16 T.C. 1566 (1951)

For purposes of calculating excess profits tax credit, capital stock issued for notes is not considered 'invested capital' unless the capital is actually used in the business, subject to the risk of the business, and intended for more than contingent use.

Summary

Graves, Inc. sought to include $90,000 worth of stock issued for demand notes as 'invested capital' for excess profits tax credit calculation. The Tax Court ruled against Graves, Inc., finding that the notes represented a contingent increase in working capital rather than an actual investment. The Court emphasized that the funds were not truly at risk, nor demonstrably used in the furtherance of the company's business objectives, and the contingency surrounding the notes' use indicated they should not be included as invested capital under Section 718 or as a capital addition under Section 713.

Facts

In 1943, Graves, Inc. increased its capital stock and issued $90,000 worth of stock to Viola and Margaret Graves. Payment for the stock was facilitated by the Graves women executing promissory notes to Sopaco Finance Company (later Wilson Investment Company). Sopaco then issued demand notes to Graves, Inc. The notes were interest-bearing, but it was understood that payments would only be made if Graves, Inc.'s financial condition required it. In 1946, after the excess profits tax legislation had been repealed, the stock was reduced, and the notes were returned to the respective parties without any principal having been paid.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Graves, Inc.'s excess profits tax for 1943, disallowing the inclusion of the $90,000 in invested capital. Graves, Inc. petitioned the Tax Court for review. The Tax Court upheld the Commissioner's determination.

Issue(s)

Whether the $90,000 in demand notes, received in exchange for stock, constituted 'invested capital' under Section 718 or a 'capital addition' under Section 713 of the Internal Revenue Code for the purpose of computing Graves, Inc.'s excess profits tax credit.

Holding

No, because the notes were not actually invested in the business, were not demonstrably utilized in earning profits, and were not truly subject to the risk of the business. The notes represented only a contingent promise to increase working

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capital if needed.

Court’s Reasoning

The court reasoned that for capital to be considered in computing the excess profits credit, it must be actually invested as part of the working capital, utilized for earning profits, and subject to the risk of the business. The court found that the $90,000 in notes did not meet these criteria. The court noted testimony indicating the notes were for contingent use only and were canceled when no longer needed. The court pointed out that no payments were made on the notes, even when due. The court stated, “Graves, Incorporated, had Wilson Investment Company demand notes for certain dollars and the Wilson Finance Company paid them two per cent for not cashing those notes and taking the cash at that time, unless it was necessary in the business.” The court concluded that the notes merely represented a promise to increase Graves, Inc.’s working capital if needed, while the funds were used elsewhere. Therefore, the $90,000 could not be considered in determining Graves, Inc.’s excess profit.

Practical Implications

This case clarifies that simply issuing stock for notes does not automatically qualify the funds as invested capital for tax purposes. The key is whether the capital is truly at the disposal of the company, being actively used, and subject to the risks of the business. This ruling emphasizes the importance of demonstrating actual investment and use of capital, not just a nominal increase in capitalization. Later cases applying this ruling would likely scrutinize the actual economic impact of the capital infusion on the business’s operations and risk profile. Practitioners must advise clients that the mere issuance of stock for notes is insufficient; the proceeds must be integrated into the company’s operations and exposed to its business risks to qualify as invested capital for tax purposes.

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