4 T.C. 931 (1945)

The substitution of stock for debt in a corporate reorganization under Section 77B of the Bankruptcy Act does not constitute a cancellation or reduction of indebtedness for purposes of adjusting the tax basis of the corporation's assets.

Summary

Motor Mart Trust, undergoing reorganization under Section 77B of the Bankruptcy Act, issued stock to its bondholders in exchange for their debt. The Commissioner of Internal Revenue argued that this exchange reduced the Trust's indebtedness, requiring a reduction in the tax basis of its building for depreciation purposes. The Tax Court held that exchanging stock for debt in a reorganization does not constitute a cancellation or reduction of debt under Sections 268 and 270 of the Chandler Act. Therefore, the Trust's original cost basis for depreciation was upheld, illustrating that a mere change in the form of obligation does not trigger a reduction in asset basis.

Facts

Motor Mart Trust acquired a leasehold and constructed a building financed by bonds and preferred shares. Due to financial difficulties, the Trust filed for reorganization under Section 77B of the Bankruptcy Act. The reorganization plan involved canceling existing securities and issuing new preferred and common shares to the bondholders and trustees in exchange for their claims. The Commissioner determined that the reorganization required the Trust to use the building's fair market value at the time of reorganization as its basis for depreciation, significantly reducing the depreciation deduction.

Procedural History

The Commissioner assessed deficiencies in the Trust's income and excess profits taxes for 1939 and 1940 based on the reduced depreciation deduction. The Trust petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court reviewed the Commissioner's determination, focusing on whether the reorganization resulted in a cancellation or reduction of the Trust's indebtedness.

Issue(s)

Whether the exchange of stock for debt in a Section 77B reorganization constitutes a cancellation or reduction of indebtedness under Sections 268 and 270 of the Chandler Act, thereby requiring an adjustment to the tax basis of the reorganized entity's assets.

Holding

No, because the substitution of stock for bonds in a reorganization proceeding is a

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continuation of the obligation in another form, not a cancellation or reduction of debt within the meaning of the tax law.

Court’s Reasoning

The Tax Court relied on *Capento Securities Corporation, 47 B.T.A. 691*, and *Alcazar Hotel, Inc., 1 T.C. 872*, holding that substituting stock for bonds does not effect a cancellation or reduction of indebtedness. The court reasoned that the obligation to make payment to those who advanced money for the building’s construction continued in another form. Citing the Commissioner’s earlier letter stating there was an “exchange of its new convertible preferred shares and common stock for its first and second mortgage bonds and the accrued interest thereon,” the court found this was not a debt cancellation triggering a basis reduction. The court distinguished this situation from cases involving the discharge of indebtedness for less than its face value, as in *United States v. Kirby Lumber Co., 284 U.S. 1*.

Practical Implications

This case clarifies that exchanging stock for debt in a corporate reorganization does not automatically trigger a reduction in the tax basis of the corporation’s assets. It is significant for companies undergoing restructuring, as it allows them to preserve their asset basis for depreciation purposes, potentially leading to lower tax liabilities. This ruling encourages companies to explore stock-for-debt swaps as a means of restructuring without adverse tax consequences related to asset basis. Later cases have distinguished this ruling based on the specific facts of debt forgiveness versus debt restructuring through equity issuance.

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