20 T.C. 816 (1953)

A taxpayer's obligation under a conditional land purchase contract, even when accompanied by a purported promissory note, does not constitute "borrowed capital" evidenced by a note or mortgage, as defined by Section 719(a)(1) of the Internal Revenue Code, if the obligation to pay is contingent on future events like the extraction of timber.

Summary

The Oregon-Washington Plywood Company sought to include the balance due on a timberland purchase in its "borrowed capital" to calculate its excess profits tax credit. The company had a contract to purchase land, paid a portion upfront, and delivered a note for the remaining amount. Payment on the note was contingent on the amount of timber harvested. The U.S. Tax Court ruled against the company, holding that the contract and note did not qualify as "outstanding indebtedness evidenced by a note or mortgage" under Internal Revenue Code §719(a)(1). The court reasoned that the obligation was conditional, not absolute, because payment was tied to the extraction of timber, making it an executory contract rather than a simple debt instrument.

Facts

Oregon-Washington Plywood Co. (taxpayer) owned and operated a plywood manufacturing plant and entered into a contract on August 30, 1943, to purchase approximately 3,500 acres of timberland for $500,000. The purchase agreement required $100,000 in cash payments and a $400,000 note. The note's payments, plus 3% annual interest on the remaining balance, were to be made monthly at a rate of $5 per thousand feet of logs harvested. The contract stipulated that logging operations would cease if the taxpayer defaulted, and the seller retained title until full payment. The taxpayer made the required cash payments and delivered the note. The taxpayer sought to include the unpaid balance of the purchase price as "borrowed capital" for excess profits tax purposes.

Procedural History

The Commissioner of Internal Revenue determined an excess profits tax deficiency against Oregon-Washington Plywood Co. The Tax Court heard the case based on stipulated facts and numerous exhibits and determined that the taxpayer could not include the land purchase obligation in its calculation of borrowed capital. The Tax Court issued a ruling on July 10, 1953.

Issue(s)

Whether the taxpayer's obligation for the balance due under the timberland purchase contract and note constitutes an "outstanding indebtedness evidenced by a note or mortgage" within the meaning of Internal Revenue Code §719(a)(1).

Holding

No, because the Tax Court held that the obligation was conditional, and did not qualify as a “note” or “mortgage” as defined by the Internal Revenue Code.

Court’s Reasoning

The court focused on the nature of the timberland purchase contract and the accompanying note. The court cited Internal Revenue Code §719(a)(1) which specified that “borrowed capital” must be evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust. The court determined that the contract was not a mortgage, as it was a conditional land contract where the seller retained title until the purchase price was fully paid. The court held that the obligation to pay was not unconditional, as the seller could terminate the contract upon default of certain conditions (like the quantity of timber removed). Additionally, the court found that the note was not unconditional because the amount of payment was determined by the volume of timber cut and removed each month. The court relied on prior cases, such as *Consolidated Goldacres Co. v. Commissioner* and *Bernard Realty Co. v. United States*, which held that similar conditional contracts did not constitute a “mortgage” or “note” under the statute.

The court stated that the petitioner’s obligation to pay the balance of the purchase price was not unconditional, the court stated “the controlling fact here is that the contract was conditional and therefore does not qualify as a “mortgage” within the meaning and for the purpose of section 719 (a)(1). A land contract or other conditional sales contract is not synonymous with and therefore may not be considered as a “mortgage” under that section.”.

Practical Implications

This case underscores the importance of the unconditional nature of debt instruments when determining “borrowed capital” for tax purposes. Attorneys should carefully analyze the terms of land contracts, promissory notes, and other agreements to assess whether an obligation is truly an “outstanding indebtedness evidenced by a note or mortgage.” If the obligation to pay is tied to future events or performance, it may not qualify. This ruling has implications for businesses that finance property acquisitions through installment contracts or agreements where payments are contingent on future production or sales. Subsequent cases dealing with similar fact patterns would likely reference this case.

