Rivers v. Commissioner, 49 T. C. 663 (1968)

Gain realized on installment payments from notes received in a non-recognized gain transaction must be taxed as ordinary income, not capital gains, unless the payments constitute a sale or exchange.

Summary

In Rivers v. Commissioner, the Tax Court ruled on the taxation of installment payments received on promissory notes issued during a non-taxable exchange under Section 112(b)(5) of the Internal Revenue Code of 1939. The petitioners transferred assets to controlled corporations in exchange for stock and notes, with the notes to be paid over 20 years. The court held that a portion of each monthly payment represented taxable gain, which must be treated as ordinary income due to the absence of a sale or exchange. This decision reinforced the principle that non-recognized gains at the time of a transaction do not eliminate future taxation on installment payments.

Facts

On April 1, 1951, E. D. Rivers transferred assets to WEAS, Inc. and WJIV, Inc. in exchange for their respective stocks and promissory notes, in transactions that qualified as non-taxable under Section 112(b)(5) of the 1939 Internal Revenue Code. The notes from WEAS and WJIV were for $240,000 and $120,000 respectively, to be paid in monthly installments over 20 years. The fair market value of the notes equaled their face amounts. Rivers reported interest income but did not report any gain from the principal payments on the notes for the years 1958-1960, claiming that no taxable gain was realized due to the non-recognition provisions of Section 112(b)(5).

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Rivers' income tax for 1958, 1959, and 1960, asserting that the principal payments on the notes constituted taxable income. Rivers petitioned the U. S. Tax Court, which heard the case and issued its decision on March 22, 1968.

Issue(s)

1. Whether Rivers realized gain upon receipt of monthly principal payments on promissory notes issued in 1951 pursuant to a nontaxable exchange.
2. If so, whether such gain constituted a proportionate share of each monthly note payment.
3. If so, whether the gain attributable to each monthly note payment was taxable as ordinary income or as capital gain.

Holding

1. Yes, because the fair market value of the notes exceeded Rivers’ basis, resulting in realized gain upon receipt of monthly payments.
2. Yes, because each monthly payment, after deduction of interest, must be allocated in part to the return of basis and in part to income, following the principle established in the discount note cases.
3. No, because the gain was not from a sale or exchange, thus it was taxable as ordinary income, not capital gain.

Court’s Reasoning

The court applied the principle from discount note cases that when the basis of a note is less than its face value, each payment includes a proportionate share of income. The court rejected Rivers’ argument that the non-recognition of gain under Section 112(b)(5) eliminated future taxation on the note payments, stating that Congress intended only to postpone, not eliminate, tax on such gains. The court also held that the payments did not constitute a sale or exchange under Sections 117(f) or 1232(a) because the notes were not issued with interest coupons or in registered form. The court emphasized that gain from the collection of a claim, without a sale or exchange, is taxed as ordinary income, not capital gain.

Practical Implications

This decision clarifies that taxpayers receiving installment payments from notes acquired in a non-recognized gain transaction must allocate a portion of each payment to taxable income. It impacts tax planning for transactions involving non-recognition provisions by requiring consideration of the tax implications of future payments. Practitioners must advise clients to report such income correctly to avoid deficiencies and potential penalties. The ruling has influenced subsequent cases involving similar transactions, reinforcing the principle that non-recognition at the time of transfer does not preclude future taxation of realized gains.