4 T.C. 829 (1945)

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Proceeds from the sale of discounted municipal bond coupons are not tax-exempt interest when a syndicate purchases old bonds, exchanges them for new bonds with coupons, detaches the coupons, and then sells the bonds and coupons separately.

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Summary

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H. Gates Lloyd, a partner in Drexel & Co., contested a tax deficiency arising from Drexel & Co.'s participation in a bond refunding syndicate. The syndicate bought old Philadelphia bonds, exchanged them for new bonds with two types of interest coupons (A and B), detached the B coupons, sold the new bonds with A coupons, and then sold the B coupons at a discount. The Tax Court held that the proceeds from the discounted B coupons were not tax-exempt interest but part of the overall gain or loss from the bond transactions, and thus taxable. This decision emphasizes that gains from dealing in municipal bonds are taxable even when involving instruments related to tax-exempt interest.

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Facts

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The City of Philadelphia sought to refund its outstanding bonds to take advantage of lower interest rates. Drexel & Co. and Lehman Brothers formed a syndicate to facilitate this. The syndicate agreed to exchange new refunding bonds for old outstanding bonds. The new bonds had A coupons (interest at the reduced rate) and B coupons (the difference between old and new rates until the old bonds' call date). The syndicate bought old bonds, exchanged them, detached the B coupons, sold the new bonds with A coupons, and separately sold the B coupons at a discount. H. Gates Lloyd was a partner in Drexel & Co., which had a 4% interest in the syndicate.

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Procedural History

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The Commissioner of Internal Revenue determined a deficiency in Lloyd’s income tax, arguing that the proceeds from the discounted B coupons were taxable income, not tax-exempt interest. Lloyd contested this determination in the Tax Court.

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Issue(s)

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Whether the proceeds from the discount sale of B coupons detached from municipal bonds are tax-exempt interest under Section 22(b)(4) of the Internal Revenue Code, or whether they should be considered part of the overall gain or loss from the bond transactions and included in gross income under Section 22(a).

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Holding

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No, because the syndicate was dealing in property, and the sale price was the total amount received for the bonds and coupons. The proceeds from discounting the B coupons are not tax-exempt interest separable from the computation of gain or loss on the sale of the new refunding bonds.

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Court’s Reasoning

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The court reasoned that the syndicate was not receiving

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