***Federal Bulk Carriers, Inc. v. Commissioner, 57 T. C. 739 (1972)***

Losses from indemnification agreements related to the sale of capital assets are to be treated as capital losses.

**Summary**

In Federal Bulk Carriers, Inc. v. Commissioner, the Tax Court determined that losses incurred by the petitioner from indemnification agreements were capital losses, not ordinary losses. The case involved a complex series of transactions where Federal Bulk Carriers sold its interest in a ship-operating entity to Maple Leaf Mills Ltd. , with subsequent agreements to guarantee earnings from the ship. The court rejected the petitioner's argument that these losses should be treated as ordinary business expenses or losses from a joint venture, emphasizing that the losses were directly tied to the sale of capital assets and thus should be classified as capital losses.

**Facts**

Federal Bulk Carriers, Inc. (FBC) sold its interest in Federal Tankers Ltd. and its subsidiary to Maple Leaf Mills Ltd. (Maple Leaf) in 1961. As part of the transaction, FBC and its co-seller, Bessemer Securities Corp. , formed Bessbulk Ltd. to indemnify Maple Leaf against shortfalls in the earnings from a ship, the Monarch, operated by Federal Tankers. The indemnity agreement projected specific earnings and expenses over a 15-year period. When actual earnings fell short, FBC paid Maple Leaf, claiming these payments as ordinary losses on its tax returns. The IRS disagreed, asserting these losses were capital losses related to the sale of the Tankers stock and debentures.

**Procedural History**

The IRS issued a deficiency notice disallowing FBC's claimed ordinary losses for 1965 and 1966 and related net operating loss deductions. FBC challenged this determination in the Tax Court, which ruled in favor of the Commissioner, classifying the losses as capital losses.

**Issue(s)**

1. Whether the losses incurred by FBC in 1965 and 1966 from payments to Maple Leaf under the indemnity agreement should be classified as ordinary losses or capital losses.

**Holding**

1. No, because the losses were directly tied to the sale of capital assets (the Tankers stock and debentures) and thus must be classified as capital losses.

 

## Court’s Reasoning

The Tax Court reasoned that the losses stemmed from an obligation to adjust the purchase price of the Tankers stock and debentures sold to Maple Leaf. The court found that the various agreements did not establish a joint venture but were instead mechanisms to secure the earnings guarantee. The court relied on the Arrowsmith doctrine, which holds that losses incurred in connection with a prior sale of capital assets must be treated as capital losses. The court noted the lack of joint venture characteristics, such as shared profits and losses, and emphasized that the agreements were structured to adjust the purchase price of the original sale, not to operate a business. The court also highlighted the contractual language and the absence of any indication that FBC or Bessemer had a proprietary interest in the operation of the Monarch.

## Practical Implications

This decision underscores the importance of examining the substance over the form of transactions for tax purposes. It illustrates that losses from agreements directly tied to the sale of capital assets will be treated as capital losses, impacting how taxpayers structure and report complex transactions. Practitioners should be cautious in structuring deals involving guarantees or indemnifications related to capital asset sales, as these may not be deductible as ordinary losses. The case also serves as a reminder of the Arrowsmith doctrine’s application in tax law, influencing how subsequent payments or losses related to prior capital transactions are characterized. Subsequent cases have continued to apply this principle, reinforcing the need for careful transaction planning to achieve desired tax outcomes.

 