14 T.C. 1375 (1950)

When a bank recovers an amount on debt previously charged off and deducted as a bad debt with a tax benefit, the recovery is treated as ordinary income, not capital gain, regardless of whether the recovery stems from the retirement of a bond.

Summary

Merchants National Bank of Mobile charged off bonds as worthless debts, resulting in a tax benefit. Later, the issuer redeemed these bonds. The IRS argued that the recovered amount should be treated as ordinary income, while the bank contended it should be treated as capital gains due to the bond retirement. The Tax Court held that the recovery of a debt previously deducted as a bad debt with a tax benefit is ordinary income. The bonds, having been written off, lost their character as capital assets for tax purposes and became representative of previously untaxed income.

Facts

The petitioner, Merchants National Bank of Mobile, acquired bonds of Pennsylvania Engineering Works in 1935. From 1936 to 1941, the bank charged off the bonds as worthless debts on its income tax returns, resulting in a reduction of its taxes. In 1944, the issuer of the bonds redeemed a part of the bonds, and the bank received $58,117.73 on which it had previously received a tax benefit. The bank treated a portion of this as ordinary income but claimed overpayment, arguing for capital gains treatment. The IRS determined that the recovered amount was ordinary income.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the petitioner's income tax for 1944. The petitioner contested this determination in the Tax Court, arguing that the recovered amount should be treated as capital gains. The Tax Court ruled in favor of the Commissioner, holding that the recovery was ordinary income.

Issue(s)

1. Whether the amount recovered by the bank in 1944 from the retirement of bonds, after the bonds had been charged off as worthless debts with a tax benefit in previous years, is taxable as ordinary income or capital gain.

Holding

1. No, because after the charge-off with tax benefit, the bonds ceased to be capital assets for income tax purposes. The retirement of the bonds, in this case, amounted to the recovery of a previously deducted bad debt, which is treated as ordinary income.

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Court’s Reasoning

The court reasoned that while Section 117(f) of the Internal Revenue Code states that amounts received upon the retirement of bonds should be considered amounts received in exchange therefor, this does not automatically result in capital gains. The exchange must be of a capital asset. The court emphasized that the bank, having previously written off the bonds as worthless debts with a tax benefit, had effectively eliminated them as capital assets for tax purposes. Section 23(k)(2) also indicates that for banks, even if securities which are capital assets become worthless, deduction of ordinary loss shall be allowed. The court cited several cases supporting the principle that the recovery of an amount previously deducted as a bad debt with a tax benefit constitutes ordinary income. The court noted that the bonds, after being charged off, had a basis of zero and were no longer reflected in the capital structure of the corporation. *“The notes here ceased to be capital assets for tax purposes when they took on a zero basis as the result of deductions taken and allowed for charge-offs as bad debts.”*

Practical Implications

This case reinforces the tax benefit rule, clarifying that recoveries of amounts previously deducted as losses are generally taxable as ordinary income. It specifically addresses the situation of banks and bonds, underscoring that the initial character of an asset as a bond does not override the principle that a recovery of a previously deducted bad debt is ordinary income. This decision informs how banks and other financial institutions must treat recoveries on assets they have previously written off. Later cases cite this as the established rule, meaning similar cases must be treated as ordinary income. It prevents taxpayers from converting ordinary income into capital gains by deducting the loss as an ordinary loss and then treating the recovery as a capital gain.

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