8 T.C. 1302 (1947)

For excess profits tax purposes under Section 719(a)(1) of the Internal Revenue Code, indebtedness qualifies as 'borrowed capital' only if evidenced by a specific instrument like a bond, note, or mortgage; a mere open account, even with an agreement to pay interest, is insufficient.

Summary

Pendleton & Arto, Inc. sought to classify debt owed to its parent company, Davidson Dental Supply Co., as borrowed capital to reduce its excess profits tax liability. The debt arose from ongoing advances made by Davidson for operating capital, documented as an open account with an agreement to pay interest. The Tax Court ruled against Pendleton & Arto, holding that the indebtedness was not evidenced by any of the instruments specified in Section 719(a)(1) of the Internal Revenue Code, such as a bond, note, or mortgage, and therefore did not qualify as borrowed capital. The key rationale was the absence of a formal debt instrument reflecting a fixed sum and repayment terms.

Facts

Pendleton & Arto, Inc. (Petitioner) was a dental and medical supply company. The parent company, Davidson Dental Supply Co. (Davidson), provided operating capital to Petitioner via open account. An agreement existed between the companies to pay interest on the outstanding balance. Davidson had previously paid off Petitioner's creditors in 1936. Funds were deposited into a bank account controlled by Davidson. Petitioner sought to treat the amounts owed to Davidson as "borrowed capital" for excess profits tax purposes.

Procedural History

The Commissioner of Internal Revenue denied Pendleton & Arto's claim to include the debt to Davidson as borrowed capital when calculating its excess profits tax. Pendleton & Arto, Inc. then petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

Whether the indebtedness of Pendleton & Arto, Inc. to its parent corporation, Davidson Dental Supply Co., constituted borrowed capital within the meaning of Section 719(a)(1) of the Internal Revenue Code.

Holding

No, because the indebtedness was not evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust as required by Section 719(a)(1) of the Internal Revenue Code.

© 2025 SCOTUSreports.com. All rights reserved.

Court’s Reasoning

The court emphasized that Section 719(a)(1) specifically requires that borrowed capital be evidenced by a formal debt instrument. While the court acknowledged that a genuine indebtedness existed between the companies and that the funds were used for legitimate business purposes, these factors alone were insufficient. The court found that the open account, even coupled with the interest agreement, did not meet the statutory requirements. The court stated, “The amount of the note has never exactly equaled the amount of the obligation, which fluctuates as bills are paid…There is found here no absolute promise to pay, no sum certain, no fixed or determinable future time.” The court reasoned that allowing a flexible open account to qualify as borrowed capital would broaden the definition beyond the explicit terms of the statute, a power reserved for Congress. The court cited the principle of "*Inclusio unius est exclusio alterius*" (the inclusion of one thing implies the exclusion of another), emphasizing that the explicit listing of specific debt instruments implies the exclusion of other forms of indebtedness.

Practical Implications

This case highlights the importance of formal documentation when seeking to classify debt as “borrowed capital” for tax purposes. It underscores that a mere open account, regardless of its economic substance or the existence of an interest agreement, will not suffice under Section 719(a)(1). Taxpayers must ensure that indebtedness is evidenced by a qualifying instrument (bond, note, mortgage, etc.) to claim the benefits associated with borrowed capital. The decision demonstrates a strict interpretation of tax law, emphasizing adherence to the explicit statutory language. Later cases applying this ruling would likely focus on whether the purported debt instrument possesses the essential characteristics of the enumerated instruments, namely, a fixed sum, a promise to pay, and defined repayment terms.

© 2025 SCOTUSreports.com. All rights reserved.