T.C. Memo. 1947-370

A secured debt becomes worthless for tax deduction purposes when the creditor asserts dominion over the security, acting as the owner rather than a mere pledgee, even if the security hasn't been formally disposed of.

Summary

Industrial Trust Co. claimed a worthless debt deduction in 1943 related to a secured debt from a corporation (Dutee) that became insolvent in 1930. The debt was secured by stock. The court disallowed the deduction, finding that Industrial Trust had effectively taken ownership of the collateral (the stock) long before 1943 through its actions, such as registering the stock in its nominee's name, receiving dividends directly, and selling shares without consulting anyone. The court reasoned that a creditor cannot treat property as its own while simultaneously claiming it as collateral for tax deduction purposes. The deduction should have been taken much earlier when Dutee became insolvent and Industrial Trust began acting as the owner of the stock.

Facts

On January 2, 1929, Dutee borrowed $850,000 from Industrial Trust, evidenced by a demand note secured by stock valued at $1,076,367.63.
In 1930, Dutee became insolvent and ceased operations without making payments on the debt.
Dutee's corporate existence was terminated in Rhode Island in 1933.
From 1932 onward, Industrial Trust registered the stock in the name of a nominee and received dividends directly. Industrial Trust sold shares of the stock at its discretion, retaining the proceeds.
In 1943, Industrial Trust claimed a worthless debt deduction for the remaining shares.

Procedural History

Industrial Trust sought a worthless debt deduction on its 1943 tax return. The Commissioner disallowed the deduction. The Tax Court reviewed the Commissioner's determination.

Issue(s)

Whether a secured debt "become[s] worthless" within the meaning of Section 23(k)(1) of the Internal Revenue Code only when the security is disposed of, even if the debtor became hopelessly insolvent years prior and the creditor has acted as the owner of the security.

Holding

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No, because Industrial Trust had asserted dominion over the stock well before 1943 and thus had effectively become the owner of the security. The debt became worthless prior to 1943. Therefore, the deduction was not allowable in 1943.

Court’s Reasoning

The court reasoned that while generally a secured debt isn’t considered fully worthless until the security is disposed of, this rule doesn’t apply when the creditor has already acquired ownership of the security or acted as its owner. The court distinguished this case from others where the creditor lacked ownership or the ability to easily acquire it. The court emphasized Industrial Trust’s actions:

Taking title to the stock in its nominee’s name.
Receiving and retaining dividends directly.
Selling the stock at its discretion without consulting anyone.

The court found that these actions demonstrated Industrial Trust’s assertion of dominion over the property long before 1943. The court stated,

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