***Petitioner v. Commissioner*, 18 T.C. 407 (1952)**

For purposes of determining "borrowed capital" under the excess profits tax, an indebtedness must be clearly and definitively evidenced by a formal instrument, not merely by periodic notes representing fluctuating balances in open accounts created for tax avoidance purposes.

Summary

This case addressed whether a parent corporation's advances to its subsidiary, documented by periodic notes, qualified as "borrowed capital" under the excess profits tax, entitling the subsidiary to a tax credit. The Tax Court held that the notes did not constitute borrowed capital. The court found that the notes were merely a formality, reflecting fluctuating balances in open accounts. These balances resulted from the parent advancing funds to the subsidiary and lacked the permanence and evidentiary quality required by the tax code, as they were not for standard business operations. Because the primary purpose of the notes was to attempt to secure a tax advantage, they were not considered as valid evidence of indebtedness for purposes of the tax credit.

Facts

The petitioner, a wholly owned subsidiary of Paxton & Gallagher Co., maintained two open accounts with its parent, one each for its grocery business and its liquor business. The parent advanced money by paying the petitioner's purchase invoices, and the petitioner deposited sales receipts. Generally, the petitioner owed the parent for advances in excess of sales for the grocery business, while the parent owed the petitioner for an excess of deposits over advances on the liquor business. At the end of each month or accounting period, each corporation gave the other its note for the separate balance due, without offset for the other account. These notes were then replaced with new ones each period, and the previous notes were marked "canceled." The petitioner included the amounts advanced by its parent as borrowed capital in its excess profits tax returns, intending to use those amounts to compute its excess profits credit.

Procedural History

The Commissioner of Internal Revenue determined that the amounts advanced by the parent and represented by the notes did not qualify as borrowed capital under section 719(a)(1) of the Internal Revenue Code. The petitioner challenged this determination in the Tax Court. The Tax Court ultimately sided with the Commissioner.

Issue(s)

1. Whether the amounts advanced by the parent to the petitioner, and represented by the monthly notes, constituted "borrowed capital" as defined by section 719(a)(1)

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of the Internal Revenue Code.

Holding

1. No, because the notes were not considered to be valid evidence of indebtedness for the purpose of calculating the petitioner's excess profits tax credit. The notes lacked the necessary characteristics to be considered evidence of borrowed capital as the term is used in the relevant section of the Internal Revenue Code.

Court's Reasoning

The court focused on the substance of the transactions, rather than their form. It emphasized that the advances were recorded on open accounts and the notes were prepared to reflect balances in those open accounts, which fluctuated. The court noted that the notes served no real business purpose beyond the potential tax benefit. The court reasoned that the notes were created solely for tax purposes. It found that the notes did not represent a true, long-term loan, but instead were simply a periodic accounting of an open account. Furthermore, the court referred to the lack of business purpose in the creation of the notes. The parent company, which already had significant control over the subsidiary, did not need the notes for security or any other business purpose.

The court cited *Kellogg Commission Co.*, 12 T.C. 182 (1949), where it held that similar promissory notes, also created to reflect fluctuating balances in open accounts, did not constitute borrowed capital. The court found that the principle in *Kellogg Commission Co.* applied here, distinguishing between the loan used to purchase assets and the day-to-day operational financing via open accounts.

The court stated, "The tax consequences depend upon what the petitioner did, not upon what it might have done."

Practical Implications

This case underscores the importance of substance over form in tax law. It demonstrates that taxpayers cannot simply create formal documentation to achieve a tax benefit if the underlying economic reality of the transaction does not support it. For attorneys, this case provides guidance on the elements of proof required to establish

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