Estate of Bertha B. Lowenstein v. Commissioner, 6 T.C. 1135 (1946)

Payment received by a creditor from a debtor in satisfaction of a judgment is not considered a sale or exchange, and therefore does not qualify for capital gains treatment under Section 117 of the Internal Revenue Code of 1939.

Summary

The petitioner, Estate of Bertha B. Lowenstein, received a payment on a judgment against a corporation. Lowenstein argued that this payment should be taxed as a long-term capital gain, claiming it arose from either a "sale or exchange" of a capital asset or the "retirement of notes." The Tax Court disagreed, holding that the receipt of payment on a judgment from the debtor is not a "sale or exchange." Furthermore, the court found that the notes underlying the judgment were not "in registered form," a requirement for capital gains treatment upon retirement under Section 117(f) of the Internal Revenue Code. Thus, the payment was taxable as ordinary income, not capital gain.

Facts

The petitioner held notes from a corporation. These notes were also endorsed by members of a bondholders' protective committee. The petitioner obtained a judgment against the corporation and the endorsers on these notes. Subsequently, the petitioner received a payment representing a portion of the principal due on the judgment. The petitioner conceded that the portion of the payment representing interest and the portion applicable to notes made by the committee members were taxable as ordinary income. The dispute concerned the tax treatment of the portion of the payment applicable to the principal of the notes issued by the corporation and endorsed by the committee members.

Procedural History

The case originated in the Tax Court of the United States. The Commissioner of Internal Revenue determined a deficiency in income tax against the Estate of Bertha B. Lowenstein. The estate petitioned the Tax Court to redetermine the deficiency. This Tax Court opinion represents the court's initial ruling on the matter.

Issue(s)

1. Whether the payment received by the petitioner in satisfaction of a judgment against the corporation constitutes gain from the "sale or exchange" of a capital asset under Section 117(a)(4) of the Internal Revenue Code.
2. Whether the payment received by the petitioner can be considered as "amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation…in registered form" under Section 117(f) of the Internal Revenue Code.

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Holding

1. No, because the payment received by a debtor in satisfaction of a judgment is not considered a “sale or exchange” under Section 117(a)(4) of the Internal Revenue Code.
2. No, because even if the payment were considered a retirement of notes, the notes were not shown to be “in registered form” as required by Section 117(f) of the Internal Revenue Code.

Court’s Reasoning

The court reasoned that the payment on the judgment was not a “sale or exchange.” Citing precedent, including *Hale v. Helvering* and *Fairbanks v. United States*, the court established that payments by a debtor to satisfy an obligation are not considered sales or exchanges for capital gains purposes. The court rejected the petitioner’s argument that the payment from the endorsers constituted a “forced sale” through subrogation, deeming it a “strained interpretation” of the statute unsupported by authority. Regarding the “retirement of notes” argument, the court emphasized the requirement that the notes be “in registered form.” The court found no evidence that the notes were registered in the conventional sense, meaning ownership was listed in a register and negotiability was restricted by registration. The court quoted *Gerard v. Helvering*, stating that “'[i]t refers to the common practice in the issuance of corporate bonds which allows the holder of one or more coupon bonds of a series the option to surrender them and have one bond “registered” upon the books of the obligor, or of a transfer agent…The purpose is to protect the holder by making invalid unregistered transfers, and the bond always so provides upon its face.’” Because the notes were not registered, they did not meet the statutory requirements for capital gains treatment upon retirement.

Practical Implications

This case clarifies that receiving payment on a judgment from the original debtor is not a “sale or exchange” for tax purposes, a crucial distinction for creditors seeking capital gains treatment. It reinforces the importance of the “sale or exchange” requirement for capital gains and highlights that mere satisfaction of a debt obligation does not meet this criterion. Furthermore, it underscores the specific requirements for capital gains treatment upon the retirement of corporate debt instruments, particularly the necessity for such instruments to be “in registered form.” This case is instructive for tax practitioners advising clients on the tax implications of debt collection and judgment enforcement, emphasizing that such recoveries are generally taxed as ordinary income unless specific statutory exceptions, like a true sale or exchange, apply.

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