20 T.C. 449 (1953)

The cancellation of worthless debt in a bankruptcy reorganization does not increase a company's equity invested capital for excess profits tax purposes, nor does the issuance of preferred stock in exchange for a portion of those debts if the debts' value is not proven.

Summary

The Times Tribune Company sought to increase its equity invested capital for excess profits tax calculation by including the value of debt canceled during a 77B bankruptcy reorganization and the value of preferred stock issued to creditors in exchange for partial debt satisfaction. The Tax Court ruled against the company, holding that the cancellation of worthless debt does not constitute a contribution to capital. The court also found that the company failed to prove the actual value of the debts exchanged for preferred stock, preventing their inclusion in equity invested capital.

Facts

The Times Tribune Company underwent a reorganization under Section 77B of the Bankruptcy Act. As part of the reorganization, a plan was approved to alter the capital structure, including issuing new common and preferred stock. A portion of the preferred stock was designated for distribution to creditors in partial satisfaction of outstanding debts, including mortgage bond interest, wage claims, rent claims, and general creditor claims. The company reported losses for several years leading up to and following the reorganization.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Times Tribune Company's declared value excess-profits tax and excess profits tax for the years 1944-1946. The company petitioned the Tax Court, contesting the Commissioner's calculation of its equity invested capital. The Tax Court upheld the Commissioner's determination.

Issue(s)

1. Whether the issuance of preferred stock in exchange for debt constitutes property paid in for stock under Section 718(a) of the Internal Revenue Code, thereby increasing equity invested capital.
2. Whether the forgiveness of indebtedness by creditors during a reorganization can be considered a contribution to capital under Section 718 of the Internal Revenue Code, thus increasing equity invested capital.

Holding

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1. No, because the company failed to prove the debts exchanged for preferred stock had any actual value or basis at the time of the exchange.
2. No, because the cancellation of a worthless debt does not constitute a contribution of money or property to the debtor corporation.

Court's Reasoning

The court reasoned that to include property (other than money) in equity invested capital under Section 718(a)(2), the property must have a basis for determining loss upon sale or exchange. The court found that the Times Tribune Company failed to prove the debts exchanged for preferred stock had any actual value at the time of the exchange. The court noted that the debts were old and the company had been operating at a loss for years, suggesting the debts were, at least partially, worthless. The court stated, "Creditors of a corporation in a situation in which this petitioner found itself in 1936 would not, by accepting preferred stock for a part of their claims, be paying into the corporation money or the substantial equivalent of money."

Regarding the canceled debt, the court held that the cancellation of a worthless portion of debt does not constitute a contribution of money or property. The court stated that creditors were merely recognizing the corporation's losses. The court emphasized that "Congress was aware that worthless debts are sometimes canceled, yet it has not indicated in section 718 (a) (1) or (2) a desire or intent to recognize the cancellation of a worthless debt as a contribution by the creditor to the equity invested capital of the debtor."

Judge Johnson dissented, arguing that the exchange of debt for preferred stock implied that the debts had some value and should be considered property paid in for stock.

Practical Implications

This case highlights the importance of establishing the value or basis of assets contributed to a company in exchange for stock, particularly in the context of bankruptcy reorganizations, to increase equity invested capital for tax purposes. It clarifies that the mere cancellation of worthless debt does not automatically increase equity invested capital. Taxpayers must demonstrate that the canceled debt or exchanged property had a real economic value at the time of the transaction. This decision emphasizes that a taxpayer's self-serving statements on tax returns are insufficient to prove facts necessary to prevail in a tax dispute and reinforces the principle that the burden of proof lies with the taxpayer. Later cases would cite this to underscore the need to provide concrete evidence, not assumptions, when claiming tax benefits related to invested capital.

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