Grain King Co. v. Commissioner, 14 T.C. 329 (1950)

Expenditures for research and development are generally treated as capital expenditures, and indebtedness claimed as 'borrowed invested capital' for excess profits tax purposes must be bona fide and incurred for legitimate business reasons.

Summary

Grain King Co. sought to deduct expenses paid to a research institute as a business expense and to include sums borrowed to purchase U.S. obligations in its 'borrowed invested capital' for excess profits tax purposes. The Tax Court held that the research expenses were capital expenditures and could not be deducted until the entire project was abandoned. The court further held that the borrowed funds used to purchase U.S. obligations did not qualify as 'borrowed invested capital' because the borrowing was not for a legitimate business purpose but rather to increase the excess profits credit.

Facts

Grain King Co. contracted with Midwest Research Institute to conduct research on chemicals derivable from grain through fermentation. The agreement stipulated that Grain King would provide up to $20,000 for the project, and any resulting patentable inventions would belong to Grain King. During the tax year ending April 30, 1946, $7,942.04 was expended by the Institute. Grain King also borrowed money to purchase U.S. obligations during war loan drives, later claiming these sums as 'borrowed invested capital' for excess profits tax purposes.

Procedural History

The Commissioner of Internal Revenue disallowed Grain King's deduction of the research expenses and the inclusion of borrowed funds in 'borrowed invested capital.' Grain King appealed to the Tax Court, contesting the Commissioner's determinations.

Issue(s)

1. Whether the $7,942.04 expenditure by Midwest Research Institute during the taxable year is deductible as a business expense.
2. Whether sums borrowed by Grain King to purchase U.S. obligations during war loan drives constitute 'borrowed invested capital' under Section 719 of the Internal Revenue Code.

Holding

1. No, because expenditures for research and development of patents, formulas, and processes are capital expenditures, not deductible business expenses until the project is abandoned.

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2. No, because the borrowed sums were not incurred for bona fide business reasons but primarily to increase the excess profits credit.

Court's Reasoning

Regarding the research expenses, the court relied on precedent establishing that such expenditures are capital in nature. The court emphasized that the agreement between Grain King and the Institute contemplated the development of something of permanent value. The court reasoned that unsuccessful experiments are part of the cost of any ultimately developed capital asset and that deducting the expenses before the project's completion or abandonment was premature. Quoting from *Acme Products Co., 24 B.T.A. 194*, the court stated that "[w]hile additional work was being done in an effort to succeed and while hope for ultimate success was not unreasonable, there was no occasion to deduct any part of the expenditures as a loss."

Regarding the borrowed invested capital, the court upheld the validity of Treasury Regulations requiring that indebtedness included in borrowed capital be bona fide and incurred for business reasons. The court reasoned that the purpose of the excess profits tax legislation was to tax profits above a normal return on capital at risk in the business. The court found that Grain King's borrowing to purchase U.S. obligations lacked a business purpose, noting that the company paid nearly the same interest on the borrowed funds as it received on the securities and sold the securities soon after the excess profits tax was terminated. The court stated, "[i]t is not questioned that the borrowings in question were evidenced by notes, nor that they constituted indebtedness of petitioner. They therefore meet the bald requirements of the statute. The question then is simply whether or not these sums qualify as borrowed invested capital within the intent of the statute and under the disputed regulation."

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