Alabama Coca-Cola Bottling Co. v. Commissioner, 22 T.C. 524 (1954)

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Unrecognized gains, such as those arising from the discharge of indebtedness where the taxpayer elects to reduce the basis of assets, are not immediately included in a corporation's earnings and profits for tax purposes.

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Summary

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Alabama Coca-Cola repurchased its own bonds at a discount, realizing a gain but elected to exclude the gain from its gross income by reducing the basis of its assets. When calculating its excess profits tax credit based on accumulated earnings and profits, the company included the bond repurchase gain. The Commissioner excluded this gain, resulting in a deficiency. The Tax Court upheld the Commissioner, reasoning that unrecognized gains are not included in earnings and profits until the related assets are disposed of, preventing a double inclusion of the same gain.

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Facts

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In 1942, Alabama Coca-Cola Bottling Company repurchased its bonds for $497,553.30, which had a face value of $634,000, resulting in a gain of $136,446.70.r
The company elected under Section 22(b)(9) and 113(b)(3) of the Internal Revenue Code to exclude this gain from its 1942 gross income, instead reducing the basis of its assets.r
For its 1943 excess profits tax calculation, the company sought to include the 1942 bond profit in its accumulated earnings and profits as of the beginning of 1943, to increase its excess profits credit.r

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Procedural History

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The Commissioner excluded the bond profit from Alabama Coca-Cola's accumulated earnings and profits, resulting in a reduced excess profits credit and a tax deficiency.r
Alabama Coca-Cola challenged the Commissioner's determination in the Tax Court.r

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Issue(s)

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Whether a gain realized from the repurchase of a corporation's own bonds at a discount, which is excluded from gross income under Section 22(b)(9) of the Internal Revenue Code with a corresponding reduction in the basis of the corporation's assets, should be included in the corporation's accumulated earnings and profits for purposes of computing its excess profits tax credit.

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Holding

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No, because the gain is not recognized for income tax purposes until the assets whose basis was reduced are sold or disposed of, and including it earlier would lead to a double inclusion of the same gain in earnings and profits.

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Court's Reasoning

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The court reasoned that Section 115(l) of the Internal Revenue Code, while not directly applicable to the discharge of indebtedness, reflects a broader principle that earnings and profits should not be affected by transactions where gain or loss is not recognized for income tax purposes.r
Including the unrecognized gain in earnings and profits would allow the taxpayer to postpone the recognition of income for income tax purposes while simultaneously treating it as earnings and profits for excess profits tax purposes, an inconsistent

approach.r

The court also noted that when the assets whose basis was reduced are eventually sold, the adjusted basis will increase the taxable gain, and a comparable increase in earnings and profits will occur at that time. Including the bond profit now would result in a duplication of the increase in earnings and profits.r

The court highlighted the practical implications of the election under Section 22(b)(9), stating that