13 T.C. 623 (1949)

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A transaction structured as a sale of a debt instrument will be recharacterized for tax purposes if it is, in substance, a payment on that debt, with the determination focusing on the economic realities rather than the formal steps taken.

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Summary

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Conrad Hilton sold a debenture note to a bank. The Tax Court examined whether this transaction should be treated as a sale of a capital asset, resulting in capital gains, or as a payment on the note, resulting in ordinary income. The court found that $75,000 of the transaction was effectively a payment on the note facilitated through the bank, while the remaining $100,000 was a bona fide sale. The court reasoned that the substance of the transaction, not its form, dictates its tax treatment, and an existing settlement agreement did not preclude capital gains treatment on the portion that was genuinely sold.

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Facts

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Hilton received a $250,000 debenture note from the Lubbock Hilton Hotel Co. in exchange for a judgment. Over time, the note was paid down to $175,000. Hilton needed funds and explored selling the note. He contacted Sam Young at El Paso National Bank. Young indicated the bank could only lend a maximum of $100,000, requiring the note to be reduced to that amount. Hilton arranged for the hotel to pay $75,000. Ultimately, Hilton’s account was credited $175,243.05 by the bank, but shortly thereafter, the hotel paid $75,000 to the bank. Hilton had previously agreed with the IRS to treat payments on the note as ordinary income.

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Procedural History

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The Commissioner of Internal Revenue determined a deficiency in Hilton's 1944 income tax, arguing the transaction was not a sale, but a payment on the note resulting in ordinary income. Hilton contested this determination in Tax Court, arguing the disposition of the note was a sale of a capital asset eligible for capital gains treatment.

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Issue(s)

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Whether the transaction involving the disposition of the Lubbock Hilton Hotel Co. note should be treated as a sale of a capital asset, eligible for capital gains treatment, or as a payment on the note, resulting in ordinary income; and whether a prior settlement agreement with the IRS estops Hilton from claiming capital gains treatment.

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Holding

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1. No, as to $75,000 of the transaction because it was, in substance, a payment on the note facilitated through the bank, which acted as a mere conduit.

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2. Yes, as to $100,000 of the transaction because it constituted a bona fide sale of a portion of the note to the bank.

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3. No, the prior settlement agreement does not estop Hilton because it only addressed the treatment of

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