8 T.C. 87 (1947)

For the purpose of calculating excess profits tax under Section 719(a)(1) of the Internal Revenue Code, an outstanding indebtedness must be evidenced by a specific type of instrument, such as a bond, note, or mortgage, and a conditional sales contract where title is retained by the seller does not qualify as a mortgage equivalent.

Summary

Consolidated Goldacres Co. sought to include amounts owed under a conditional sales contract for mining equipment as 'borrowed invested capital' to reduce its excess profits tax. The Tax Court ruled against the company, holding that the conditional sales contract, where title remained with the seller until full payment, did not constitute a 'note' or 'mortgage' as required by Section 719(a)(1) of the Internal Revenue Code. The court emphasized that the contract was a bilateral agreement with ongoing obligations for both parties, unlike a unilateral promise to pay found in a note or mortgage.

Facts

Consolidated Goldacres Co. (petitioner), a Nevada corporation, entered into a 'Contract of Conditional Sale' and a 'Supplemental Agreement on Conditional Sale' with Western-Knapp Engineering Co. (seller) for the construction and installation of mining machinery and a plant.

The contract stipulated that the seller retained title to the equipment until the full purchase price was paid.

Payments were based on the amount of ore processed, with a fixed rate per ton milled.

A subsequent memorandum modified the payment terms based on reduced ore processing due to War Production Board restrictions.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Consolidated Goldacres Co.'s excess profits tax liability for the year ended November 30, 1942.

Consolidated Goldacres Co. petitioned the Tax Court for a redetermination of the deficiency, arguing that the amount owed under the conditional sales contract should be included as borrowed invested capital.

Issue(s)

Whether the agreement between Consolidated Goldacres Co. and Western-Knapp

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Engineering Co. constituted an outstanding indebtedness evidenced by a ‘note’ or ‘mortgage’ within the meaning of Section 719(a)(1) of the Internal Revenue Code, thus qualifying as borrowed invested capital.

Holding

No, because the conditional sales contract was a bilateral executory contract and did not represent a ‘note’ or its equivalent.

No, because the contract was a conditional sales agreement under Nevada law, and not equivalent to a mortgage.

Court’s Reasoning

The court emphasized that Section 719(a)(1) requires indebtedness to be evidenced by specific instruments, including a bond, note, or mortgage.

The court found that the ‘Contract of Conditional Sale’ and ‘Supplemental Agreement’ were bilateral contracts with mutual obligations, unlike a unilateral promise to pay found in a note.

Quoting Aetna Oil Co. v. Glenn, 53 Fed. Supp. 961, the court stated that a note is executory on one side only, with the entire consideration already passed. The court found that the agreement involved required performance by both parties.

Regarding whether the contract was ‘in substance’ a mortgage, the court looked to Nevada law, where the property was located. Citing Studebaker Bros. Co. v. Witcher, supra, the court noted Nevada law distinguishes between a conditional sales contract and a mortgage, with the former retaining title in the seller until full payment.

The court stated, “So here we think it is significant that Congress omitted any reference to ‘conditional sales contract’ along with ‘mortgage’ in section 719 (a) (1), and that we should not consider the conditional sales agreement here presented as within the ambit of that section.”

Practical Implications

This case clarifies the strict requirements for what constitutes ‘borrowed invested capital’ under Section 719(a)(1) of the Internal Revenue Code (as it existed at the time) for excess profits tax calculations.

The decision highlights the importance of properly classifying debt instruments and understanding the applicable state law regarding conditional sales contracts versus mortgages.

Attorneys and tax professionals should carefully analyze the specific terms of

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financing agreements to determine if they meet the statutory requirements for inclusion as borrowed invested capital, particularly focusing on whether the instrument represents a unilateral promise to pay or a bilateral executory contract.

Later cases and tax regulations would need to be consulted to determine the continuing relevance of this holding in light of subsequent changes to the tax code.

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