14 T.C. 892 (1950)

Credits to a company's bank account for sight drafts drawn on customers, accompanied by bills of lading, do not constitute 'borrowed capital' for excess profits tax purposes when the bank immediately credits the account and allows withdrawals.

Summary

Fraser-Smith Co. drew sight drafts on its customers, payable to its bank, attaching bills of lading. The bank credited Fraser-Smith's account with the draft amounts, allowing immediate withdrawals. The Commissioner of Internal Revenue argued that these credits did not constitute borrowed capital under Section 719(a)(1) of the Internal Revenue Code. The Tax Court agreed with the Commissioner, holding that the transactions were sales of the drafts to the bank, not loans. This determination impacted the company's excess profits tax calculation, leading to a deficiency assessment.

Facts

Fraser-Smith Co., a grain merchandiser, routinely drew sight drafts on customers, payable to its bank (Northwestern National Bank & Trust Co.), and attached bills of lading endorsed in blank.

The bank credited Fraser-Smith's account with the face value of the drafts, permitting immediate withdrawals.

The bank then sent the drafts and bills of lading to correspondent banks at the customers' locations. Customers honored the drafts to obtain the bills of lading and take possession of the grain.

The bank charged Fraser-Smith a collection fee and interest based on the time between credit and payment.

Fraser-Smith's balance sheets showed the drafts as contingent liabilities in a footnote, not as actual liabilities.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Fraser-Smith's excess profits tax for the fiscal years ending June 30, 1943, and 1944.

Fraser-Smith challenged the Commissioner's assessment in the Tax Court, arguing that the sight draft credits constituted borrowed capital.

Issue(s)

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Whether the face amounts of drafts credited to Fraser-Smith's account by the bank before collection constituted borrowed capital under Section 719(a)(1) of the Internal Revenue Code.

Holding

No, because the transactions constituted a sale of the drafts to the bank, not a loan, and did not create an outstanding indebtedness as required by Section 719(a)(1).

Court's Reasoning

To qualify as borrowed capital under Section 719(a)(1), the taxpayer must demonstrate an "outstanding indebtedness" evidenced by specific financial instruments. The court found that the bank's crediting of Fraser-Smith's account upon deposit of the drafts and bills of lading constituted a purchase of the drafts, not a loan.

The court noted that the bank had a right to charge back uncollected drafts but cited *City of Douglas v. Federal Reserve Bank of Dallas, 271 U.S. 489*, stating that "When paper is indorsed without restriction by a depositor, and is at once passed to his credit by the bank to which he delivers it, he becomes the creditor of the bank; the bank becomes owner of the paper, and in making the collection is not the agent for the depositor."

The court analogized the transactions to discounting promissory notes, which is treated as a sale rather than a loan. It distinguished the arrangement from a loan, highlighting that Fraser-Smith did not provide a note to the bank, the bills of lading were endorsed in blank, and the credits were unrestricted.

The court also dismissed the argument that Fraser-Smith's contingent liability as the drawer of the drafts qualified as borrowed capital, citing *C. L. Downey Co. v. Commissioner, 172 Fed. (2d) 810*, for the proposition that a contingent liability is not an "outstanding indebtedness."

Practical Implications

This case clarifies the definition of 'borrowed capital' for excess profits tax purposes. It emphasizes that transactions where a bank immediately credits a company's account for drafts and bills of lading are generally treated as sales of those instruments to the bank, not loans, even if the bank retains a right of charge-back.

The decision affects how businesses account for and report such transactions, particularly in industries like grain merchandising where sight drafts are common.

Later cases applying this ruling would likely focus on whether the transaction truly transferred ownership of the draft to the bank (through unrestricted endorsement and immediate credit) or whether the bank acted solely as a collection agent.

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