*7 T.C. 554 (1946)*

Section 112(b)(9) of the Internal Revenue Code, concerning non-recognition of loss in certain railroad reorganizations, does not apply to deny a deduction for a balance due on bonds of a railroad, held by a non-railroad corporation, that became uncollectible.

**Summary**

Bar B Company owned bonds of a railroad that underwent reorganization. After the reorganization, a portion of the debt owed to Bar B Company became worthless. Bar B Company claimed a loss deduction, which the Commissioner disallowed, arguing that Section 112(b)(9) of the Internal Revenue Code prevented the recognition of the loss. The Tax Court held that Section 112(b)(9) did not apply to Bar B Company, as that section was intended to protect the railroads themselves from recognizing losses during reorganization, not to deny deductions to creditors of the railroad. Thus, Bar B Company was allowed to deduct the loss.

**Facts**

Bar B Company owned first mortgage bonds of the Utah-Idaho Central Railroad Co. for which its basis was $90,297.72. The railroad's properties were sold at a receiver's sale to a bondholders' committee. The committee purchased the properties and then transferred them to a new corporation, Utah-Idaho Central Railroad Corporation, which was formed to effectuate the reorganization plan. Bar B Company paid a portion of the bid price by crediting its bonds at a certain rate, which left an uncollected amount due on the bonds with a basis of $55,532.72. The remaining debt became worthless in 1940.

**Procedural History**

Bar B Company reported a long-term loss on its 1940 income tax return. The Commissioner of Internal Revenue disallowed the deduction, leading to a deficiency assessment. Bar B Company petitioned the Tax Court for a redetermination of the deficiency.

**Issue(s)**

Whether Section 112(b)(9) of the Internal Revenue Code applies to deny a deduction for a balance due on bonds of a railroad, which became uncollectible, when the bondholder is not a railroad corporation?

**Holding**

No, because Section 112(b)(9) is intended to apply to the railroad corporation undergoing reorganization, not to the corporation holding bonds of the railroad.

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## Court’s Reasoning

The court reasoned that Section 112(b)(9) is an exception to the general rule that gains or losses from the sale or exchange of property shall be recognized. The Commissioner argued that the section applied to deny Bar B Company’s loss deduction. However, the Tax Court disagreed, stating, “The deduction in question is not based upon a transfer by the petitioner of ‘property of a railroad corporation’ to a railroad corporation. The petitioner is not a railroad corporation.” The court emphasized that the legislative history of Section 112(b)(9) indicates that it was enacted to help debt-ridden railroads by allowing them to retain their old basis after a transfer in receivership. The provision was not meant to apply to losses of owners on securities issued by railroads. The court stated, “Congress enacted it along with section 113 (a) (20) to help debt-ridden railroads out of receiverships… The provision did not apply to losses of owners on securities issued by railroads and was not interpreted in the Commissioner’s regulations as applying to such losses.”

## Practical Implications

This case clarifies the limited scope of Section 112(b)(9) of the Internal Revenue Code. It establishes that the section’s non-recognition of loss provision applies primarily to railroad corporations undergoing reorganization, preventing them from recognizing losses on the transfer of their property during such proceedings. It provides guidance that the statute should not be interpreted to deny deductions to creditors or bondholders of the railroad, who experience losses on their investments as a result of the railroad’s financial difficulties. This ruling helps to ensure that investors are not unfairly penalized by a provision designed to aid struggling railroads. Later cases and IRS guidance would need to address scenarios where a creditor might also be considered to be acting in the capacity of the railroad in the reorganization.

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