33 T.C. 720 (1960)

Certificates issued by an industrial loan company to raise working capital, registered by owner, are considered evidence of investment by the registered owners and borrowed capital under section 439(b)(1) for excess profits tax credit calculations.

Summary

The Morris Plan Company of California, an industrial loan company, sought to include its outstanding thrift certificates as "borrowed capital" when calculating its excess profits tax credit. The IRS disallowed the inclusion, arguing the certificates were not "certificates of indebtedness" under the relevant tax code section. The Tax Court sided with the Morris Plan, holding that the certificates, which were registered, transferable, and used to raise capital, were indeed evidences of indebtedness and qualified as borrowed capital, entitling the company to a higher excess profits tax credit. This decision hinged on the nature of the certificates as investments rather than bank deposits, differentiating them from typical deposit instruments.

Facts

The Morris Plan Company of California, an industrial loan company incorporated under California's financial codes, issued various thrift certificates to raise working capital. The company was subject to state regulation, including approval of the certificates' issuance by the California Division of Corporations. The certificates, registered in the owners' names, had interest rates higher than typical bank savings accounts. The certificates were transferable, could be used as collateral, and could be redeemed in part or in full. Advertising for the certificates was subject to state approval to avoid misleading the public into believing they were bank deposits. The Commissioner of Internal Revenue disallowed the company's inclusion of the certificates as borrowed capital for excess profits tax calculations.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioner's income and excess profits tax. The Morris Plan Company challenged the Commissioner's determination in the U.S. Tax Court, arguing that the thrift certificates constituted borrowed capital. The Tax Court reviewed the case and sided with Morris Plan.

Issue(s)

Whether the thrift certificates issued by The Morris Plan Company are "borrowed capital" within the meaning of Section 439(b)(1) of the 1939 Internal Revenue Code, for purposes of computing the company's excess profits credit based upon invested capital.

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Holding

Yes, the court held that the certificates issued by the Morris Plan Company were “borrowed capital” because they met the requirements for being certificates of indebtedness.

Court’s Reasoning

The court applied Section 439(b)(1) of the 1939 Internal Revenue Code which defined borrowed capital and emphasized that the term “certificate of indebtedness” includes instruments with the general character of investment securities issued by a corporation. The court differentiated the certificates from bank deposits, which the company, as an industrial loan company, was prohibited from receiving. It noted the state’s oversight of the company’s advertising, which was meant to avoid misleading the public. The court found the certificates represented investments, were transferable, and were issued under specific authority from the state’s Department of Corporations. The court referenced and relied on the prior ruling in *Valley Morris Plan*. The court also distinguished the case from cases involving banks and certificates of deposit.

Practical Implications

This case clarifies the definition of “borrowed capital” for excess profits tax credit purposes, specifically for industrial loan companies that issue certificates to raise working capital. It is important for attorneys advising similar companies to carefully analyze the characteristics of their financial instruments (e.g., certificates) to determine if they qualify as borrowed capital. This case supports the argument that, in the absence of being a bank or acting as such, certificates that function like investment securities and represent investments by the holders, can be considered indebtedness for tax purposes. This impacts the calculation of excess profits tax credits, potentially affecting the financial health of the company and the tax liability of the certificate holders. The ruling emphasizes the need to differentiate these instruments from traditional banking products such as certificates of deposit. Later cases dealing with the definition of debt and capital for tax purposes would likely consider this precedent.

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