10 T.C. 1001 (1948)

A taxpayer can amortize the premium paid on callable and convertible bonds in the year of acquisition, even if the premium is attributable to the conversion feature, if the option to convert rests with the bondholder.

Summary

The taxpayer, Christian Korell, purchased American Telephone & Telegraph Co. convertible debenture bonds at a premium. These bonds were callable on 30 days' notice. Korell deducted the premium as amortization in the year of purchase. The Commissioner disallowed the deduction, arguing that the premium was paid for the conversion feature, not the investment. The Tax Court held that Korell could deduct the premium in the year of purchase because the bonds were callable and the option to convert rested with the bondholder, aligning with Congressional intent.

Facts

Korell purchased $50,000 of American Telephone & Telegraph Co. 3% convertible debenture bonds in 1944 at a price above face value (at a premium).

The bonds were convertible into common stock at $140 per share, while the market price of the stock was around $163 per share.

The bonds were callable by the company on 30 days' notice at specified redemption prices, with the call price being 104% of the face value at the time of Korell's purchase.

Korell did not sell the bonds or convert them into stock in 1944.

The entire issue of bonds was called for redemption on September 1, 1947.

Procedural History

Korell deducted the bond premium amortization on his 1944 tax return.

The Commissioner of Internal Revenue disallowed the deduction, leading to a deficiency assessment.

Korell petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

Whether the taxpayer is entitled to deduct the premium paid on callable and convertible bonds as amortization in the year of purchase, where the premium may be attributable to the conversion feature.

Holding

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Yes, because the legislative history of Section 125 explicitly states that convertible bonds are within its purview if the option to convert rests with the bondholder, and the bonds were also callable on short notice.

Court's Reasoning

The court acknowledged the Commissioner's argument that the premium was paid for the conversion privilege, not the investment feature of the bond. However, the court relied heavily on the legislative history of Section 125 of the Internal Revenue Code, specifically the reports from the Ways and Means Committee and the Finance Committee.

The court quoted the committee reports: "The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section... In the case of a convertible bond, *if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of this section*."

The court found that the Commissioner's regulation (Sec. 29.125-5) added a condition ("on a date certain") not found in the statute or its legislative history, and therefore, the court gave greater weight to the expressed congressional intent.

The court reasoned that since Korell, as the bondholder, had the option to convert, the bond fell within the scope of Section 125, and the premium was deductible as amortization.

Practical Implications

This case clarifies the circumstances under which bond premiums on convertible bonds can be amortized. It emphasizes the importance of legislative history in interpreting tax statutes.

Taxpayers holding callable and convertible bonds with conversion options resting with them can deduct the premium, subject to the limitations and conditions of Section 125.

This decision highlights that even if the premium is largely attributable to the conversion feature, the amortization deduction is still available if the conversion option rests with the bondholder and the bonds are callable. It also indicates the courts will look to legislative history to determine congressional intent when interpreting tax laws.

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