17 T.C. 506 (1951)

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A corporation does not realize taxable income from purchasing its own debt at a discount if it is insolvent both before and after the purchase; a recapitalization does not change the basis of the original asset.

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Summary

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Conestoga Transportation Company purchased its bonds at less than face value during 1940, 1941, and 1943. The IRS claimed that the difference between the face value and the purchase price constituted taxable income. Conestoga also exchanged notes from Baltimore & Ohio Railroad Company pursuant to a plan that changed the interest rate and maturity date of the notes, and the IRS disputed Conestoga's basis in the notes when they were redeemed in 1944. The Tax Court held that Conestoga did not realize income from the bond purchases because it was insolvent during those years and that the exchange of notes was a recapitalization, thus retaining the original basis.

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Facts

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Conestoga Transportation Company, formed in 1931 from a merger, operated electric railways and buses. It assumed a $2,000,000 bond issue from one of the merged companies. Over time, Conestoga began replacing its railway lines with buses. It maintained a reserve for contingencies related to railway abandonment. The company discovered that its railway property was overvalued on its books. During 1940, 1941 and 1943, Conestoga purchased some of its own bonds at a discount. In 1936, Conestoga purchased notes of the Baltimore & Ohio Railroad Company. In 1940, the notes were surrendered and returned with a changed interest rate and maturity date.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in Conestoga's income taxes for 1942, 1943, and 1944. These deficiencies stemmed from the purchase of bonds at a discount and the basis of certain notes. Conestoga filed claims for refund, arguing it had erroneously included income from the bond purchases. The Tax Court was tasked with determining whether Conestoga realized income from purchasing its bonds at a discount and what the correct basis was for the Baltimore & Ohio Railroad Company notes.

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Issue(s)

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1. Whether Conestoga realized taxable income when it purchased its own bonds at less than face value during 1940, 1941, and 1943.

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2. Whether the 1940 transaction involving the Baltimore & Ohio Railroad Company notes constituted a recapitalization, thus allowing Conestoga to retain its original basis in the notes.

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Holding

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1. No, because Conestoga was insolvent both before and after purchasing the bonds, meaning that the discharge of indebtedness did not free any assets.

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2. Yes, because the exchange of notes was pursuant to a reorganization plan, and the new notes represented a continuation of the original investment.

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Court's Reasoning

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Regarding the bond purchases, the court applied the principle from *United States v. Kirby Lumber Co.*, which generally states that a company realizes income when it purchases its own debt at a discount. However, the court cited *Porte F. Quinn*, stating that this principle does not apply if the taxpayer is insolvent both before and after the transaction, because

