***14 T.C. 401 (1950)***

A taxpayer using the accrual method must recognize income when the right to receive it is fixed, unless there is reasonable doubt of collection; railroads using the retirement method of accounting are not required to adjust for pre-1913 depreciation.

**Summary**

Union Pacific Railroad Co. challenged deficiencies assessed by the IRS regarding the accrual of bond interest, the taxability of bond modifications, and depreciation adjustments. The Tax Court held that Union Pacific, using the accrual method, must accrue interest income unless collection is doubtful. The court also found that modification of Baltimore & Ohio (B&O) bonds was a tax-free recapitalization, meaning the original cost basis applied. Finally, the court sided with Union Pacific on the pre-1913 depreciation issue, stating that railroads using the retirement method need not adjust for pre-1913 depreciation, reinforcing established accounting practices.

**Facts**

Union Pacific owned bonds of Lehigh Valley Railroad Co. and Baltimore & Ohio Railroad Co. Due to financial difficulties, Lehigh Valley deferred interest payments, while B&O modified its bond terms under a court-approved plan. Union Pacific used the retirement method of accounting for its ways and structures, retiring assets acquired both before and after 1913. The IRS assessed deficiencies, arguing that Union Pacific should have accrued the full amount of Lehigh Valley interest, that the B&O bond modification was a taxable exchange, and that pre-1913 depreciation should reduce the basis of retired assets.

**Procedural History**

The IRS determined deficiencies in Union Pacific's income and excess profits taxes. Union Pacific contested these deficiencies in Tax Court. The cases were consolidated for hearing. A prior Tax Court decision, Los Angeles & Salt Lake Railroad Co., 4 T.C. 634, involving similar depreciation issues, was cited.

**Issue(s)**

1. Whether Union Pacific should accrue the full amount of interest income from Lehigh Valley bonds in 1938 and 1939, despite deferred payments.

2. Whether the modification of B&O bonds constituted a taxable exchange in 1940.

3. Whether Union Pacific must reduce the basis of retired assets by depreciation sustained before March 1, 1913.

© 2025 SCOTUSreports.com. All rights reserved. 

4. Whether the Los Angeles & Salt Lake Railroad Co. decision is res judicata on the pre-1913 depreciation issue.

**Holding**

1. Yes, because Union Pacific used the accrual method, and there was no reasonable certainty that the deferred interest would not be paid.

2. No, because the B&O bond modification was a recapitalization and reorganization under section 112 (g).

3. No, because for taxpayers using the retirement method of accounting, an adjustment for pre-1913 depreciation would be inconsistent with that system.

4. The Court found it unnecessary to rule on the res judicata issue since they ruled in favor of the petitioners on the merits of the pre-1913 depreciation issue.

**Court's Reasoning**

Regarding the Lehigh Valley interest, the court emphasized that accrual accounting requires recognizing income when the right to receive it becomes fixed. The court cited Spring City Foundry Co. v. Commissioner, 292 U.S. 182. While acknowledging that income need not be accrued if its receipt is uncertain, the court found no such certainty here, noting Lehigh Valley's improving revenues and the belief that its difficulties were temporary. The Court stated, "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."

On the B&O bonds, the court followed Commissioner v. Neustadt's Trust, 131 F.2d 528 and Mutual Fire, Marine & Inland Insurance Co., 12 T.C. 1057, holding that the bond modification was a recapitalization, a form of reorganization under section 112 (g), thus a non-taxable event.

As for pre-1913 depreciation, the court relied on its prior decision in Los Angeles & Salt Lake Railroad Co., 4 T.C. 634, which stated that railroads using the retirement method need not adjust for pre-1913 depreciation because their accounting system charges maintenance, renewals, and restorations to operating costs rather than capitalizing them. An adjustment would be inconsistent with this established method.

**Practical Implications**

This case clarifies the application of accrual accounting for interest income, emphasizing that the right to receive, not actual receipt, is the determining factor unless collection is doubtful. It also reinforces the principle that bond modifications under a reorganization plan can be tax-free recapitalizations, preserving the original cost basis. Crucially, the decision affirms the accepted accounting practice for

© 2025 SCOTUSreports.com. All rights reserved. 

railroads using the retirement method, shielding them from complex and potentially unfair depreciation adjustments. This ruling provides certainty for railroads in their tax planning and accounting practices, preventing the need to retroactively calculate depreciation under a different method.

© 2025 SCOTUSreports.com. All rights reserved. 