19 T.C. 1130 (1953)

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Payments made by a corporation to settle a statutory liability as a bank stockholder are deductible as an ordinary loss when the stock is already worthless, while the underlying worthless stock constitutes a capital loss.

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Summary

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Adam, Meldrum & Anderson Co. (Petitioner) sought to deduct payments made to a bank to settle a judgment related to its statutory liability as a stockholder. The petitioner also sought to deduct legal fees incurred during the settlement, and the cost basis of the now-worthless bank stock. The Tax Court held that the settlement payment was an ordinary loss under Section 23(f) because the petitioner's obligation accrued when the bank stock was worthless. The court further held that the basis of the worthless bank stock was a capital loss because the bank's income was primarily from interest. Legal fees were allocated between deductible expenses and capitalized acquisition costs.

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Facts

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The Petitioner, a department store, held 1,700 shares of Adam, Meldrum & Anderson State Bank. The bank was located within the department store and served its customers. Due to financial difficulties, the bank's capital was impaired. To avoid statutory liability as a shareholder, the Petitioner transferred its shares to its president, Adam, who assumed the liability. The Petitioner agreed to indemnify Adam. The Superintendent of Banking took possession of the bank but allowed it to reopen under the condition that stockholders execute promissory notes. Adam executed a note, but the bank later sued Adam's estate and the Petitioner to recover on the note. A judgment was entered against the Petitioner. To settle the matter, a statutory plan was created under New York Banking Law Section 609. The petitioner paid $137,187.35 to the bank in exchange for a release from the judgment.

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Procedural History

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The Commissioner of Internal Revenue determined a deficiency in the Petitioner's excess profits tax liability for the year ending January 31, 1944. The Petitioner challenged the Commissioner's determination, arguing that certain payments, legal fees, and stock losses should be deductible. The Tax Court addressed these issues in this case.

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Issue(s)

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1. Whether the payment of $137,187.35 to the bank is deductible as an ordinary loss or must be capitalized as an additional cost of the bank stock.

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2. Whether the loss from the bank stock is deductible as an ordinary loss or a capital loss.

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3. Whether the legal fees paid by the petitioner are deductible as ordinary and necessary business expenses or must be capitalized.

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Holding

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1. No, because the petitioner's obligation to pay accrued at a time when the bank stock was worthless.

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2. Yes, it’s a capital loss because more than 90% of the bank’s gross income came from interest.

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3. Legal fees related to defending against the bank’s claim are deductible, while fees related to acquiring new shares of stock must be capitalized.

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Court’s Reasoning

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The court reasoned that the $137,187.35 payment was deductible as an ordinary loss under Section 23(f) because the petitioner’s shares were declared valueless before the payment. The payment was in lieu of an assessment, but the shares were already worthless at the time of the settlement. The court distinguished this from situations where shares retain value, where such payments would be added to the cost basis of the stock. Regarding the worthless stock, the court held that Section 23(g)(4) dictated capital loss treatment because the bank’s income was primarily from interest, preventing it from being classified as an

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