11 T.C. 188 (1948)

For tax purposes, a letter acknowledging a debt to a parent company does not constitute a 'certificate of indebtedness' suitable for inclusion as 'borrowed invested capital' under Section 719(a)(1) of the Internal Revenue Code.

Summary

Ciro of Bond Street, Inc., a New York corporation wholly owned by a British parent, sought to include advancements from its parent company as 'borrowed invested capital' for excess profits tax purposes. The Tax Court held that letters from Ciro to its parent acknowledging the debt did not qualify as 'certificates of indebtedness' under Section 719(a)(1) of the Internal Revenue Code. The court emphasized that such certificates must have the characteristics of investment securities and a defined maturity date, which the letters lacked. Therefore, the advancements could not be included as borrowed invested capital.

Facts

Ciro of Bond Street, Inc. was formed in 1939 and was wholly owned by Ciro Pearls, Ltd., a British corporation. The paid-in capital of $10,000 was insufficient for its business needs. During 1939, Ciro Pearls, Ltd., advanced $96,201.10 to Ciro of Bond Street, Inc. for business purposes, including alterations to business premises and merchandise inventory. At the time of the advances, Ciro of Bond Street did not issue any formal evidence of indebtedness. At the end of 1939, Ciro of Bond Street sent letters to Ciro Pearls, Ltd., acknowledging the debt for audit purposes, stating no interest was payable and repayment would occur when the company was able to do so.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Ciro of Bond Street's income tax, declared value excess profits tax, and excess profits tax for 1940 and 1941. Ciro of Bond Street contested the excess profits tax deficiencies, arguing the Commissioner failed to include the amount due to Ciro Pearls, Ltd. as part of its average borrowed capital. The Tax Court reviewed the Commissioner's determination.

Issue(s)

Whether letters from a subsidiary to its parent company acknowledging debt constitute 'certificates of indebtedness' under Section 719(a)(1) of the Internal Revenue Code, thereby allowing the subsidiary to include the debt as 'borrowed invested capital' for excess profits tax purposes.

Holding

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No, because the letters lacked the characteristics of investment securities and a definite maturity date, as required by the statute and related regulations. The letters were merely acknowledgments of debt for audit purposes and did not meet the criteria for ‘certificates of indebtedness’.

Court’s Reasoning

The court relied on Section 719(a)(1) of the Internal Revenue Code, which defines ‘borrowed capital’ to include indebtedness evidenced by specific instruments, including ‘certificates of indebtedness.’ The court referenced Section 35.719-1(d) of Regulations 112, which clarifies that ‘certificate of indebtedness’ includes instruments having the general character of investment securities issued by a corporation. The court found that the letters from Ciro of Bond Street to Ciro Pearls, Ltd., lacked these characteristics. The court stated: “The term ‘certificate of indebtedness’ includes only instruments having the general character of investment securities issued by a corporation as distinguishable from instruments evidencing debts arising in ordinary transactions between individuals.” Additionally, the letters lacked a definite maturity date, stating repayment would occur ‘when this Company is in a position to do so.’ The court distinguished the facts from cases cited by the petitioner, emphasizing that the letters did not meet the statutory requirements for inclusion as borrowed invested capital.

Practical Implications

This case clarifies the strict requirements for debt instruments to qualify as ‘borrowed invested capital’ under Section 719(a)(1) of the Internal Revenue Code. It highlights that mere acknowledgment of debt, even in writing, is insufficient. The instrument must resemble an investment security with attributes like a defined maturity date and rights enforceable against the debtor. This ruling impacts how corporations, particularly subsidiaries, structure their debt arrangements with parent companies to maximize tax benefits related to borrowed invested capital. It informs tax planning by emphasizing the need for formal debt instruments that meet specific criteria to be recognized as borrowed capital for tax purposes. Subsequent cases and IRS guidance would likely refer to this decision when interpreting the requirements for ‘certificates of indebtedness’.

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