3 T.C. 518 (1944)

For purposes of the excess profits tax, a taxpayer's outstanding indebtedness qualifies as 'borrowed capital' only if evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, and a bilateral contract does not meet this definition.

Summary

Journal Publishing Co. sought to include a portion of its debt to a competitor as 'borrowed capital' for excess profits tax purposes. The debt arose from a contract where Journal Publishing Co. purchased assets and a non-compete agreement from the competitor. The Tax Court held that the debt, not being evidenced by a specific financial instrument listed in Section 719 of the Internal Revenue Code, did not qualify as borrowed capital. The court emphasized the need for the debt to be evidenced by a specific type of financial instrument, rather than a general contractual obligation.

Facts

Journal Publishing Co. (petitioner) entered into an agreement with The Portland News Publishing Company (News Co.).
Petitioner agreed to purchase certain assets from News Co. and News Co. agreed to refrain from competing with petitioner for a specified period.
In consideration, petitioner promised to pay News Co. $520,000, with $25,000 paid upfront.
The balance was to be paid in installments.
The daily average outstanding indebtedness during the 1940 tax year was $483,770.49.

Procedural History

The Commissioner of Internal Revenue eliminated 50% of the petitioner's daily average outstanding indebtedness to News Company from its average borrowed invested capital.
The Commissioner argued the indebtedness did not qualify as borrowed capital under Section 719 of the Internal Revenue Code.
Journal Publishing Co. petitioned the Tax Court for review.

Issue(s)

Whether the written contract between Journal Publishing Co. and News Co., representing a purchase agreement and non-compete clause, constitutes an 'outstanding indebtedness' evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust under Section 719(a)(1) of the Internal Revenue Code, as amended, such that it qualifies as 'borrowed capital' for excess profits tax purposes?

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Holding

No, because the contract was a bilateral agreement dependent on News Co.'s performance, not a unilateral promise to pay evidenced by a specific financial instrument listed in Section 719(a)(1).

Court's Reasoning

The court focused on the specific language of Section 719(a)(1), which defines borrowed capital as indebtedness evidenced by particular financial instruments.
The court noted the legislative history, pointing out that an earlier version of the bill included 'any other written evidence of indebtedness' but this phrase was ultimately omitted in the final version.
The court reasoned that the omission suggested a deliberate intent to limit the definition of borrowed capital to the enumerated instruments.
The court distinguished the contract from a 'note,' emphasizing that a note represents an unconditional promise to pay, whereas the contract was bilateral, requiring News Co. to perform its side of the agreement (non-competition).
The court cited *Deputy v. Du Pont, 308 U.S. 488*, stating, "The term 'indebtedness' does not include every obligation."
The court also cited *Frank J. Cobbs, 39 B.T.A. 642*, indicating that "evidence of indebtedness" did not denote contracts that had been regarded as somewhat similar to securities.

Practical Implications

This case provides a strict interpretation of what qualifies as 'borrowed capital' under Section 719 for excess profits tax, emphasizing the requirement of a specific financial instrument.
It limits the ability of taxpayers to include general contractual obligations as borrowed capital, even if they represent a genuine indebtedness.
Practitioners should ensure that indebtedness intended to be treated as borrowed capital is clearly documented with the specific instruments listed in the statute.
This ruling highlights the importance of carefully structuring transactions to meet the technical requirements of the tax code.
Later cases have cited this decision for the proposition that the definition of 'indebtedness' for tax purposes is not all-encompassing and depends on the specific statutory context.

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