Duveen Brothers, Inc. v. Commissioner, 17 T.C. 124 (1951)

When a seller of stock agrees to refund a portion of the purchase price if certain future events occur, the subsequent refunds are treated as capital losses that adjust the original capital gain from the sale, rather than as ordinary losses.

Summary

Duveen Brothers, Inc. sold a block of Kress & Company stock with an agreement to refund a portion of the purchase price if the stock was redeemed at a lower price. When the stock was redeemed, Duveen Brothers made the agreed-upon refunds and sought to deduct these payments as ordinary losses. The Tax Court held that the refunds were capital losses because they were directly related to the original sale of a capital asset (the stock). The refunds effectively reduced the original capital gain realized from the stock sale.

Facts

Duveen Brothers, Inc. sold 50,000 shares of Kress & Company stock at prices ranging from $11.75 to $12.50 per share.
The sales agreements included a provision that Duveen Brothers would refund part of the purchase price if the stock was later redeemed at $11 per share.
In December 1944, Kress & Company redeemed the stock at $11 per share, triggering the refund obligation.
Duveen Brothers then paid $30,950 to the stock purchasers as refunds.

Procedural History

Duveen Brothers, Inc. deducted the $30,950 refund payments as ordinary losses on its tax return.
The Commissioner of Internal Revenue determined that the payments represented a long-term capital loss.
Duveen Brothers petitioned the Tax Court for review of the Commissioner’s determination.

Issue(s)

Whether the payments made by Duveen Brothers to purchasers of Kress & Company stock, representing refunds of a portion of the purchase price due to a subsequent redemption, constitute ordinary losses or capital losses for tax purposes.

Holding

No, because the refunds were directly related to the original sale of a capital asset (the stock), and therefore, they are treated as capital losses that adjust the original capital gain. However, with respect to 10,000 shares sold in the same fiscal year as the refund, the refund reduces the capital gain realized in that year.

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Court’s Reasoning

The Tax Court reasoned that the substance of the agreement was to sell the stock at a reduced price, with the refund contingency merely adjusting the final sale price.
Since the original stock sales resulted in long-term capital gains, the subsequent refunds were part of the same transaction and must be treated as capital losses.
The court distinguished this case from *Stanley Switlik*, where payments of a dissolved corporation’s tax deficiencies by transferees were considered ordinary losses because they were not directly related to the sale or exchange of capital assets.
In this case, the refunds were made “in compliance with the terms of the very contracts of sales.”
The court stated, “The payments in question constituted reductions in the sales prices, and they were part of each sales transaction. There was a continuing relation under each sales contract between the total payment received at the time of each sale and the subsequent refund of part of the purchase price.”
For the 10,000 shares sold in the same fiscal year as the refund, the court reasoned that the refund simply reduces the capital gain realized in that year, citing *Albert W. Russel*.

Practical Implications

This case clarifies that refunds or adjustments to the purchase price in stock sales are generally treated as capital gains or losses, aligning the tax treatment with the original character of the sale.
Attorneys should advise clients that agreements to refund portions of the purchase price of assets, including stock, will likely result in capital loss treatment for the refunds, which may be subject to capital loss limitations.
When drafting sales agreements, it is important to consider the potential tax implications of any provisions that could result in future price adjustments or refunds.
This ruling has been applied in subsequent cases to determine whether post-sale payments are ordinary or capital in nature, focusing on whether the payments are integrally related to the original sale.

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