Union Pacific Railroad Company, et al., Petitioners, v. Commissioner of Internal Revenue, Respondent., T.C. Memo. (1949)

Taxpayers using accrual accounting must recognize income when the right to receive it is fixed and there is a reasonable expectation of receipt, even if payment is deferred; modifications of bond terms under a reorganization plan may qualify as a recapitalization and not result in a taxable exchange; and taxpayers using the retirement method of accounting for railroad assets are not required to adjust for pre-1913 depreciation.

Summary

Union Pacific Railroad Company, using accrual accounting, deferred reporting a portion of bond interest income due from Lehigh Valley Railroad, arguing uncertainty of receipt. The Tax Court held that the interest was accruable as the obligation was absolute and receipt was reasonably expected. Further, the court addressed whether modifications to Baltimore & Ohio Railroad bonds constituted a taxable exchange. It concluded that these modifications were part of a recapitalization and thus a tax-free reorganization. Finally, the court considered whether Union Pacific, using the retirement method of accounting for railroad assets, needed to adjust for pre-1913 depreciation. The court ruled against this adjustment, finding it inconsistent with the retirement method.

Facts

Union Pacific owned bonds of Lehigh Valley Railroad Co. and Baltimore & Ohio Railroad (B&O). Lehigh Valley deferred 75% of interest payments due in 1938-1940 under a reorganization plan, paying them in 1942-1945. Union Pacific, on accrual accounting, only reported interest received in 1938 and 1939. B&O also modified terms of its bonds in 1940 under a plan. In 1941, Union Pacific sold some B&O bonds, claiming a capital loss based on original cost. Union Pacific used the retirement method of accounting for its railroad assets and did not reduce the basis of retired assets for pre-1913 depreciation.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Union Pacific for underreporting income in 1938, 1939, and for improperly calculating capital loss in 1941. Union Pacific petitioned the Tax Court for review of the Commissioner's determinations.

Issue(s)

1. Whether Union Pacific, on the accrual basis, was required to accrue the full amount of interest income from Lehigh Valley bonds in 1938 and 1939, even though a portion was deferred and not received until later years.
2. Whether the modification of terms of the B&O bonds in 1940 constituted a

taxable exchange for Union Pacific.
3. Whether Union Pacific, using the retirement method of accounting for its ways and structures, was required to adjust the basis of retired assets for depreciation sustained prior to March 1, 1913.

Holding

1. Yes, because the obligation to pay the full interest was absolute, and there was a reasonable expectation of receipt, despite the temporary deferment.
2. No, because the modification of the B&O bonds constituted a recapitalization, which is a form of tax-free reorganization under Section 112(g) of the Internal Revenue Code, and thus not a taxable exchange.
3. No, because requiring an adjustment for pre-1913 depreciation is inconsistent with the principles of the retirement method of accounting as applied to railroad assets.

Court's Reasoning

Accrual of Interest Income: The court reiterated the accrual accounting principle: "*where a taxpayer keeps accounts and makes returns on the accrual basis, it is the right to receive and not the actual receipt that determines the inclusion of an amount in gross income.*" The court found no evidence suggesting that in 1938 and 1939 there was reasonable doubt that the deferred interest would be paid. The Lehigh Valley plan itself indicated a belief that the financial difficulties were temporary, and the deferred interest was indeed paid. Therefore, accrual was proper.

Taxable Exchange of Bonds: Relying on precedent (*Commissioner v. Neustadt's Trust* and *Mutual Fire, Marine & Inland Insurance Co.*), the court held that the B&O bond modification was a recapitalization and thus a reorganization under Section 112(g). This meant the alterations were treated as a continuation of the investment, not an exchange giving rise to taxable gain or loss. The basis of the new bonds remained the cost basis of the old bonds.

Pre-1913 Depreciation Adjustment: The court upheld its prior decision in *Los Angeles & Salt Lake Railroad Co.*, stating that under the retirement method of accounting, adjustments for pre-1913 depreciation are not "proper." The retirement method, unique to railroads, expenses renewals and replacements, unlike standard depreciation methods. Requiring a pre-1913 depreciation adjustment would create an imbalance, as the system isn't designed to track depreciation in that manner. The court quoted *Southern Railway Co. v. Commissioner*, explaining the impracticality of detailed depreciation accounting for railroads due to the volume of similar replacement items.

Practical Implications

This case clarifies several tax accounting principles. For accrual accounting, it emphasizes that deferral of payment doesn't prevent income accrual if the right to receive is fixed and collection is reasonably expected. It reinforces that bond modifications under reorganization can be tax-free recapitalizations, preserving the original basis. Crucially for railroads and potentially other industries using retirement accounting, it confirms that pre-1913 depreciation adjustments are not required, respecting the unique accounting practices of these sectors. This ruling impacts how companies using retirement accounting calculate deductions for asset retirements and how investors in reorganized companies calculate gain or loss on bond sales following recapitalization.

