Merchants National Bank of Mobile v. Commissioner, 14 T.C. 1375 (1950)

When a taxpayer recovers an amount on a debt previously written off and deducted as a bad debt for tax purposes, the recovery is treated as ordinary income, not capital gain, to the extent of the prior tax benefit.

Summary

Merchants National Bank charged off certain notes as bad debts in prior years, receiving a tax benefit from those deductions. Later, the bank sold these notes for $18,460.58. The IRS determined that this amount was taxable as ordinary income, while the bank argued it was a long-term capital gain. The Tax Court held that because the bank had previously received a tax benefit from writing off the notes, the subsequent recovery was taxable as ordinary income, not capital gain. This is because the notes, having a zero basis after the write-off, represented a recovery of previously deducted ordinary income.

Facts

Merchants National Bank charged off certain notes as bad debts in prior tax years, resulting in a reduction of its taxable income for those years.
In a subsequent year, the bank sold these notes for $18,460.58.
The bank had taken full tax benefit from the prior charge-offs, giving the notes a zero basis.

Procedural History

The Commissioner of Internal Revenue determined that the $18,460.58 realized from the sale of the notes was taxable as ordinary income.
The Merchants National Bank of Mobile petitioned the Tax Court for a redetermination, arguing that the amount should be taxed as a long-term capital gain.
The Tax Court ruled in favor of the Commissioner, upholding the determination that the income was ordinary income.

Issue(s)

Whether the amount realized from the sale of notes previously charged off as bad debts, from which the taxpayer received a tax benefit, is taxable as ordinary income or as long-term capital gain.

Holding

Yes, because the cost or capital the petitioner had in the notes was recovered in prior years by the charge-offs with full tax benefit; therefore, the notes ceased to be capital assets but instead represented income.

Court's Reasoning

The Tax Court relied on the principle that a recovery of an amount previously deducted as a bad debt is treated as ordinary income to the extent of the prior tax benefit. The court cited *National Bank of Commerce of Seattle v. Commissioner*, 115 F.2d 875 (9th Cir. 1940), and *Commissioner v. First State Bank of Stratford*, 168 F.2d 1004 (5th Cir. 1948), which held that recoveries on debts previously charged off as worthless constitute ordinary income, not capital gain.

The court distinguished cases like *Rockford Varnish Co.*, 9 T.C. 171 (1947), and *Conrad N. Hilton*, 13 T.C. 623 (1949), where the assets sold had not been previously written off for tax purposes. In those cases, the assets retained their character as capital assets.

The Tax Court emphasized the substance over form, stating that the transaction was essentially a recoupment of ordinary income that had escaped taxation due to the bad debt deductions. The court quoted *Rice Drug Co. v. Commissioner*, 175 F.2d 681 (5th Cir. 1949), stating that the "recovery of bad debts" concept encompasses the entire cycle of a claim becoming worthless and later being recovered.

Practical Implications

This case establishes that taxpayers cannot convert ordinary income into capital gains by charging off debts as bad debts and then selling them. Any recovery on a debt previously written off as a bad debt is taxable as ordinary income to the extent a tax benefit was previously received. This rule prevents a double tax benefit. It is important for legal practitioners to recognize this principle when advising clients on tax strategies involving debt and asset write-offs. Later cases applying this ruling generally involve similar fact patterns, where a prior deduction created a zero basis in the asset, resulting in ordinary income upon disposition. This principle continues to be relevant in modern tax law, particularly in the context of loan workouts and debt restructuring.

