National Bank of Commerce of Seattle v. Commissioner, 12 T.C. 717 (1949)

The "recovery exclusion" under Section 22(b)(12) of the Internal Revenue Code is only available to the same entity that both charged off the debt as bad and subsequently recovered it; a successor entity cannot claim the exclusion based on the predecessor's actions.

Summary

National Bank of Commerce of Seattle sought to exclude from its 1942 and 1943 taxable income certain recoveries on debts that its predecessor banks had charged off as worthless in 1933. The predecessor banks' 1933 deductions did not reduce their tax liability due to other losses. The Tax Court held that the bank could not claim the "recovery exclusion" under Section 22(b)(12) because the predecessor banks, and not the petitioner, had taken the original deductions. Res judicata from a prior case was deemed inapplicable due to a change in the relevant tax statute. The Court emphasized that the same entity must charge off and recover the debt to qualify for the exclusion.

Facts

- In 1933, Marine Bancorporation owned approximately 90% of the petitioner, National Bank of Commerce of Seattle, and six smaller banks.
- Pursuant to a reorganization plan, the assets of the six smaller banks were transferred to the petitioner, subject to their liabilities. The petitioner continued the business of the smaller banks through its branches.
- Prior to the transfer, the smaller banks charged off certain debts considered worthless or subject to examiner criticism.
- Deductions were claimed for some of these debts in the smaller banks' 1933 income tax returns.
- The 1933 deductions did not result in a reduction of the predecessor banks' tax liability due to other losses they sustained.
- In 1942 and 1943, the petitioner recovered some of these previously charged-off debts.

Procedural History

- The Commissioner determined that the recoveries should be included in the petitioner's gross income for 1942 and 1943.
- The petitioner appealed to the Tax Court, arguing it was entitled to a "recovery exclusion" under Section 22(b)(12) of the Internal Revenue Code.
- A prior case, National Bank of Commerce of Seattle v. Commissioner, involving recoveries in 1934, had been decided against the bank by the Board of Tax Appeals (affirmed by the Ninth Circuit), but the Tax Court found that decision was not res judicata due to changes in the tax law.

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Issue(s)

1. Whether the doctrine of res judicata bars the petitioner from claiming a recovery exclusion based on a prior decision involving recoveries in a different tax year.
2. Whether the petitioner, as the successor bank, is entitled to the "recovery exclusion" under Section 22(b)(12) of the Internal Revenue Code for debts charged off by its predecessor banks, when those deductions did not reduce the predecessor banks' tax liability.

Holding

1. No, because a different tax statute (Section 22(b)(12) I.R.C., enacted in 1942) is involved in this proceeding, changing the legal issue.
2. No, because the "recovery exclusion" is only available to the same entity that both charged off the debt and recovered it.

Court's Reasoning

- The court distinguished this case from its prior ruling and the Supreme Court's holding in *Commissioner v. Sunnen* (333 U.S. 591 (1948)), stating that the enactment of Section 22(b)(12) created a new legal question.
- The court interpreted Section 22(b)(12) as requiring the same entity to both charge off the debt and recover it to qualify for the "recovery exclusion."
- The court relied on *Michael Carpenter Co. v. Commissioner*, 136 F.2d 51 (7th Cir. 1943), where a successor corporation could not use the tax attributes of its predecessor to avoid tax on recovered processing taxes.
- The court reasoned that the petitioner never considered the debt to be bad, had not charged off any deduction for loss, and therefore, was not eligible for the tax benefit provided by the recovery exclusion.
- The court quoted *Rice Drug Co., 10 T.C. 642,* stating "the same entity must charge off and recover, in order to exclude the recovery from income."

Practical Implications

- This case clarifies that the "recovery exclusion" under Section 22(b)(12) is a personal attribute of the taxpayer who originally took the deduction, and it does not automatically transfer to a successor entity in a reorganization.
- Legal practitioners should carefully analyze whether the same taxpayer both took the initial deduction and made the subsequent recovery when determining eligibility for the "recovery exclusion".
- This decision emphasizes the importance of maintaining separate identities for tax purposes, even in the context of reorganizations.
- The case is frequently cited in tax law for the principle that tax attributes are not freely transferable between entities.
- Later cases distinguish this ruling by focusing on situations where the

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successor entity is essentially a continuation of the predecessor’s business, or where specific statutory provisions allow for the transfer of tax attributes.

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