



## Tax Reduction Letter

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### ***Pierce Estates, Inc. v. Commissioner***

16 T.C. 1020 (T.C. 1951)

Docket No. 26834.

United States Tax Court.

Promulgated May 14, 1951.

Robert Ash, Esq., and John W. Cragun, Esq., for the petitioner.

Oscar L. Tyree, Esq., for the respondent.

The Commissioner determined a deficiency in income tax for the year 1946 in the amount of \$16,769.38. Two issues are involved: (1) Whether certain payments by petitioner constituted interest payments which are deductible for income tax purposes or dividends which are not deductible, and (2) whether certain expenditures made by petitioner are deductible as ordinary and necessary business expenses or whether they constitute capital expenditures.

Some of the facts were stipulated.

#### **FINDINGS OF FACT.**

The stipulated facts are so found and are incorporated herein.

Petitioner is a Delaware corporation organized January 17, 1918, and has its principal place of business at Bound Brook, New Jersey. Its books are kept on an accrual basis. Its Federal income tax return for 1946 was filed with the collector of internal revenue for the fifth district of New Jersey.

At the time of its incorporation, petitioner's authorized capital stock consisted of 6,000 shares of no par value stock which was issued to certain heirs and personal representatives of Ray Vaughn Pierce, deceased, in exchange for certain real and personal property forming a part of the estate of Ray Vaughn Pierce. These assets were placed on the books of the petitioner at a valuation of \$527,652.40. In July 1930 petitioner's authorized capital stock was increased to 6,500 shares, and it's board of directors authorized the issuance of 30-year cumulative income debenture notes in the total amount of \$150,000

At the time of such authorization all of petitioner's stock was owned by two surviving sons of Ray Vaughn Pierce and the estate of his deceased son, Ralph W. Pierce. On July 18, 1930, they offered to turn over to the petitioner certain properties, owned individually and in equal shares by them. On this same date the offer was accepted and it was at this time that the issuance of the

income debenture notes was authorized. These notes, plus 498 shares of the unissued authorized 500 shares of petitioner's no-par stock and the surrender of a promissory note of one of the stockholders as agent of all the stockholders, were transferred to the stockholders in exchange for the property offered.

The book values of the properties respectively conveyed pursuant to the accepted offer appeared on petitioner's books as follows:

Transferred from Stockholders:

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Way Mortgage (face amount \$ 50,000 subject to 10% lien)	\$ 25,000.00
American Engine Co. plant at Bound Brook, N. J	110,000.00
Securities of Pierce Development:	
Notes (face amount \$ 178,539.35).	
Bonds (principal \$ 122,000) plus past-due interest.	
Stock, 1221 shares.	
The lot	100,000.00
	\$ 235,000.00
Transferred by Petitioner:	
Thirty-year cumulative income debenture 6% notes of petitioner, due July 21, 1960	\$ 150,000.00
Note of Hugh C. Pierce, agent of the stockholders	31,632.52
Petitioner's no-par capital stock, 498 shares	53,367.48
	\$ 235,000.00

The 30-year cumulative income debenture notes which petitioner issued promised to pay the individual named in each note or his assigns the face value of the note, which was \$1,000, on July 21, 1960. They bore 6 per cent cumulative interest and no dividends were to be paid or declared until all interest outstanding on the notes should have been paid. The notes were registered and carried no voting rights. They further provided:

The company on or before the 1st day of March in each year, or at such more frequent intervals during any year as its Board of Directors may at their option determine, and prior to the payment of any dividends out of the income of such year, shall cause its Board of Directors to ascertain and declare the amount of net income for the preceding calendar year or such more frequent interval applicable to the payment of the interest on all of the notes of this series then issued and outstanding. Such amount shall be ascertained by deducting from the gross income of the company for such period all current expenses for operating the properties and business of the company and such sums as may be necessary in the judgment of said Board to maintain the property of the company and keep the same in good repair, to pay taxes and interest charges, and such sums as in the judgment of said Board may be proper to set aside as a reserve for depreciation upon the physical properties of the company. From the net income thus ascertained, the Directors shall set aside amounts required to pay any and all unpaid interest upon said series of notes then issued and outstanding, accruing up to the end of the last preceding calendar year or

the end of such shorter period, and thereupon shall apply the same to the payment of such interest.

The property individually owned by the stockholders of petitioner was conveyed to the corporation to avoid any difficulties which might arise due to the necessity of unanimous agreement in the administration or liquidation of the interests while owned individually. Debenture notes rather than stock were issued since the parties, particularly the trustees of the estate of Ralph W. Pierce, wanted to have a definite date for realization of principal. They were made income debenture notes to eliminate the risk petitioner might otherwise have had in the event of a default in interest during a bad year.

