***13 T.C. 1029 (1949)***

In a corporate reorganization, the exchange of old bonds for new securities, including stock representing accrued interest, qualifies as a tax-free exchange, but cash payments received as adjustments for the period between the effective date of the reorganization and the actual exchange are taxable as ordinary income.

**Summary**

William Carman exchanged bonds of a company undergoing reorganization for new bonds and stock in the reorganized entity. The exchange was deemed to have occurred on January 1, 1939, the effective date of the reorganization, though the actual exchange occurred in 1944. In 1944, Carman also received cash payments to compensate for the delay in receiving the new securities. The Tax Court held that the exchange of securities was tax-free under Section 112(b)(3) of the Internal Revenue Code, as the accrued interest was an integral part of the security. However, the cash adjustment payments were deemed outside the exchange and taxable as ordinary income because they related to the period after the effective reorganization date.

**Facts**

The Western Pacific Railroad Co. underwent reorganization under Section 77 of the Bankruptcy Act. William Carman owned $25,000 face value of the company's first mortgage bonds. Interest on these bonds was in arrears from September 1, 1933. The reorganization plan, approved in 1939, stipulated an effective date of January 1, 1939. The plan provided that bondholders would receive new income-mortgage bonds, preferred stock, and common stock for their old bonds and accrued unpaid interest. The actual exchange of securities occurred in 1944, at which time Carman also received cash adjustment payments to compensate for the period between the effective date of the reorganization and the actual exchange.

**Procedural History**

The company filed for reorganization in district court, which approved a plan certified by the Interstate Commerce Commission. The Circuit Court of Appeals reversed the district court's order, but the Supreme Court reversed the Circuit Court and affirmed the district court's approval. The district court then confirmed the plan and approved adjustment payments. The IRS later assessed a deficiency against Carman, leading to this case in the Tax Court.

**Issue(s)**

1. Whether the receipt of common stock in exchange for accrued interest on old bonds, as part of a corporate reorganization, qualifies as a tax-free exchange under Section 112(b)(3) of the Internal Revenue Code.

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2. Whether cash adjustment payments received as compensation for the period between the effective date of the reorganization plan and the actual exchange of securities are taxable as ordinary income or qualify for tax-free exchange treatment under Section 112(b)(3).

**Holding**

1. Yes, because the accrued interest is considered an integral part of the bond security, and the exchange of old bonds, including the accrued interest, for new securities is tax-free under Section 112(b)(3).

2. No, because the cash adjustment payments are not part of the exchange of securities contemplated by the reorganization plan effective January 1, 1939, and are therefore taxable as ordinary income.

**Court's Reasoning**

The Tax Court reasoned that the accumulated unpaid interest on the old bonds was not separate from the bonds themselves but was an integral part of the security. Citing Fletcher's Cyclopedia of the Law of Private Corporations and Section 23 of the Internal Revenue Code, the court emphasized that coupons and interest are inherently linked to the underlying bond. The court stated, "However, coupons are part of a bond and are affected by its infirmity as well as endowed with its strength and their character is not changed by detaching them from the bond." Therefore, the common stock received in exchange for the accrued interest was part of a tax-free exchange under Section 112(b)(3). However, the cash adjustment payments were made to compensate for the delay in receiving the new securities and represented earnings that would have been distributed had the reorganization been completed earlier. Because these payments related to the period after the effective date of the reorganization (January 1, 1939) and were not part of the original exchange of securities, they were deemed taxable as ordinary income.

**Practical Implications**

This case clarifies the tax treatment of securities and cash received in corporate reorganizations. It confirms that accrued interest on bonds is considered part of the security for tax purposes, allowing for tax-free exchanges of bonds for new securities. However, it establishes a clear distinction between the exchange of securities and later adjustment payments. Attorneys advising clients on corporate reorganizations must carefully analyze the nature and timing of payments to determine their tax implications. Later cases applying this ruling focus on whether payments are directly tied to the exchange of securities or represent compensation for delays or other factors, impacting their tax treatment.

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