Abraham & Straus, Inc. v. Commissioner, 17 T.C. 1453 (1952)

For indebtedness to qualify as borrowed invested capital for excess profits tax purposes, it must be bona fide and incurred for legitimate business reasons, not solely to increase the excess profits credit.

Summary

Abraham & Straus, Inc., a mortgage and investment business, borrowed funds to invest in U.S. Government securities when wartime restrictions limited mortgage loan opportunities. The Tax Court held that these borrowings qualified as borrowed invested capital under Section 719 of the Internal Revenue Code because they were bona fide business transactions made with the expectation of profit. The court distinguished this case from situations where borrowings were solely for tax benefits, emphasizing that the taxpayer's primary motive was to generate profit within its normal business operations, subjecting the capital to business risks.

Facts

Abraham & Straus, Inc. was engaged in the general mortgage and investment business and regularly borrowed money from banks to finance its investments. Due to wartime building restrictions, the company had difficulty finding sufficient mortgage loan investments. Consequently, the company used its credit to borrow money and invest in U.S. Government securities, an area where its officers had prior experience. The company realized a substantial profit on these investments and did not liquidate them until a decline in the Government securities market threatened its profits.

Procedural History

The Commissioner of Internal Revenue disallowed the inclusion of the borrowed funds in the company's borrowed invested capital for excess profits tax purposes. Abraham & Straus, Inc. petitioned the Tax Court for a redetermination. The Tax Court reversed the Commissioner's decision, holding that the borrowings qualified as borrowed invested capital.

Issue(s)

Whether the taxpayer's borrowings to purchase U.S. Government securities during wartime, when its usual mortgage business was restricted, constitute borrowed invested capital for excess profits tax purposes under Section 719 of the Internal Revenue Code.

Holding

Yes, because the borrowings were bona fide business transactions entered into with the expectation of profit and subjected the borrowed capital to business risks, thus

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satisfying the requirements for inclusion in borrowed invested capital under Section 719 of the Internal Revenue Code.

Court’s Reasoning

The court reasoned that the taxpayer’s borrowings were made in the normal course of its business as bona fide business transactions, subjecting the borrowed capital to business risks for profit. The court distinguished this case from *Hart-Bartlett-Sturtevant Grain Co.*, where the borrowings were solely to obtain goodwill and tax benefits without genuine business risk. The court emphasized that the fundamental purpose of the excess profits tax legislation was to establish a measure by which the amount of profits which were “excess” could be judged, and that capital funds placed at the risk of the business were entitled to an adequate return. The court acknowledged that while the company was aware of the tax benefits, the primary motive was to make a profit, which is permissible. Citing *Gregory v. Helvering*, the court stated that a taxpayer is not required to transact business by other means to avoid saving taxes.

Practical Implications

This case clarifies that borrowings can qualify as borrowed invested capital even when they result in tax benefits, provided they are primarily motivated by legitimate business purposes and subject the capital to business risks. This case emphasizes the importance of demonstrating a profit motive and genuine business purpose when claiming borrowed invested capital for tax purposes. Later cases will likely examine the intent and business context of borrowings to determine whether they meet the ‘bona fide’ requirement, rather than focusing solely on the tax advantages gained. It reinforces the principle that while tax planning is acceptable, the economic substance of the transaction must align with a legitimate business purpose.

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