

SMITH v. COMMISSIONER
48 T.C. ____ No. 83 (1967)

Editor's Summary

Key Topics

LOSSES

- Capital v. ordinary
- Purchase price prepaid at discount

Facts

The taxpayer was a stockholder in a corporation which on April 10, 1962, entered into an agreement to sell a tract of timberland. The terms of the agreement were \$3,000 down, a \$9,000 *interest-bearing* promissory note to be paid January 1, 1963, and ten annual installments totaling \$39,960 at 6 percent interest. However, the purchaser had the right to pay the \$39,960 at any time prior to January 1, 1963, at a discount of 18 percent. The corporation reported a capital gain on the sale in its tax return for its fiscal year ended October 31, 1962. Thereafter, the purchaser exercised his right to prepay the contract balance at a saving to him and a loss to the corporation of \$7,192.80. The corporation deducted the loss from ordinary income, but the Commissioner contended that it was a capital loss and disallowed the deduction.

Tax Court

Held: For the Commissioner. The character of a loss is fixed by reference to the character of the original transaction. In the instant case the original transaction was capital in nature. Thus, the discount should properly be treated as a capital loss. In effect, the discount amounted to a reduction in the purchase price of the timberland. [NOTE-As to payments received after 12/31/63 on account of sales or exchanges occurring after 6/30/63, see also Section 483, I.R.C. 1954.]

Case Text

[Timber Issues Only]

Fay, Judge: Respondent determined deficiencies in the Federal income tax of petitioners for the years 1962 and 1963 as follows:

Year	Docket No.	Petitioner	Amount
1962	1182-66	Joe M. and Florence Smith	\$ 2,438.44
	1307-66	Robert H. Anderson, Dec'd, Laria M. Anderson, Executrix, and Laria M. Anderson	596.31
1963	1186-66	Joe M. and Florence Smith	100,323.57
	1183-66	Henry V. and Margaret E. Nielsen	77,852.86

Various adjustments have been stipulated to by the parties, and an unrelated issue in Docket No. 1307-66 was abandoned by petitioners at trial. The remaining issues for determination are:

2. Whether Smith-Nielsen Manufacturing Company, having reported as a long-term capital gain the gain on the sale of timberland under a contract which gave the purchaser the right to a discount for full payment before a certain date, may in a subsequent year treat the amount of the discount as an ordinary expense or as a capital loss in the amount of \$7,192.80.

FINDINGS OF FACT

General

Most of the facts have been stipulated, and the stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

Joe M. Smith (hereinafter referred to as Smith) and Florence P. Smith are husband and wife with legal residence in Spokane, Washington, at the time the petition herein was filed. They filed Federal joint income tax returns for the years 1962 and 1963 with the district director of internal revenue at Tacoma, Washington.

Henry V. Nielsen (hereinafter referred to as Nielsen) and Margaret E. Nielsen are husband and wife with legal residence in Spokane, Washington, at the time the petition herein was filed. They filed a Federal joint income tax return for the taxable year 1963 with the district director of internal revenue at Tacoma, Washington.

Laria M. Anderson, for herself and as executrix of the estate of Robert H. Anderson, deceased, had legal residence in Spokane, Washington, at the time the petition herein was filed. Robert H. Anderson (hereinafter referred to as Anderson) and Laria M. Anderson filed a Federal joint income tax return for the year 1962 with the district director of internal revenue at Tacoma, Washington.

In 1962 Smith, Nielsen, and Anderson (sometimes hereinafter referred to collectively as petitioners), and one Alvin W. Luhr (hereinafter referred to as Luhr) were associated together either as common stockholders or partners in two businesses, namely, Smith-Nielsen Manufacturing Company, a small business corporation (hereinafter sometimes referred to as the corporation), and Smith-Nielsen Logging and Lumber Company, a partnership (hereinafter sometimes referred to as the partnership).

