Alfred Decker & Cohn, Inc., T.C. Memo. 1953-200 (1953)

When property received in satisfaction of a debt has no ascertainable fair market value at the time of receipt due to significant restrictions, the cost basis of the property for tax purposes is the amount of the debt satisfied.

Summary

Alfred Decker & Cohn, Inc. disputed tax deficiencies related to capital gains, equity invested capital, borrowed invested capital, and accrued interest income. The Tax Court addressed four issues: the basis of stock received with a 10-year option, the valuation of goodwill, the inclusion of debentures in borrowed invested capital, and the accrual of interest income from a subsidiary. The court held that stock encumbered by a long-term option had no ascertainable fair market value, thus the basis was the debt satisfied. The court also determined the fair market value of goodwill, allowed debentures to be included in borrowed invested capital, and found that accrued interest from a subsidiary was not includible income due to a mutual agreement of non-payment.

Facts

Alfred Decker & Cohn, Inc. (petitioner) sold 24,000 shares of its treasury common stock in 1943 under an option agreement. These shares were originally acquired in 1934 from Alfred Decker and Continental Bank in cancellation of Alfred Decker's debt. The stock, when acquired in 1934, was encumbered by a 10-year option granted to Raye Decker. In 1919, the petitioner acquired goodwill from its predecessor partnership in exchange for stock. In 1944, petitioner underwent recapitalization, issuing debentures in exchange for preferred stock and accumulated dividends. Petitioner also held a note from its subsidiary, on which interest was contractually due but not accrued as income.

Procedural History

This case came before the Tax Court of the United States to redetermine deficiencies in excess profits tax and income tax determined by the Commissioner of Internal Revenue.

Issue(s)

1. Whether the long-term capital gain from the sale of stock should be calculated using a cost basis of $133,488.55 or $29,075.
2. Whether the fair market value of goodwill acquired in 1919 was $1,400,000, $850,000, or $1,000,000 for equity invested capital purposes.
3. Whether debentures issued in exchange for preferred stock and accumulated dividends should be included in borrowed invested capital at face value.
4. Whether the petitioner, an accrual basis taxpayer, must include accrued interest income from a subsidiary's note when there was a mutual agreement

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that no interest would be paid until the subsidiary's financial capacity improved.

Holding

1. Yes, the long-term capital gain should be calculated using a cost basis of $133,488.55 because the stock received in 1934, encumbered by a 10-year option, had no ascertainable fair market value at that time, making the basis the remaining debt owed by Alfred Decker.
2. The fair market value of the goodwill acquired in 1919 was determined to be $1,000,000.
3. Yes, the debentures should be included in borrowed invested capital at their face value because the recapitalization effectively converted equity invested capital into borrowed capital, which is permissible.
4. No, the petitioner is not required to include the accrued interest income because there was a mutual agreement that interest payment was contingent upon the subsidiary's financial ability, meaning the right to receive the income was not fixed.

Court's Reasoning

Issue 1 (Stock Basis): The court relied on *Gould Securities Co. v. United States*, stating that if stock received in debt cancellation has no ascertainable fair market value due to restrictions, the basis is the debt satisfied. Expert testimony indicated the 10-year option significantly diminished the stock's fair market value to a nominal amount. The court found that the stock, encumbered by the option, had no ascertainable fair market value when received. Therefore, the cost basis was the remaining debt, supporting the petitioner's calculation of capital gain.

Issue 2 (Goodwill Valuation): The court considered various factors, including past earnings, market conditions, and expert testimony, to determine the fair market value of goodwill. While acknowledging petitioner's initial valuation and later increased claim, the court determined a value of $1,000,000 based on a comprehensive review of the evidence.

Issue 3 (Borrowed Invested Capital): The court distinguished this case from *McKinney Manufacturing Co.* and *Columbia, Newberry & Laurens Railroad Co.*, which disallowed the inclusion of debt instruments issued in lieu of interest in borrowed invested capital. The court reasoned that in this case, the debentures represented a conversion of equity capital (preferred stock and accumulated dividends) into borrowed capital, which is not statutorily prohibited. The court emphasized that the issuance of debentures reduced equity invested capital, thus justifying their inclusion in borrowed invested capital.

Issue 4 (Accrued Interest): Citing *Combs Lumber Co.* and *Spring City Foundry Co. v. Commissioner*, the court held that accrual accounting requires income

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recognition when the right to receive it becomes fixed. Because of the mutual agreement that interest payment was contingent, the right to receive interest was not fixed during the taxable year. Therefore, the petitioner was not required to accrue the interest income.

Practical Implications

Alfred Decker & Cohn, Inc. provides practical guidance on determining the tax basis of assets received in satisfaction of debt, especially when those assets are subject to significant restrictions impacting their marketability. It clarifies that if restrictions render fair market value unascertainable at the time of receipt, the debt satisfied becomes the cost basis. This case also illustrates the importance of expert testimony in valuation disputes and distinguishes between permissible conversion of equity to debt for invested capital purposes versus attempts to reclassify interest as debt. Furthermore, it reinforces the principle that accrual of income requires a fixed right to receive it, which can be negated by mutual agreements contingent on future events. This case is relevant for tax practitioners dealing with debt restructuring, asset valuation, and accrual accounting, particularly in situations involving closely held businesses and intercompany transactions.

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