12 T.C. 770 (1949)

Certificates of deposit issued by a bank, which are not subject to check, bear interest, and are payable only at fixed maturities, can be included in "borrowed capital" under Section 719 of the Internal Revenue Code for calculating excess profits credit.

Summary

Ames Trust & Savings Bank sought to include outstanding certificates of deposit in its "borrowed capital" to increase its excess profits credit for the years 1942-1944. The Tax Court ruled that these certificates, which were not subject to check and payable only at 6- or 12-month maturities, qualified as certificates of indebtedness and could be included in borrowed capital. The court distinguished these from ordinary bank deposits, emphasizing their investment-like characteristics, aligning with the precedent set in *Economy Savings & Loan Co.*

Facts

Ames Trust & Savings Bank, an Iowa banking corporation, issued standard form certificates of deposit. These certificates were not subject to check, bore interest, and were payable only at maturity dates of either six or twelve months. The bank generally repaid the principal only at maturity, except in cases of unusual hardship where the holder forfeited accrued interest. The daily average amounts of outstanding certificates were substantial, reaching $41,201.28 in 1944.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the bank's excess profits tax for 1943 and 1944, disallowing the inclusion of the certificates of deposit in borrowed capital. The bank challenged this determination in the Tax Court, also claiming an overpayment for 1944.

Issue(s)

Whether outstanding obligations evidenced by certificates of deposit issued by the bank, not subject to check, bearing interest, and payable only at maturities of 6 months and 1 year, are includible in borrowed capital under Section 719 of the Internal Revenue Code for purposes of computing the bank's excess profits credit.

Holding

Yes, because the certificates of deposit represent indebtedness with the general character of investment securities rather than ordinary bank deposits, and therefore, qualify for inclusion in borrowed capital under Section 719.

Court's Reasoning

The Tax Court relied heavily on its prior decision in *Economy Savings & Loan Co.*, which also involved certificates of deposit. The court distinguished the certificates from ordinary bank deposits, noting their fixed maturity dates, interest-bearing nature, and non-checkable status. The court reasoned that these characteristics gave the certificates the "general character of investment securities," making them eligible for inclusion in borrowed capital. The court rejected the Commissioner's argument that the certificates should be excluded because the bank was in the banking business, stating that the form and function of the certificates, not the nature of the issuer, were determinative. The court observed that the regulation excluding bank deposits from borrowed capital was "manifestly directed at the ordinary bank deposit of a demand nature" and did not apply to these certificates, which had a fixed term and were not payable on demand. The Court stated "The regulation is manifestly directed at the ordinary bank deposit of a demand nature. Under the principle of *noscitur a sociis*, the association of certificates of deposit with passbooks and checks satisfies us that what was referred to was a certificate of demand deposit."

Practical Implications

This case clarifies that not all certificates of deposit are treated equally under tax law. The key is the nature of the instrument: if it functions more like an investment security (fixed term, interest-bearing, not subject to check), it is more likely to be considered borrowed capital. This decision emphasizes a functional analysis over a formalistic one. Later cases must look to the specific terms of the certificate of deposit to determine whether it more closely resembles a demand deposit or an investment security. This ruling affects how banks and other financial institutions calculate their excess profits credit, providing a potential avenue for reducing their tax liability by carefully structuring their certificate of deposit offerings.

