4 T.C. 536 (1945)

Advances to a corporation from its stockholders, documented only as open accounts, do not qualify as "borrowed invested capital" for excess profits tax purposes unless evidenced by a formal debt instrument as defined by the Internal Revenue Code.

Summary

Flint Nortown Theatre Company sought to include advances from its stockholders in its invested capital to reduce its excess profits tax liability. The advances, used for construction and equipment, were documented as open accounts. The Tax Court held that these advances did not qualify as either equity invested capital or borrowed invested capital under Sections 718 and 719 of the Internal Revenue Code because they were not evidenced by a formal debt instrument such as a bond, note, or mortgage. This decision highlights the importance of properly documenting debt to qualify for specific tax treatments.

Facts

Flint Nortown Theatre Company was formed in 1939 with $5,000 capitalization, split equally between Alex Schreiber and A. Eiseman. To fund the construction and equipping of the theatre, Schreiber and Eiseman advanced additional funds to the company. Each stockholder advanced $22,400, recorded as open accounts on the company's books. A corporate resolution acknowledged these advances and contemplated issuing promissory notes, but no notes were ever actually issued.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Flint Nortown Theatre Company's excess profits tax for 1941. The company petitioned the Tax Court, arguing that the stockholder advances should be included in its invested capital, either as equity invested capital or borrowed invested capital. The Tax Court ruled in favor of the Commissioner, upholding the deficiency.

Issue(s)

1. Whether advances made by stockholders to a corporation on open account can be considered "equity invested capital" under Section 718 of the Internal Revenue Code for excess profits tax purposes.
2. Whether advances made by stockholders to a corporation on open account can be considered "borrowed invested capital" under Section 719 of the Internal Revenue Code for excess profits tax purposes, when no formal debt instrument was issued.

Holding

1. No, because the advances were loans and were not paid in for stock, as paid-in

surplus, or as a contribution to capital as required by Section 718.
2. No, because the advances were not evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, as required by Section 719.

Court's Reasoning

The court strictly interpreted Sections 718 and 719 of the Internal Revenue Code. The court emphasized that the advances were treated as loans, not as contributions to capital. Furthermore, Section 719 explicitly requires that borrowed capital be evidenced by specific types of debt instruments. The court noted that the resolution indicated an intent to issue promissory notes in the future, but the fact that no such notes were ever issued was determinative. The court stated, "It is plain that the moneys which petitioner's stockholders advanced to it on open account do not fall within the statutory definitions of either equity invested capital or borrowed invested capital…They were not within the statutory definition of borrowed invested capital because not evidenced by 'a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust.'" The court acknowledged potential hardship but stated it could not alter the statute's plain meaning.

Practical Implications

This case highlights the critical importance of proper documentation when structuring financial transactions, especially in the context of taxation. To treat stockholder advances as borrowed invested capital, corporations must ensure the debt is formally documented with instruments like notes or bonds. This decision serves as a reminder that the substance of a transaction alone is not enough; the form must also comply with statutory requirements to achieve desired tax consequences. Later cases applying this ruling emphasize the need for contemporaneous documentation that clearly establishes the intent to create a debtor-creditor relationship and satisfies the specific requirements of Section 719. Businesses and their legal counsel must be diligent in creating and maintaining proper documentation to support their tax positions.