At the time petitioner issued these income debenture notes it had made a profit in every year (except 1921) since its incorporation. It had sufficient profits in 1930 to pay or accrue on its books the interest on the notes for so much of that year as they were outstanding. From 1931 until 1942, petitioner suffered a loss in each year without regard to debenture interest.

Interest was accrued for the notes on petitioner's books for the years 1931, 1932, and 1933 by an auditing and tax service company which prepared petitioner's annual audit, despite the fact that petitioner realized no net profits for these years. In 1934, when petitioner's president took over the preparation of the statements, as a result of legal advice no further interest was accrued on these debentures. Beginning in 1938, petitioner's balance sheets noted that the debenture interest for 1931, 1932, and 1933 had been accrued "by error"; and in 1941, the accrual was written off in connection with an adjustment of capital accounts.

In 1942, and in following years, including the taxable year in question, petitioner had profits before debenture interest. It accrued interest upon its books equal to the amount of profits before the interest and paid such amounts not later than the following year. In each of the years from and including 1942, petitioner charged the amount which it accrued as debenture interest notes payable to interest expense. The amount of profits before debenture interest for the taxable year 1946 was \$65,156.94, all of which was charged as interest expense and accrued as interest payable on petitioner's books. It represented the \$9,000 in interest due for 1946 plus cumulative interest for prior years. In determining the deficiency, respondent disallowed such amount as interest for Federal income tax purposes.

During the taxable year petitioner expended \$513 to replace ties and rails and grade the siding of a railroad it owned. Such expenditures occurred almost every year and varied from a few hundred to several thousand dollars. Petitioner spent \$300 to patch leaks in an asphalt roof of a building. It also expended \$375 to replace with corrugated metal the roof of a second building. This latter roof had a life of more than one year. In determining the deficiency, respondent disallowed such expenditures as ordinary and necessary business expenses for the taxable year.

## **OPINION.**

RICE, Judge:

The first issue is whether certain payments by petitioner corporation represented payments of interest or of dividends. This in turn is dependent upon whether certain securities were a form of indebtedness or were stock. If the payments were interest payments they are deductible by petitioner under section 23 (b) of the Internal Revenue Code, which provides:

## SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

\* \* \* \* \*

(b) INTEREST. — All interest paid or accrued within the taxable year on indebtedness, except \* \* \*.

The status of hybrid corporate securities containing characteristics of both stock and indebtedness has frequently been before this Court. No one factor is sufficient for a determination of such status but all of the attributes must be carefully weighed and each case will turn on its own facts.

Some of the characteristics which are considered are: The maturity date if any, the method used in accounting for the securities on the books, the designation of the security, the ratio of these securities to capital stock, the interest rate, subordination of interest payments, specified designation of the source of the interest payments, right of action by the holder in case of default, voting rights, and consideration.

While nomenclature is not controlling in this type of case, it has some evidentiary value. *Richmond, Fredericksburg & Potomac Railroad Co.*, 33 B. T. A. 895 (1936), *affd.* (C. A. 4, 1937), 90 F. 2d 971. The securities issued by petitioner were denominated 30-year cumulative income debenture notes. They had a definite maturity date in the reasonable future, an important characteristic of an evidence of indebtedness. *Kelley Co. v. Commissioner*, 326 U. S. 521 (1946); *Swoby Corporation*, 9 T. C. 887 (1947). They were carried on the books as a liability, being the first item which appeared on the liability side of petitioner's profit and loss statements.

The book value of petitioner's outstanding no-par stock was nearly \$600,000 for the period 1930 until 1941, from which time it was over \$200,000 following a write-down in connection with adjustments of the capital accounts. The notes had a face value of \$150,000. The ratio of the two was not of such a character as to make it appear that in reality the notes indicated an investment in the corporation. *Swoby Corporation*, *supra*.

The notes provided for 6 per cent cumulative interest payable out of the net income of the corporation. Such net income was defined in the note itself as being any amount remaining after current expenses, taxes, interest (other than on the notes), repairs, and depreciation reserves had been set aside by the Board of Directors. Such a condition for payment is not unusual and, while it is more like a stock characteristic, has been present in cases where the security has been held to represent an indebtedness, *Kelley Co. v. Commissioner*, *supra*, although it is a factor which weighs against such result.

Since the notes were silent as to rights of the holder in case of default, there was no limitation on those rights which are available to any creditor upon default of a legal obligation. *Cf. Mullin Building Corporation*, 9 T. C. 350, 356 (1947), *affd.* (C. A. 3, 1948), 167 F. 2d 1001.

These securities were part of the consideration given to the stockholders of petitioner in exchange for assets transferred by the stockholders to the corporation. Notes rather than capital

stock were given since one of the stockholders (the trustees of the estate of a deceased son) wanted a definite date for return of the principal.

