7 T.C. 228 (1946)

When determining the basis for gain or loss on securities acquired in a corporate reorganization, the tax treatment of the exchange in prior years is controlling if the tax liability for those years has been finalized.

Summary

Bertha Henry exchanged bonds in a bankrupt company for new bonds and stock in a reorganized entity. She initially claimed a bad debt loss, which was disallowed. Later, she sought to deduct a loss on the exchange, but it was also disallowed. When she finally sold the new securities, the IRS argued for a gain based on their fair market value at the time of the exchange. The Tax Court held that because no loss was recognized in the final determination of her tax for the year of the exchange, the basis of the original bonds carried over to the new securities, allowing her to deduct a capital loss upon their sale.

Facts

In 1925, Bertha Henry purchased $5,000 in bonds of Allerton-Cleveland Co. The company defaulted on interest payments in 1929, leading to a bondholders' committee. In 1935, Henry wrote off the bonds as worthless, claiming a $5,000 bad debt loss, which was disallowed by the IRS. In 1936, the company underwent bankruptcy reorganization, resulting in the creation of Cleveland-Allerton Hotel, Inc. Henry exchanged her old bonds for $500 in new bonds and 10 shares of stock in the new company.

Procedural History

The IRS disallowed Henry's 1935 bad debt deduction. In 1938, during an examination of Henry's 1936 return, her request for a bad debt deduction related to the exchange was also disallowed. The IRS determined a deficiency for 1936, which Henry paid. In 1941, when Henry sold the new bonds and stock, she claimed a capital loss. The IRS disallowed the loss, asserting a capital gain. Henry then petitioned the Tax Court.

Issue(s)

Whether, for the purposes of determining gain or loss, the basis of securities received in a corporate reorganization is the original cost of the exchanged securities or the fair market value of the new securities at the time of the exchange, when the tax treatment of the exchange in the year it occurred was previously determined.

Holding

No, because under Section 112(l)(2)(A) of the Internal Revenue Code, as

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retroactively applied by the Revenue Act of 1943, the tax treatment accorded to the exchange in the final determination for the year of the exchange controls. Since no loss was recognized then, the basis carries over.

Court’s Reasoning

The court relied on Section 121 of the Revenue Act of 1943, which retroactively amended the Internal Revenue Code to address the tax consequences of insolvency reorganizations. The court emphasized that, according to the Senate Finance Committee, the intent was to provide clarity and uniform tax treatment for these reorganizations, affecting both corporations and security holders. Section 112(l)(2)(A) specifically addresses exchanges occurring before 1943, stating that gain or loss recognition depends on the tax treatment in the final determination for the year of the exchange. The court found that because the IRS had disallowed Henry’s claimed loss deductions related to the exchange in prior years, no loss was

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