19 T.C. 384 (1952)

The sale of accrued interest on an indebtedness is taxed as ordinary income, not capital gain, regardless of whether the interest was reported as income prior to the sale.

Summary

Charles T. Fisher sold notes with accrued interest to Prime Securities Corporation. The Tax Court addressed whether the portion of the sale attributable to the accrued interest ($66,150.56) should be taxed as a long-term capital gain or as ordinary income. The court held that the amount representing accrued interest was taxable as ordinary income. This decision underscores the principle that the right to receive ordinary income (like interest) does not transform into a capital asset merely by selling that right to a third party.

Facts

Fisher held notes from a Florida corporation with a principal amount of $133,849.44. As of September 1, 1944, unpaid interest on these notes totaled $75,574.29. Fisher owed Prime Securities Corporation $167,475. Fisher offered to sell the Florida corporation's notes and the right to receive interest to Prime for $200,000, with Prime to offset Fisher's debt to them as part of the purchase price. Prime accepted, canceling Fisher's debt and paying him the $32,525 balance. Fisher reported $66,150.56 as a long-term capital gain on his 1944 tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Fisher's 1944 income tax. The Commissioner argued that the $66,150.56 should be taxed as ordinary income rather than as a capital gain, leading to the tax deficiency. The case was brought before the Tax Court to resolve this dispute.

Issue(s)

Whether the portion of the proceeds from the sale of notes attributable to accrued interest should be taxed as ordinary income or as a long-term capital gain under Section 117 of the Internal Revenue Code.

Holding

No, because the right to receive already accrued ordinary income, such as interest, does not become a capital asset simply because the right is sold. The sale of that right still represents ordinary income. "A sale of a right to receive in the future ordinary income already accrued produces ordinary income rather than a captial gain."

Court's Reasoning

The court reasoned that interest represents payment for the use of money. Fisher, as the owner of the money, loaned it to the Florida corporation and thus became entitled to interest payments. When Fisher sold the notes and the right to receive the accrued interest to Prime, he was essentially being compensated for the use of his money. The court noted that the IRS code specifically includes interest in the definition of gross income. The court analogized the situation to the sale of a bond with accrued interest, where the seller reports the accrued interest as income, not as part of the amount realized on the sale of the bond itself. The court also referenced cases involving retiring partners being paid for their share of accrued partnership earnings, which are treated as ordinary income.

Practical Implications

This case clarifies that taxpayers cannot convert ordinary income into capital gains by selling the right to receive that income. Attorneys and tax advisors must recognize that the source of income is determinative of its character for tax purposes, even when the right to receive that income is transferred. This ruling has implications for structuring sales of debt instruments, partnership interests, and other assets where accrued but unpaid income is involved. It reinforces the principle that the substance of a transaction, rather than its form, will govern its tax treatment. Later cases have cited Fisher to support the proposition that assigning the right to receive future income does not change the character of that income.