Some of these factors point in one direction, others in the opposite direction. Having carefully considered all the enumerated characteristics plus others which have not been set forth, we hold that the income debenture notes evidenced indebtedness, and that interest paid thereon is deductible under section 23 (b) of the Code.

Having determined that interest paid on the notes is properly deductible for income tax purposes, we must determine how much petitioner may deduct. Petitioner is on an accrual basis. For the taxable year in question it deducted \$65,156.94, which represented payment of interest on the debenture notes including back interest which had not been paid in prior years. The theory petitioner advances for such treatment is that the interest did not accrue until such time as petitioner made the income with which to pay it. The respondent, on the other hand, argues that since petitioner is on an accrual basis, the interest accrued yearly and should have been claimed as a deduction each year. We uphold the respondent on this question. While it is true that until such time as petitioner showed a net income for any year the interest would not be payable, all steps necessary to determine liability arose in each year that the notes were outstanding and it was merely the time of payment which was postponed.

In *Miller & Vidor Lumber Co. v. Commissioner* (C. A. 5, 1930), 39 F. 2d 890, affirming 15 B. T. A. 948 (1929), certiorari denied, 282 U. S. 864 (1930), the court said:

In this case the petitioner kept its books and made its returns on the accrual basis, which reflected true income. The interest on the notes was a fixed liability of a definite amount, ascertainable at the end of each year. While the interest was not paid annually, and was not due annually, it was earned annually. Each year's interest was ratably earned by the use of the principal sum in the business of the taxpayer during the year of its use. It was an expense of creating the income for each separate year, and the net income of the business for a particular year could be ascertained only by deducting from gross income the item of annual interest. The year of the payment of the interest and the year when the interest matured have no importance, where the accounting is on the accrual basis. Scientific accounting requires the deduction to be made from the gross income, which the item of expense helped to create, and that requires the deduction for annual interest to be made from the gross income of the year in which the principal served to create it.

In *Warner Co.*, 11 T. C. 419 (1948), affd. (C. A. 3, 1950), 181 F. 2d 599, petitioner kept its books on an accrual basis. In that case the original bond indenture called for 6 per cent annual interest payments. During the depression petitioner suffered losses and was unable to pay such interest as it became due. It therefore executed a supplemental indenture with the bondholders, providing that for the years 1933 through 1935, interest not to exceed 6 per cent be paid only to the extent that there were sufficient earnings. Any deficiency in such interest was to be paid at maturity or any earlier redemption. No interest was paid for these years until 1942, when it was all paid and a deduction for the entire amount was claimed for that year. We held that since petitioner was on an accrual basis it was not entitled to such a deduction in the year the interest was paid. Such interest was accruable in the years it became due and the supplemental indenture merely extended the time for payment, but did not alter or postpone the unconditional liability to pay the interest. See also, *American National Co. v. United States*, 274 U. S. 99 (1927); *United States v. Anderson*, 269 U. S. 422 (1926); *Keebey's Inc. v. Paschal* (C. A. 8, 1951), 188 F. 2d

113; *Cumberland Glass Mfg. Co. v. United States* (Ct. Cl., 1930), 44 F. 2d 455; *National City Lines, Inc. v. United States* (D. C., Del., 1951), 97 F. Supp. 283.

In the instant case, it is true that the time of payment was uncertain. But that did not prevent the interest from accruing. The amount was fixed and definite. The contingency as to time of payment was not such a contingency as to prevent the interest from accruing. Cf. I. T. 3635, 1944 C. B. 101. The payment of the interest was not so uncertain as to prevent its accrual annually. Cf. *Millar Brainard*, 7 T. C. 1180 (1946). Under such circumstances, the interest was properly accruable annually, and petitioner is entitled to a \$9,000 deduction, representing that interest which accrued during the taxable year.

The second issue is whether certain expenditures made by petitioner during the taxable year were for repairs deductible under section 23 (a) (1) (A). Whether such an expenditure is deductible as a repair is a question of fact. Treasury Regulations 111 § 293.23 (a)-4 distinguishes between a repair and a capital expenditure as follows:

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. \* \* \*

Applying such considerations to the instant case, we hold that the \$300 spent to patch the asphalt roof and the \$513 spent to repair the railroad siding are properly deductible as repair expenses. Neither expenditure prolonged the life of the asset, nor materially increased its value. Each was made to restore the asset to a useful state. *Illinois Merchants Trust Co., Executor*, 4 B. T. A. 103 (1926).

The corrugated metal roof is another matter. It was a replacement with a life of more than one year, and the cost thereof is not properly deductible as an ordinary and necessary expense but should be treated as a capital expenditure. *Georgia Car & Locomotive Co.*, 2 B. T. A. 986 (1925).

Decision will be entered under Rule 50.