***Conestoga Transportation Company v. Commissioner, 17 T.C. 506 (1951)***

A company's solvency, for determining whether the discharge of indebtedness results in taxable income, should consider the going concern value of its assets, not just tangible assets, but that value cannot be used to mask true insolvency.

**Summary**

Conestoga Transportation Company purchased its own bonds at a discount. The Tax Court addressed whether this created taxable income, which depends on whether the company was solvent. Conestoga argued it was insolvent, considering only tangible asset values. The Commissioner argued for solvency, considering Conestoga's history and potential earning power, including its "going concern value." The court held that going concern value should be considered, but Conestoga was still insolvent and thus realized no income. The court also determined the basis of redeemed railroad notes.

**Facts**

Conestoga Transportation Company, a transportation company, purchased its own bonds at less than face value during 1940, 1941, and 1943. Conestoga calculated its solvency by comparing its tangible assets to its liabilities, claiming insolvency. The Commissioner contested Conestoga's calculation, arguing for solvency based on Conestoga's history, earning power, and "going concern value." Conestoga had also sustained excess depreciation on its buses.

**Procedural History**

The Commissioner determined that Conestoga had realized income from the bond purchases and challenged the basis of railroad notes. Conestoga petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court reviewed the case.

**Issue(s)**

1. Whether Conestoga realized income upon purchasing its own obligations at less than face value, minus unamortized discount, during the years 1940, 1941, and 1943.

2. Whether the basis of the Baltimore & Ohio Railroad Company notes that were called and redeemed should be cost at the time of acquisition or fair market value when the notes were modified.

**Holding**

1. No, because Conestoga was insolvent during those years, even when considering a reasonable "going concern value."

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2. Cost at the time of acquisition because the modification of the notes constituted a recapitalization.

**Court's Reasoning**

The court relied on *United States v. Kirby Lumber Co.*, establishing that a solvent corporation realizes income when discharging debt at less than face value. However, if a taxpayer is insolvent both before and after the transaction, no income is realized because no assets are freed. The court considered the company's "going concern value" in determining solvency. Quoting *Los Angeles Gas & Electric Corp. v. Railroad Commission of California, 289 U. S. 287*, the court acknowledged "that there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced." The court found that Conestoga's liabilities exceeded its assets, even with a $100,000 going concern value, and after correcting depreciation errors. Citing *Mutual Fire, Marine & Inland Ins. Co., 12 T. C. 1057*, the court determined the note modification was a recapitalization; therefore, the original cost basis applied.

**Practical Implications**

This case clarifies that when determining solvency for discharge of indebtedness income, the "going concern value" of a business must be considered, not just tangible assets. However, it prevents companies from artificially inflating this value to avoid recognizing income. This decision impacts how businesses in financial distress evaluate potential tax liabilities when negotiating debt reductions. Later cases may scrutinize the valuation of going concern value, requiring strong evidentiary support. This case is a reminder that a company's financial history and realistic earnings potential play a significant role in determining solvency.

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