* * *

Issue 2

On April 10, 1962, the corporation entered into an agreement to sell to James E. Wyatt (hereinafter sometimes referred to as Wyatt) approximately 3,464 acres of timberland for a price of \$51,960. The terms of the contract were \$3,000 down, a \$9,000 interest-bearing promissory note to be paid January 1, 1963, and ten equal annual installments totaling \$39,960 at 6 percent interest, the first of which was due March 1, 1963. The purchaser had a right to pay the \$39,960 balance at any time prior to January 1, 1963, at a discount of 18 percent. The term of the contract pertaining to the right of prepayment provides as follows:

4. That it is understood and agreed between the parties that the Purchasers may have the right to pay the entire unpaid purchase price of \$39,960.00 at any time before the 1st day of January, 1963 conditioned upon the Seller then being the owner of said contract, at a discount of 18% and said Seller further agrees that if said Seller has an opportunity to sell said contract, prior to said January 1, 1963, it shall give the Purchasers notice in writing of said opportunity and said Purchasers shall have ten (10) days in which to purchase contract at said 18% discount, And, in the event said contract has not been sold by the 1st day of January, 1963, and the Seller elects at a later date to sell said contract, at that time shall also give said Purchasers at least ten (10) days notice in writing of election to sell said contract and at which the same is to be sold and the Purchasers shall have ten (10) days from and after receiving said notice in which to purchase said contract at the same price the said Seller has elected to sell the same.

For the fiscal year ended October 31, 1962, the corporation reported a long-term capital gain on the sale to Wyatt in the amount of \$29,871.83. Thereafter Wyatt timely exercised his right to prepay the contract balance and to take advantage of the 18 percent discount in the amount of \$7,192.80.

For the fiscal year ended *October 31*, 1963, the corporation claimed the \$7,192.80 as an ordinary expense. Respondent in his statutory notice of deficiency disallowed the deduction and determined that the amount was properly allowable as a capital loss.

OPINION

Issue 2

The second issue is whether the corporation's discounting of a contract in the fiscal year ended October 31, 1963, entitles petitioners Smith and Nielsen to treat such amount as an ordinary expense or a capital loss.

The discount arose pursuant to the terms of a sales contract entered into between the corporation and Wyatt on April 10, 1962. The corporation reported the gain on that transaction as long-term

capital gain for the fiscal year ended October 31, 1962. Exercising his contract option to prepay the balance of the purchase price and obtain a discount, Wyatt prepaid the balance during the fiscal year ended October 31, 1963.

Petitioners contend that the discounting of the contract is productive of an ordinary loss due to the absence of any sale or exchange in the fiscal year ended October 31, 1963. We cannot agree.

We are of the opinion that this situation is clearly within the rationale of such cases as *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952); *Estate of James M. Shannon*, 21 T. C. 422 (1953); and *Rees Blow Pipe Manufacturing CO.*, 41 T. C. 598 (1964), aff'd, per curiam 342 F. 2d 990 (C. A. 9, 1965), so that the character of the loss is fixed by reference to the original transaction, which in this case was capital in nature.⁷

We also note the case of *Weber v. Commissioner*, 242 F. 2d 938 (C. A. 9, 1957), affirming 24 T. C. 529 (1955), which though it dealt with a single tax year, held that where a release or compromise is in reality part of the original transaction, it is to be treated as one transaction, *i.e.*, as a reduction in the original purchase price.⁸ This case, when viewed in conjunction with the line of authority cited earlier, clearly supports respondent's contention that the discount is productive of a capital loss on the facts before us.

Decisions will be entered under Rule 50.

⁷ The only authority cited by petitioners on this issue was *Hale v. Helvering*, 85 F. 2d 819 (C.A.D.C. 1936)~ which is clearly distinguishable from the instant case. In *Hale* the debt which was compromised was past due. In the case at bar the discounting was accomplished pursuant to the terms of the original contract and in advance of the date that the installment payments matured,

⁸ In the case of *Wener v. Commissioner*, 242 F. 2d 938 (C.A. 9, 1957), affirming 24 T.C. 529 (1955) taxpayer partners sold their interests in a partnership to the remaining partners for cash and an installment obligation. Later that same year, before the various installments became due, the taxpayers agreed to accept a prepayment in cash for the unearned balance. The court held that such a reduction in amounts not yet due was not merely cancellation of indebtedness but was a reduction in the original purchase price and was treated as a capital loss.