10 T.C. 135 (1948)

Scrip issued to bondholders in a reorganization to satisfy past-due interest retains its character as interest for tax purposes and is excluded from borrowed invested capital; further, the issuance of scrip for the full amount of defaulted interest, even if its market value is less than its face value, does not automatically justify amortization as bond discount unless a loss is forecasted upon ultimate payment.

Summary

McKinney Manufacturing Company challenged the Commissioner's deficiency determination, arguing that non-interest-bearing scrip issued during reorganization should be included as borrowed invested capital for excess profits tax credit and that they were entitled to amortize the difference between the scrip's face value and market value. The Tax Court held that the scrip retained its character as interest, thus excluding it from borrowed invested capital. Additionally, because the scrip represented past-due interest and did not forecast a loss upon payment, the court disallowed amortization of the difference between face value and market value as bond discount. The case clarifies the tax treatment of scrip issued in corporate reorganizations and the requirements for claiming bond discount amortization.

Facts

McKinney Manufacturing Co. reorganized in 1939 due to outstanding 6% first mortgage bonds with accrued unpaid interest. Under the reorganization plan, bondholders exchanged each $1,000 bond plus unpaid interest coupons for 10 shares of preferred stock and $360 of non-interest-bearing scrip maturing in 15 years. The scrip was issued to cover six years of accrued interest ($360) on each bond. The scrip's market value at issuance was significantly below its face value (approximately 10 cents on the dollar). The company sought to include the scrip in its borrowed invested capital for excess profits tax purposes and to amortize the difference between the face value and the market value of the scrip as bond discount.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in McKinney Manufacturing Company's declared value excess profits tax and excess profits tax for the fiscal years ended June 30, 1942 and 1943. The company petitioned the Tax Court to challenge the Commissioner's determination. The Tax Court addressed several issues, including the treatment of the scrip issued in the 1939 reorganization.

Issue(s)

1. Whether non-interest-bearing scrip issued by petitioner in connection with its reorganization should be included as borrowed invested capital for the purpose of

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computing its excess profits tax credit under section 719 (a) (1) of the Internal Revenue Code?

2. Whether the petitioner is entitled to a ratable allowance for amortization of the difference between the face amount of the scrip outstanding and its value upon issuance?

Holding

1. No, because the scrip retained its character as interest and is therefore excluded from borrowed invested capital under section 719 (a) (1) of the Internal Revenue Code.

2. No, because the issuance of scrip in the face amount of the defaulted interest obligation did not forecast a loss to the petitioner upon ultimate payment, and therefore does not justify amortization as bond discount.

Court’s Reasoning

Regarding the first issue, the court reasoned that the scrip was issued solely on account of past-due and unpaid interest on the bonds. Citing Palm Beach Trust Co., <span normalizedcite="9 T.C. 1060“>9 T.C. 1060, the court stated that since the scrip represented interest, it should be excluded from borrowed invested capital under section 719 (a) (1). The court emphasized the origin of the scrip as a satisfaction of past due interest obligations.

As to the second issue, the court denied the amortization deduction because the payment the petitioner would make when the scrip became due was not greater than the pre-existing interest obligation. The court explained that bond discount is based on the concept of compensation for a prospective loss, and since the scrip represented the interest obligation, there was no actual loss. The court cited Atlanta & Charlotte Air Line Railroad Co., <span normalizedcite="36 B.T.A. 558“>36 B.T.A. 558, stating that there was no warrant for applying bond discount in this situation where the scrip represented pre-existing debt.

Practical Implications

This case provides guidance on the tax treatment of scrip issued during corporate reorganizations, particularly when used to satisfy past-due obligations like interest. The decision emphasizes that the character of the underlying obligation determines the tax treatment of the scrip. If the scrip represents interest, it is treated as such for tax purposes, affecting calculations like borrowed invested capital. The case also clarifies that a difference between the face value and market value of scrip at issuance does not automatically create a deductible bond discount. A taxpayer must demonstrate a prospective loss beyond the original obligation for such a deduction to be warranted. Later cases would distinguish McKinney by focusing on whether the scrip represented something other than a pre-existing obligation, or whether the

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facts demonstrated an actual loss to the issuer beyond the satisfaction of that original obligation.

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