Levine v. Commissioner, 31 T.C. 1121 (1959)

A debt that has become worthless and is written off as such is not converted into a capital asset sale merely because a nominal sum is later received for the debt.

Summary

Mac Levine, a sole proprietor in the spring manufacturing business, made loans to a related fabric manufacturing company, General Textile Mills, Inc., to help his customers obtain fabrics. General struggled financially. Levine made loans to it and guaranteed a loan from another entity. When General was taken over by a factoring company and Levine's accountant determined the debts were unrecoverable, Levine wrote off the debts as business bad debts. Later, Levine transferred the debts to a purchaser for a small amount. The Commissioner argued the transfer was a sale of a capital asset. The Tax Court held that the debts were worthless before the transfer, and the subsequent nominal payment did not change the character of the loss, which was a business bad debt.

Facts

From 1945 to 1947, Mac Levine operated Webster Spring Company as a sole proprietor. Levine formed General Textile Mills, Inc. (General), a fabric manufacturer, to support his spring business. He made several loans to General totaling $15,200, which were evidenced by promissory notes. Levine also guaranteed a $4,000 loan from Paul Barrow to General and made a payment of $1,300 on the guarantee. General encountered financial difficulties, and a factoring company took control. Levine's accountant determined General's liabilities exceeded its assets. Levine instructed his bookkeeper to write off the loans and guaranty payment as uncollectible. Later, Levine transferred his claims against General to Quaker Pile Fabric Corporation for $362. Levine claimed the loss as a business bad debt.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Levine's income tax for 1947, disallowing the business bad debt deduction and classifying the loss as a long-term capital loss and a nonbusiness bad debt. The case was brought before the United States Tax Court.

Issue(s)

1. Whether Levine's claims against General became worthless in 1947, and if so, whether they constituted a business or nonbusiness bad debt.

2. Whether Levine's transfer of his claims against General to Quaker constituted the sale or exchange of a capital asset.

Holding

1. Yes, because the loans became worthless in 1947 and constituted business bad debts, proximately related to Levine's business.

2. No, because the later transfer for a nominal amount did not change the character of the loss.

Court's Reasoning

The Tax Court reasoned that the evidence showed the debts became worthless early in 1947. General's assets were insufficient to cover its liabilities. Levine's accountant determined the debts were unrecoverable, and Levine instructed his bookkeeper to write them off. The Court emphasized that, when a debt is written off, it is not disposed of; the debt remains an asset. Subsequent events, like the later transfer, might provide evidence regarding the correctness of the write-off, but in this case, the nominal payment received did not negate the prior worthlessness. The court found that the loss from both the loans and the guaranty payment was proximately related to Levine's trade or business. The court distinguished the case from *John F.B. Mitchell*, where the debt was sold on the same day of the charge-off, as the debt was already worthless here.

Practical Implications

This case highlights how the timing of a write-off and a subsequent transfer can affect the tax treatment of a debt. If a debt becomes worthless and is properly written off in a given tax year, a later transfer of the debt for a nominal amount does not necessarily negate the write-off. Attorneys and tax professionals should carefully examine the facts to determine when worthlessness occurs and when the debt is transferred to ensure the correct tax treatment, and in these cases it would be important to determine the worth of the debt before its transfer.

