25 T.C. 416 (1955)

When a bondholder sells interest-bearing bonds to the issuer at a flat price, a portion of the proceeds representing accrued interest is taxable as ordinary income, not capital gain.

Summary

Warner A. Shattuck sold interest-bearing bonds to the issuing corporation at a flat price that included accrued but unpaid interest. The IRS determined that a portion of the sale proceeds represented the accrued interest and was therefore taxable as ordinary income, while the remainder was a payment for the bonds' principal and was subject to capital gains tax. The Tax Court agreed with the IRS, holding that the portion of the sale price attributable to accrued interest was taxable as ordinary income, distinguishing this from the principal of the bonds, which was subject to capital gains treatment.

Facts

Shattuck owned bonds issued by Marblehead Land Company. These bonds accrued interest at 5% per year, but no interest had been paid since Shattuck acquired them. Marblehead offered to purchase Shattuck's bonds for $150 flat per $100 bond. Shattuck accepted the offer and received $54,600 for the bonds. Shattuck's basis in the bonds was $17,161.50. Shattuck reported the difference between the proceeds and his basis, $37,438.50, as a long-term capital gain. The IRS determined that $19,933.37 of the proceeds was accumulated interest taxable as ordinary income and the rest was payment for the debentures. The total face value of the bonds was $36,400.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Shattuck's income tax for 1950. The Tax Court reviewed the Commissioner's determination, focusing on the proper characterization of the proceeds from the bond sale.

Issue(s)

1. Whether a portion of the proceeds Shattuck received from selling interest-bearing bonds to the issuing corporation represented accrued interest, taxable as ordinary income.

2. Whether Shattuck could treat the entire proceeds from the bond sale as capital gain.

Holding

1. Yes, because the court found that a portion of the proceeds represented payment

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for the accrued interest on the bonds.

2. No, because the court determined that the accrued interest portion was not part of the capital gain.

Court’s Reasoning

The court distinguished between the sale of the bonds and the payment of accrued interest. It emphasized that the corporation’s payment for the bonds included a component for the unpaid interest. The court referenced the

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