H.E. Reisner, 28 T.C. 571 (1957)</p>

When a taxpayer purchases bonds in default at a flat price, subsequent payments received in excess of the taxpayer's basis, even if representing accrued interest, are treated as capital gains, not ordinary income.

Summary</p>

The case concerns the tax treatment of payments received on defaulted bonds purchased at a flat price. The taxpayer bought the bonds when interest payments were in default, meaning the purchase price didn't distinguish between principal and accrued interest. After the taxpayer recovered the basis, additional payments were received but still fell short of the principal due. The IRS argued these additional payments were ordinary income, but the Tax Court ruled that they were capital gains. The court reasoned that since the purchase was made at a flat price, the right to receive accrued interest was part of the capital acquisition and the subsequent payments were a return of capital, irrespective of their source or how they were labeled.

Facts</p>

The taxpayer, H.E. Reisner, purchased bonds that were in default. The bonds were purchased at a "flat price," which included both the principal and the accrued interest. The taxpayer did not segregate the purchase price. After recovering the cost basis of the bonds, the taxpayer received additional payments, which the IRS treated as ordinary income. The taxpayer reported the payments as capital gains.

Procedural History</p>

The IRS assessed a deficiency against the taxpayer, treating the payments as ordinary income. The taxpayer petitioned the Tax Court, claiming that the payments were capital gains. The Tax Court sided with the taxpayer, resulting in this ruling.

Issue(s)</p>

Whether payments received on defaulted bonds purchased at a flat price, in excess of basis, should be taxed as ordinary income or capital gains?

Holding</p>

No, the Tax Court held that the payments should be taxed as capital gains because the right to the interest was part of the capital acquisition.

Court's Reasoning</p>

The court focused on the nature of the acquisition. Since the bonds were purchased at a flat price, the purchase included both the bonds and the right to receive the accrued but unpaid interest. The court reasoned that the subsequent payments were a return of capital, not interest income, since the parties didn't segregate the purchase price to identify principal and interest. The court rejected the IRS's argument that the payments, although not interest income, were ordinary income. The Court relied on the premise that Section 117(f) of the 1939 Internal Revenue Code, which addressed the retirement of bonds, should apply to treat such payments as amounts received in exchange for a capital asset leading to capital gains.

The court stated, "Purchase of the bonds in question included in the price paid not only the title to the securities, but the right to receive interest accrued and unpaid. As to the petitioner the whole constituted a capital acquisition and the subsequent payment of the defaulted interest was a return of a portion of his investment, regardless of the label attached by the payor."

Practical Implications</p>

The case clarifies how to treat bond interest received after purchasing a bond in default at a flat price for tax purposes. Lawyers must consider this principle when advising clients on the tax implications of investing in defaulted bonds. This is particularly true in situations where the purchase price did not distinguish between principal and accrued interest. Subsequent payments are likely to be taxed as capital gains until basis is recovered. It also emphasizes the importance of how the transaction is structured. Had the taxpayer purchased only the interest coupons, the tax consequences might have been different. Later courts have cited this case to support the idea that purchasing a debt instrument at a discount includes the right to any unpaid interest, making the subsequent recovery of that interest a return of capital that could be subject to capital gains treatment.