7 T.C. 192 (1946)

When stock warrants are received in a non-taxable corporate reorganization in exchange for accrued and unpaid interest on debentures, and the interest has never been reported as taxable income, the warrants have a zero cost basis for determining gain or loss upon their subsequent sale.

Summary

The taxpayers, beneficiaries of a trust, sold stock warrants they received during a corporate reorganization and claimed capital losses. The warrants were issued in lieu of accrued interest on debenture bonds held by the trust. The Commissioner of Internal Revenue disallowed the losses, arguing the warrants had a zero basis because the interest income was never taxed. The Tax Court upheld the Commissioner, stating the warrants were received specifically in settlement of past-due interest, and since that interest had no cost basis (never having been taxed), the warrants also had no cost basis.

Facts

John Scullin established a testamentary trust. The trust's assets included debenture bonds of Scullin Steel Co.
Scullin Steel Co. underwent a reorganization under Section 77-B of the Bankruptcy Act.
The reorganization plan involved exchanging the old debentures for new preferred stock and warrants.
The trust received preferred stock for the principal of the debentures and warrants in lieu of accrued and unpaid interest on those debentures.
The trust immediately distributed the warrants to the beneficiaries, who did not report any income from their receipt.
In 1941, the beneficiaries sold some warrants, claiming capital losses based on an allocated portion of the original debentures' cost basis.

Procedural History

The Commissioner disallowed the claimed capital losses from the sale of the warrants, determining they had a zero basis.
The taxpayers petitioned the Tax Court, contesting the Commissioner's determination.
The Tax Court consolidated the cases.

Issue(s)

Whether the taxpayers were entitled to deduct capital losses when they sold stock warrants received in a corporate reorganization, where the warrants were issued in lieu of accrued and unpaid interest on debentures and the interest had never been reported as taxable income.

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Holding

No, because the stock purchase warrants had no cost basis to the trustees of the testamentary trust or to the beneficiaries. The warrants were received in satisfaction of accrued interest, which was never taxed; therefore, they had a zero basis.

Court's Reasoning

The court emphasized that the reorganization plan specifically allocated the new preferred stock to the old debentures and the warrants to the accrued interest. Section VII of the reorganization plan stated that the 29,940 shares of Preferred Stock were for the holders of the outstanding Debentures which "shall then be cancelled, together with the coupons evidencing interest thereon."
The court stated that because the warrants were received in lieu of unpaid interest which had never been included in taxable income, the warrants had no cost basis under Section 113 of the Internal Revenue Code. The court quoted Section IX of the reorganization plan: "B. 79,840 thereof to the holders of the Debentures, which warrants are in lieu of and in satisfaction for all accrued, accumulated and unpaid interest upon said Debentures".
The court distinguished Morainville v. Commissioner, 135 Fed. (2d) 201, arguing the Commissioner wasn't contending that the receipt of warrants was taxable income in 1937 but was instead focusing on the basis of those warrants upon sale in 1941.
The court rejected the taxpayers' argument that the cost basis of the old debentures should be allocated between the preferred stock and the warrants. The court reasoned that the plan of reorganization clearly indicated the debentures were exchanged for preferred stock, and the warrants were exchanged for unpaid interest. The unpaid interest had never been taxed; therefore, the warrants had no cost basis.

Practical Implications

This case illustrates that the tax treatment of securities received in a corporate reorganization depends heavily on the specific allocation outlined in the reorganization plan.
It clarifies that when new securities are explicitly designated as being received in lieu of accrued but unpaid interest, and that interest was never included in income, those securities will have a zero cost basis.
Attorneys and tax advisors should carefully examine reorganization plans to determine the basis of assets received, especially when dealing with accrued interest or dividends.
This ruling prevents taxpayers from converting what would have been ordinary income (taxable interest) into a capital loss by allocating a portion of the original investment's basis to securities received in lieu of that income.

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