5 T.C. 543 (1945)

When a previously tax-exempt entity becomes subject to taxation, its first taxable year begins on the date it loses its exempt status, not necessarily at the beginning of its usual accounting period.

Summary

Economy Savings and Loan, formerly tax-exempt, changed its operations and became taxable mid-year. The IRS determined the company's first taxable year began when it lost its exempt status, assessing income tax under the Second Revenue Act of 1940 and an excess profits tax, along with a penalty for failing to file an excess profits tax return. The Tax Court upheld the IRS's determination of the taxable year's start date and the penalty, finding the company's belief that no return was needed was not reasonable cause. The court also ruled on the proper calculation of invested capital for excess profits tax purposes.

Facts

Economy Savings and Loan Company, an Ohio building and loan corporation, was previously exempt from federal income tax under Section 101(4) of the Internal Revenue Code. Effective February 1, 1940, the company changed its business practices, primarily serving non-shareholder borrowers, which resulted in the loss of its tax-exempt status. The company kept its books on a cash basis with a fiscal year ending September 30. It filed an income tax return for the 12 months ending September 30, 1940, prorating its income and using the tax rates from the Revenue Act of 1938. It did not file an excess profits tax return.

Procedural History

The IRS determined that Economy Savings and Loan's first taxable year was the period from February 1 to September 30, 1940. The IRS assessed a deficiency in income tax, applying rates under the Second Revenue Act of 1940, and an excess profits tax, plus a 25% penalty for failing to file an excess profits tax return. The IRS computed the excess profits credit under the invested capital method. The Commissioner later amended the answer, seeking an increased deficiency, arguing that the original calculation erroneously included certain deposits as borrowed capital. The Tax Court addressed the deficiencies, the penalty, and the computation of the excess profits tax credit.

Issue(s)

1. Whether Economy Savings and Loan's first taxable year began on February 1, 1940, when it lost its tax-exempt status, or on October 1, 1939, the beginning of its usual accounting period.

2. Whether the IRS properly annualized the excess profits tax net income for the

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short taxable year.

3. Whether the deposits secured by certificates issued by the company constituted borrowed capital for excess profits tax purposes.

4. Whether the 25% penalty for failure to file an excess profits tax return was properly imposed.

Holding

1. Yes, because based on prior precedent, when a previously exempt entity becomes taxable, its taxable year begins when it loses its exempt status.

2. Yes, because Section 711(a)(3)(A) of the Internal Revenue Code allows for annualization of income for short tax years.

3. Yes, because the certificates of deposit were certificates of indebtedness and had the general character of investment securities, meeting the requirements of Section 719 of the Internal Revenue Code.

4. Yes, because the company's mere belief that a return was unnecessary did not constitute reasonable cause for failing to file.

Court's Reasoning

The court relied on its prior decision in *Royal Highlanders, 1 T.C. 184*, holding that when a previously exempt organization becomes taxable, its taxable year begins on the date it loses its exempt status. The court rejected the argument that the accounting period should remain unchanged. The court upheld the annualization of income for excess profits tax purposes, citing *General Aniline & Film Corporation, 3 T.C. 1070*, and finding no evidence the taxpayer qualified for an exception. Regarding the certificates of deposit, the court found they were akin to investment securities. Citing *Stoddard v. Miami Savings & Loan Co.*, the court differentiated these certificates from ordinary bank deposits, noting their restrictions and use in the company's business. On the penalty, the court emphasized the taxpayer's burden to show reasonable cause and found that a mere belief that no return was required was insufficient, referencing *Burford Oil Co., 4 T.C. 614*.

Practical Implications

This case provides guidance on determining the taxable year of an entity transitioning from tax-exempt to taxable status. It confirms that the date of the status change triggers a new taxable year. The ruling clarifies that previously exempt entities cannot simply prorate income over their existing accounting period when they become taxable mid-year. It also highlights the importance of filing tax returns, even when uncertain of the obligation, to avoid penalties, and the need to demonstrate "reasonable cause" for failure to file. The decision also offers insight

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into what constitutes a certificate of indebtedness for purposes of calculating borrowed capital in excess profits tax contexts.

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