27 T.C. 886 (1957)

When bonds are purchased “flat” (at a price that includes unpaid, defaulted interest), subsequent payments attributable to pre-acquisition interest, even if exceeding the bond’s basis but not the face value, are taxed as capital gains, not ordinary income.

Summary

Marcy Rickaby purchased bonds “flat” after the issuer defaulted on interest payments. Years later, she received payments exceeding her basis but less than the face value of the bonds, which the issuer designated as interest from periods before her purchase. The Tax Court addressed whether these payments should be taxed as ordinary income or capital gains. The court held that because Rickaby purchased the bonds “flat,” her investment encompassed both principal and the right to receive defaulted interest. Therefore, the subsequent payments, even when labeled as interest by the issuer, represented capital gains from the retirement of the bonds under Section 117(f) of the 1939 Internal Revenue Code, not ordinary income.

Facts

In 1942, Marcy Rickaby purchased $50,000 face value of Retail Properties, Inc. debentures for approximately $1,750. These bonds were purchased “flat,” meaning the price included the right to receive both principal and any unpaid, defaulted interest accrued since 1931. Retail Properties had defaulted on interest payments on its original gold debentures in 1931, leading to a reorganization and the issuance of the Series B debentures Rickaby purchased. By 1950, Rickaby had recovered her initial investment. In 1950, 1951, and 1952, she received further payments on the bonds, which Retail designated as interest payments for periods prior to her purchase in 1942. Rickaby reported these payments as capital gains from bond retirement.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Rickaby, arguing the payments exceeding her basis should be taxed as ordinary income under Section 22(a) of the 1939 Internal Revenue Code. Rickaby contested this assessment in the Tax Court.

Issue(s)

1. Whether payments received by a bondholder, who purchased bonds “flat” after interest default, which exceed the bondholder’s basis but are less than the face value and are designated by the issuer as pre-acquisition interest, are taxable as ordinary income under Section 22(a) or as capital gains under Section 117(f) of the Internal Revenue Code of 1939.

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Holding

1. Yes, the payments are taxable as capital gains under Section 117(f) because the amounts received were from the retirement of bonds, and the purchase "flat" encompassed the right to receive both principal and defaulted interest as part of a single capital investment.

Court's Reasoning

The Tax Court reasoned that when bonds are purchased "flat" after a default in interest, the purchase price reflects the speculative value of recovering both principal and the defaulted interest. The court rejected the Commissioner's argument that the payments, because they were labeled as pre-acquisition interest by the issuer, must be ordinary income. The court emphasized that Rickaby's purchase was a single capital transaction. Quoting from *R.O. Holton & Co.*, 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." The court further noted that Section 117(f) was intended to treat amounts received on bond retirement similarly to sales or exchanges, and it would be contrary to Congressional intent to tax these payments as ordinary income. The court distinguished the situation from purchases of bonds with current, undefaulted interest, where an interest adjustment is typically made at the time of sale. In this case, the defaulted interest was part of the capital asset purchased.

Practical Implications

Rickaby v. Commissioner clarifies the tax treatment of investments in defaulted debt purchased "flat." It establishes that payments received on such bonds, even if attributed to pre-acquisition interest by the issuer, are not automatically ordinary income. Instead, they are considered part of the capital recovery process for the bond purchaser. This case is important for investors purchasing distressed debt at a discount. It dictates that when bonds are bought "flat," subsequent recoveries, up to the face value, are generally treated as capital gains upon retirement of the bonds, assuming the bonds are capital assets in the hands of the holder. This ruling impacts how investors and legal professionals analyze the tax implications of purchasing defaulted bonds and similar debt instruments. It has been cited in subsequent cases and IRS rulings concerning the tax characterization of income from the disposition of debt instruments purchased with defaulted interest.

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