4 T.C. 1033 (1945)

For excess profits tax purposes, outstanding indebtedness evidenced by bank acceptances of drafts drawn under letters of credit constitutes borrowed capital, while the open letters of credit themselves do not.

Summary

Wm. A. Higgins & Co., an importer, sought to include the amounts of open letters of credit and bank acceptances in its borrowed invested capital for excess profits tax calculation. The Tax Court held that while the bank acceptances of drafts drawn under the letters of credit represented outstanding indebtedness evidenced by bills of exchange (and thus qualified as borrowed capital), the open letters of credit themselves did not constitute borrowed capital because they were not 'outstanding indebtedness' evidenced by a specified instrument. This distinction significantly impacted the company's excess profits tax liability.

Facts

Wm. A. Higgins & Co. financed its foreign purchases using irrevocable commercial letters of credit. They established lines of credit with several banks. For each purchase, Higgins contracted with a foreign seller, agreeing to provide an irrevocable letter of credit. Higgins then applied to a bank for the letter of credit, which, upon approval, was sent to the seller. The seller drew drafts on the bank, attaching order bills of lading. The bank accepted the draft, returning it to the seller and giving the bills of lading to Higgins, who issued a trust receipt. Higgins was required to maintain sufficient funds to cover the accepted draft by its due date. The bank charged fees for this service.

Procedural History

Higgins claimed an average borrowed capital of $684,070 in its excess profits tax return, including amounts related to letters of credit and bank acceptances. The Commissioner of Internal Revenue disallowed the inclusion of open letters of credit in borrowed capital, resulting in a deficiency. The Commissioner later amended the answer to also disallow the inclusion of bank acceptances. Higgins petitioned the Tax Court, contesting the initial deficiency and the increased deficiency claimed by the Commissioner.

Issue(s)

1. Whether outstanding irrevocable commercial letters of credit issued by banks pursuant to Higgins' applications qualify as 'borrowed capital' under Section 719 of the Internal Revenue Code?

2. Whether the banks' accepted drafts under the letters of credit also qualify as 'borrowed capital' under Section 719 of the Internal Revenue Code?

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Holding

1. No, because the open letters of credit did not represent 'outstanding indebtedness' evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust as required by Section 719.

2. Yes, because the bank acceptances did represent outstanding indebtedness of the taxpayer evidenced by bills of exchange.

Court's Reasoning

The court reasoned that a letter of credit is a request for someone to advance money or give credit to a third person with a promise to repay. Although Higgins had an obligation to reimburse the bank for payments made under the letter of credit, this obligation did not constitute an 'indebtedness' until a draft was drawn and accepted. The court quoted *Deputy v. DuPont, 308 U.S. 488*, stating, "although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness'." The court emphasized that the statute required 'outstanding indebtedness' evidenced by specific instruments. Once the drafts were accepted, Higgins became indebted to the full extent of the drafts, and these acceptances qualified as bills of exchange. The court stated, "The statute requires that the indebtedness has to be the indebtedness 'of the taxpayer,' but it does not require that the specific type of instrument mentioned in the statute be that 'of the taxpayer'. All that the statute requires is that the outstanding indebtedness of the taxpayer be 'evidenced by' one of the specific types of instruments."

Practical Implications

This case clarifies the definition of 'borrowed capital' for excess profits tax purposes, establishing a distinction between open letters of credit and bank acceptances. It underscores the importance of demonstrating that indebtedness is evidenced by a specific type of instrument listed in the statute (bond, note, bill of exchange, etc.). For businesses, this ruling highlights the need to carefully structure financing arrangements to maximize eligibility for borrowed capital treatment. This case serves as precedent for interpreting similar provisions in subsequent tax laws, emphasizing a strict interpretation of the statutory requirements. Subsequent cases would need to analyze whether specific financing arrangements create an 'indebtedness' and whether that indebtedness is 'evidenced by' a qualifying instrument. The case also demonstrates the importance of the substance over form when evaluating tax liabilities.

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