporation’s tax liability became the petitioner’s liability under Delaware law.

   r

3. Yes, because the dividend carry-over should be computed based on the adjusted net income as defined in Section 13(a) of the Revenue Act of 1938.

   r

r
r

Court’s Reasoning

r

The court reasoned that payments on the principal of notes and coupons acquired after default represent a return of capital because the petitioner purchased the notes at a discounted price, reflecting the existing default. These payments reduce the cost basis. However, payments received on coupons acquired before the default constitute taxable interest because they represent income earned after the petitioner owned the coupons. The court also determined that

© 2025 SCOTUSreports.com. All rights reserved.