10 T.C. 1015 (1948)

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A factoring agreement where a company assigns contracts in exchange for an advance, guaranteeing payment, can be treated as borrowed capital for excess profits tax purposes, and the discount charged is considered interest, even if not explicitly labeled as such.

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Summary

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Central Station Signals assigned customer contracts to Phillips & Co. for an advance, guaranteeing the customers' payments. The Tax Court addressed whether this arrangement constituted borrowed capital for excess profits tax calculation, and whether the discount Phillips charged was considered interest. The court held that the arrangement was effectively a mortgage, classifying it as borrowed capital. Further, the discount was deemed interest. The court also determined that including borrowed invested capital was mandatory, even if it resulted in a higher tax liability for the company.

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Facts

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Central Station Signals, Inc. installed and maintained signaling systems for subscribers under five-year contracts. To obtain capital, Central Station entered an agreement with Phillips & Co. to assign these contracts in exchange for an immediate payment. Phillips paid the face value of the contracts, less a discount factor representing a finance charge. Central Station guaranteed the subscribers' payments, and the contracts would be reassigned to Central Station once all payments were received by Phillips. Central Station treated the discount as an interest expense on its books.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in Central Station's income and excess profits taxes for 1942. Central Station contested the Commissioner's inclusion of certain contingent indebtedness as borrowed invested capital, the classification of finance charges as interest, and the mandatory nature of including this indebtedness in its borrowed invested capital calculation. The Tax Court ruled in favor of the Commissioner.

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Issue(s)

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1. Whether the Commissioner erred in including certain contingent indebtedness arising from the assignment of subscriber contracts as borrowed invested capital?

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2. Whether the Commissioner erred in classifying charges from the assignment of contracts as interest when adjusting for interest on borrowed invested capital?

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3. Whether the Commissioner erred in determining that the inclusion of certain indebtedness as borrowed invested capital was mandatory, even if it resulted in a tax disadvantage for the petitioner?

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Holding

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1. Yes, because the assignment of contracts, coupled with the guarantee of payment, constituted a security transaction akin to a mortgage.

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2. Yes, because the charges, though not explicitly labeled as interest, represented compensation for the use of borrowed money.

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3. Yes, because the statutory language mandates the inclusion of all borrowed

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invested capital when computing the excess profits tax credit on the invested capital basis, even if it leads to a higher tax liability.

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Court’s Reasoning

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The court relied on *Brewster Shirt Corporation v. Commissioner*, which held that similar factoring agreements constituted a mortgage for tax purposes. The court reasoned that the assignments, coupled with Central Station’s guarantee of payment and the provision for reassignment, indicated a security transaction, not an outright sale. The court stated,

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