Grain Products Co. v. Commissioner, 17 T.C. 763 (1951)

Expenditures for research and development aimed at creating new products or processes are generally considered capital expenditures, not immediately deductible expenses, unless the project is abandoned; additionally, borrowed funds used to purchase assets must be for legitimate business reasons to qualify as borrowed invested capital for excess profits tax purposes.

Summary

Grain Products Co. sought to deduct research expenses and include debt from purchasing U.S. obligations in its borrowed invested capital for excess profits tax calculation. The Tax Court held that research expenditures were capital in nature and not deductible as a business expense because the research project hadn't been abandoned yet. The court further ruled that borrowing funds solely to purchase U.S. obligations during war loan drives, lacking a genuine business purpose beyond goodwill, did not qualify as borrowed invested capital.

Facts

Grain Products Co. engaged the Midwest Research Institute to conduct research on chemicals derivable from grain, excepting enzymes and antibiotics, for two years starting in 1945, with a budget of $20,000. Any resulting patents would belong to Grain Products Co. During the taxable year ending April 30, 1946, the Institute spent $7,942.04, but no commercially valuable product resulted. Grain Products also borrowed funds to purchase U.S. obligations during war loan drives, paying interest rates similar to those earned on the obligations. These obligations were sold shortly after the tax year ended.

Procedural History

The Commissioner of Internal Revenue determined that the research expenses were capital expenditures and disallowed their deduction. The Commissioner also disallowed the inclusion of the debt used to purchase U.S. obligations in the company's borrowed invested capital. Grain Products Co. petitioned the Tax Court for review.

Issue(s)

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

Holding

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1. No, because the expenditure was part of a larger research project that had not yet been abandoned and was therefore a capital expenditure.
2. No, because the indebtedness was not incurred for genuine business reasons as required by Treasury Regulations.

Court's Reasoning

The court reasoned that expenses for developing patents, formulas, and processes are typically capital expenditures. Because the research project was ongoing and not abandoned, the expenditures should be treated as capital investments. The court emphasized that even unsuccessful experiments contribute to the cost of any eventually developed capital asset. Citing *Acme Products Co., 24 B.T.A. 194*, the court stated that "While 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." The court distinguished the case from others where deductions were allowed after projects were abandoned or involved improvements to already patented machines.

Regarding the borrowed funds, the court upheld the validity of Treasury Regulations requiring indebtedness to be incurred for business reasons to qualify as borrowed invested capital. The court reasoned that the purpose of excess profits tax legislation was to measure profits exceeding a reasonable return on capital at risk in the business. The court found that Grain Products Co.'s borrowing to purchase U.S. obligations was not a legitimate business purpose, but rather a gesture to obtain local goodwill, especially since the securities were sold soon after the tax year ended. As the court said in *West Construction Co., 7 T.C. 974*, underlying the statute is the assumption that invested capital involves "an investment as to which the business in question assumes some risk."

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