21 T.C. 648 (1954)

Under the claim of right doctrine, income received under a claim of right and without restriction on its disposition is taxable in the year of receipt, even if the right to retain the income is later disputed.

Summary

S. Loewenstein & Son, an accrual-basis taxpayer, received subsidy payments in 1945 under a government program. Later, the Reconstruction Finance Corporation (RFC) determined Loewenstein was ineligible for the subsidies. Although Loewenstein set up a liability on its books to repay the subsidies in 1945, it ultimately did not repay them. The Tax Court held that the subsidies were taxable income in 1945, when they were received, under the claim of right doctrine. The court also ruled that the average daily outstanding sight drafts drawn on the petitioner in connection with its purchases of cattle constituted borrowed capital within the meaning of section 719 (a) (1) of the Internal Revenue Code.

Facts

- S. Loewenstein & Son (Petitioner) was a Michigan corporation engaged in purchasing and slaughtering beef cattle.
- Petitioner kept its books on the accrual basis and filed its income tax returns on a calendar year basis.
- The Federal Government had a subsidy program for businesses engaged in livestock marketing and slaughtering.
- Petitioner filed claims for and received subsidies for July, August, and September 1945, totaling $66,655.06.
- Petitioner's practice of accepting credits from a customer (A & P) created a potential violation of the subsidy regulations, rendering it ineligible for the subsidies.
- Petitioner's examiner from RFC informed it that it appeared ineligible for subsidies but that a final decision would be made by the Washington office of RFC.
- Petitioner set up a liability on its books as of December 31, 1945, to repay the subsidies.
- Ultimately, the OPA granted petitioner's application for relief, and the subsidies were not required to be repaid.
- Petitioner purchased cattle using sight drafts, and the average daily outstanding drafts totaled $64,675.71.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the petitioner's excess profits tax for 1945. The Tax Court reviewed the Commissioner's determination, addressing the taxability of the subsidies and whether certain sight drafts constituted borrowed capital. The U.S. Tax Court held for the Commissioner in part, and for the Petitioner in part.

Issue(s)

1. Whether the subsidies received by the petitioner in 1945 constituted taxable income for that year.
2. If the subsidies were taxable income in 1945, whether the amount thereof was properly deductible for that year as a liability to make repayment thereof.
3. Whether certain sight drafts drawn on the petitioner for the purchase price of livestock constituted borrowed capital for 1945.

Holding

1. Yes, because the subsidies were received under a claim of right and without restriction as to their disposition.
2. No, because at the end of 1945, the liability to repay the subsidies was not yet a fixed or definite obligation.
3. Yes, because the sight drafts represented outstanding indebtedness of the petitioner evidenced by bills of exchange.

Court's Reasoning

The court applied the claim of right doctrine, established in *North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932)*. This doctrine states that if a taxpayer receives earnings under a claim of right and without restriction as to its disposition, it must report the income even if there may be a subsequent claim that the money should not have been received and must be returned. The court found the taxpayer received the subsidies under a claim of right and had no restrictions on their use.

The court distinguished the case from *Bates Motor Transport Lines, Inc., 17 T.C. 151, aff'd. 200 F.2d 20 (7th Cir. 1952)*, where the taxpayer never claimed that the funds, later found to be overpayments, belonged to it. Here, the court determined that the petitioner treated the subsidies as its own funds. The court further found that because the petitioner's liability to repay was not fixed or definite at the end of 1945, it could not accrue a deduction for the subsidies in that year. The possibility of relief under Public Law No. 88 and the eventual grant of such relief further supported the court's decision on this point.

Regarding the sight drafts, the court held that they constituted borrowed capital under section 719 (a) (1) because they evidenced the petitioner's outstanding indebtedness. The court reasoned that the drafts served as bills of exchange, a form of evidence of the debt, even though there might have been an account payable on the seller's books.

The court cited *North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932)*, for the core principle:

"If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent…"

Practical Implications

This case reinforces the importance of the claim of right doctrine in tax law, particularly for accrual-basis taxpayers. It demonstrates that income is taxable when received under a claim of right, irrespective of potential future events that might affect the right to retain the income. Moreover, this case clarifies that mere entries on the taxpayer's books do not always determine the taxability of an item. Legal professionals should advise clients to consider the claim of right doctrine when receiving payments where there is any uncertainty about the entitlement to those payments.

The case also illustrates the need to analyze whether a liability is fixed and definite at the end of the tax year to determine whether a deduction can be accrued. Additionally, it provides guidance on what constitutes borrowed capital for excess profits tax purposes. It underscores that sight drafts can be considered as instruments evidencing indebtedness.

