14 T.C. 1216 (1950)

Certificates of deposit issued by a bank are generally not considered borrowed capital for excess profits tax purposes, and a taxpayer must make a specific charge-off on its books to claim a partial bad debt deduction.

Summary

Merchants National Bank of Mobile disputed the Commissioner's assessment of excess profits taxes for 1942 and 1943. The Tax Court addressed whether certificates of deposit qualified as borrowed capital and whether the bank properly reduced its equity invested capital due to partially worthless bonds. The court held that certificates of deposit are not borrowed capital. It also found that the bank improperly reduced its accumulated earnings and profits in prior years by establishing a valuation reserve instead of taking a direct charge-off for the bonds' partial worthlessness, allowing the bank to adjust its equity invested capital accordingly.

Facts

- In 1942 and 1943, Merchants National Bank had outstanding certificates of deposit.
- The bank also held Reclamation District bonds, which, upon the recommendation of the Comptroller of the Currency in 1930 and 1931, led to the establishment of a $100,000 valuation reserve from accumulated earnings.
- In its 1930 and 1931 income tax returns, the bank took deductions for partial bad debt losses related to these bonds.
- In 1942, the bank sold some of the bonds.

Procedural History

The Commissioner determined deficiencies in the bank's excess profits tax for 1942 and 1943. The bank petitioned the Tax Court for a redetermination, contesting the inclusion of certificates of deposit as borrowed capital, the reduction in equity invested capital, and the calculation of gain or loss on the sale of the bonds.

Issue(s)

1. Whether certificates of deposit issued by the bank are properly includible in its borrowed capital under Section 719(a)(1) of the Internal Revenue Code.
2. Whether, in computing its equity invested capital for 1942 and 1943, the bank may increase its accumulated earnings and profits by the amount of the valuation reserve set up for the partially worthless bonds.
3. Whether the bank suffered a loss on the sale of bonds in 1942, and the proper basis for determining gain or loss on that sale.

Holding

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1. No, because historically, bank deposits have not been regarded as borrowed capital.
2. Yes, because the bank improperly charged the valuation reserve against its accumulated earnings and profits in 1930 and 1931 without taking a direct charge-off.
3. The court sided with the Petitioner, because the basis of the bonds should be adjusted to reflect the improperly taken deduction in prior years.

Court's Reasoning

- **Borrowed Capital:** The court relied on *Commissioner v. Ames Trust & Savings Bank*, which held that certificates of deposit are not "certificates of indebtedness" and are not includible in borrowed capital. The court emphasized that bank deposits lack the characteristics of borrowed money and are subject to specific regulations.
- **Equity Invested Capital:** The court found that the bank's creation of a valuation reserve, instead of a direct charge-off, did not meet the requirements for a partial bad debt deduction under the Revenue Act of 1928. Quoting *Commercial Bank of Dawson*, the court stated that the procedure did not "effectually eliminate the amount of the bad debt from the book assets of the taxpayer." Therefore, the bank was allowed to increase its accumulated earnings and profits by the improperly charged amount.
- **Bond Sale Loss:** Since the bank improperly reduced the basis of the bonds in prior years, it was allowed to restore the proportionate amount of that reduction to the bonds' basis when calculating the gain or loss from their sale in 1942. This resulted in a loss for the bank, which it could treat as an ordinary loss under Section 117(i) of the Internal Revenue Code.

Practical Implications

This case clarifies the distinction between bank deposits and borrowed capital for tax purposes. It reinforces the principle that banks must follow specific charge-off procedures to claim bad debt deductions. The ruling has implications for how banks account for asset depreciation and calculate their equity invested capital, particularly when dealing with partially worthless assets. It illustrates that a taxpayer can correct prior errors in tax treatment, even if the statute of limitations has passed, when calculating equity invested capital for excess profits tax purposes, subject to potential adjustments under Section 734(b). Later cases would cite this ruling as an example of how improperly taken deductions in earlier years can impact the basis of assets when sold in subsequent years.

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