29 T.C. 989 (1958)

A taxpayer on the accrual method of accounting must reasonably expect to receive income within a reasonable time to accrue it; also, Section 45 of the Internal Revenue Code does not permit the disallowance of a deduction, but only the reallocation of income or deductions.

Summary

The Chicago and North Western Railway Company (CNW) owned a controlling interest in the Omaha railroad. CNW issued bonds and loaned the proceeds to Omaha, taking Omaha's bonds in return. CNW accrued and reported the interest income from Omaha, but after Omaha's financial difficulties, CNW ceased accruing the interest. The Commissioner sought to include the unaccrued interest income in CNW's taxable income for 1942 and 1943, arguing that CNW should have accrued interest income, alternatively that Section 45 of the Internal Revenue Code should be applied to allocate interest deductions to the railroad. The Tax Court held that CNW was correct not to accrue the interest because Omaha's insolvency made payment unlikely within a reasonable time. The court further held that Section 45 was not applicable because it does not permit the disallowance of deductions and cannot be used to create income.

Facts

CNW owned 93.66% of Omaha's stock. Both used the accrual method of accounting. Omaha's financial situation deteriorated. CNW issued bonds and loaned proceeds to Omaha. Omaha's debt to CNW included bonds and an open account. CNW accrued interest income from Omaha but ceased to do so after 1935 for bonds and 1938 for the open account because Omaha became increasingly insolvent, and was in a section 77 bankruptcy reorganization. During the war years, Omaha's revenues increased. However, Omaha remained insolvent, with liabilities far exceeding the fair market value of its assets and owing millions in past due interest to CNW. The Commissioner argued CNW should have accrued interest income, and, alternatively, sought reallocation of interest deductions under Section 45 of the Internal Revenue Code.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in CNW's income and surtaxes for 1942 and 1943, asserting the inclusion of unaccrued interest as income. The Commissioner also made a claim for increased deficiencies under section 272(e) of the Internal Revenue Code of 1939. The Tax Court considered the matter, adopting the commissioner's findings of fact with some minor adjustments. The Tax Court held against the Commissioner, and decision was entered under Rule 50.

Issue(s)

1. Whether the Commissioner erred in including unaccrued interest income from Omaha in CNW's taxable income for 1942 and 1943.
2. Whether, if the unaccrued interest income was not includible, the interest deductions of CNW and Omaha should be reallocated under Section 45 of the Internal Revenue Code.

Holding

1. No, because Omaha's insolvency meant there was no reasonable expectation of payment within a reasonable time, precluding accrual of the interest income.
2. No, because Section 45 does not permit the disallowance of deductions.

Court's Reasoning

The court addressed the first issue by stating that under the accrual method, a taxpayer must have a "reasonable expectancy" of receiving income to accrue it. The court cited *Corn Exchange Bank v. United States*, where the court stated that the government should not tax as income what is not received and will not likely be paid within a reasonable time. The court determined that Omaha's insolvency meant that a reasonable expectancy of payment of the interest did not exist. The court noted Omaha's large past-due indebtedness to CNW, its insolvency, and the fact that its increased earnings during the war were likely temporary. As a result, the court held the Commissioner erred in determining that the interest should be accrued.

Regarding the second issue, the court examined the application of Section 45 of the Internal Revenue Code, which allows the Commissioner to allocate income and deductions between related organizations to prevent tax evasion or clearly reflect income. The court found that Section 45 did not apply. It stated that Section 45 permitted the distribution, apportionment, or allocation of a deduction, but it did not permit its disallowance. The court cited *General Industries Corporation*, noting that the Commissioner was attempting to disallow a deduction, not reallocate it. The court stated there was no need to reallocate deductions.

Practical Implications

This case underscores the importance of the "reasonable expectancy" test in the accrual of income. Attorneys and accountants should consider the likelihood of payment when advising clients on income recognition. If the debtor's financial condition makes payment unlikely, then income should not be accrued. For Section 45, the case highlights the limits of the Commissioner's authority, which does not extend to simply disallowing a deduction. Instead, to use Section 45, the Commissioner must reallocate gross income or deductions. Tax practitioners should be mindful of the implications of related-party transactions. The decision is also important for understanding the correct interpretation and application of the provisions of the Internal Revenue Code, and highlights that the Tax Court will not permit the disallowance of deductions as a means to increase income.

This ruling was later cited in cases dealing with the accrual of income in the face of uncollectibility. It stands for the importance of the “reasonable expectancy” test for accrual method taxpayers.

