4 T.C. 185 (1944)

A short-term, unsecured note issued to cover current expenses does not constitute a ‘security’ for the purposes of determining whether a company qualifies as a mutual investment company under Section 361 of the Internal Revenue Code, and ‘substantially all’ of a company’s business means the great majority, in this case 98%.

Summary

Wellington Fund sought to be taxed as a mutual investment company. The IRS argued that a loan made to Pantepec Oil Co. disqualified Wellington because the loan was a ‘security,’ violating the rule that a mutual investment company could not hold more than 10% of any one company’s securities. The Tax Court held that the short-term note representing the loan was not a ‘security’ as contemplated by the statute, and that the Fund’s investment activities still constituted ‘substantially all’ of its business despite the loan.

Facts

Wellington Fund, Inc. was organized to invest in stocks and securities. Pantepec Oil Co. needed a short-term loan. Wellington loaned Pantepec $75,000, receiving a note and shares of Pantepec stock as consideration. Pantepec used the funds for current expenses and recorded the note as a current liability. Wellington reported the stock and a portion of a broker’s commission as income. Wellington’s balance sheets showed the vast majority of its assets were stocks and bonds.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Wellington Fund’s income taxes, arguing it was not a mutual investment company. Wellington Fund petitioned the Tax Court for review.

Issue(s)

1. Whether the $75,000 note from Pantepec constituted a ‘security’ under Section 361(b)(2) of the Internal Revenue Code, thus disqualifying Wellington Fund as a mutual investment company?

2. Whether Wellington Fund’s loan to Pantepec meant that ‘substantially all’ of its business no longer consisted of holding, investing, or reinvesting in stock or securities as required by Section 361(a)(1)?

Holding

1. No, because the note was a short-term loan to cover current expenses and did not represent an investment in the business.

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2. No, because Wellington Fund's investment activities still constituted over 98% of its business, which is 'substantially all'.

Court's Reasoning

The court reasoned that the term 'securities' in the tax code, when undefined, should be given its ordinary meaning, denoting "an obligation of a character giving the creditor some assured participation in the business of the debtor, or, in other words, an investment in the business," quoting *American Realty Trust v. United States*. The court distinguished the Pantepec note from true securities, emphasizing that it was a short-term, unsecured loan for current expenses, treated as such by both parties. The court also rejected the IRS's argument that the transaction should be treated as a discounted purchase of a note and stock, viewing the stock and commission share as consideration for making the loan.

Regarding the 'substantially all' requirement, the court emphasized the percentage of Wellington's business devoted to investment activities. It cited prior cases such as *Consumers Credit Rural Electric Cooperative Corporation v. Commissioner* to support the view that 'substantially all' means close to the entirety, and that 98% qualified. The court stated, "The amount of the Pantepec loan is not the controlling factor. It is the percentage or proportion of all of petitioner's business, including that loan, reflected by its investments. The words 'substantially all' make that clear."

Practical Implications

This case clarifies the definition of 'security' in the context of mutual investment companies, providing a narrower interpretation that excludes short-term financing. It also offers guidance on interpreting 'substantially all,' indicating that a very high percentage of investment activity is required to meet this threshold. Later cases will likely cite Wellington Fund to distinguish between genuine investments and short-term loans when determining whether a company qualifies as a mutual investment company for tax purposes. This case helps define the boundaries of what constitutes acceptable non-investment activity for a company seeking preferential tax treatment as a mutual investment company.

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