14 T.C. 1295 (1950)

To be included in borrowed invested capital for excess profits tax purposes, corporate indebtedness must be both bona fide and incurred for legitimate business reasons, not merely to increase the excess profits credit or for the personal benefit of shareholders.

Summary

Emeloid Co. sought to include a $97,500 loan in its borrowed invested capital for excess profits tax calculation. The loan was used to purchase single-premium life insurance policies on its two principal stockholders, Leeds and Madan. The Tax Court held that while the debt was bona fide, it was not incurred for a valid business purpose of Emeloid, but rather to facilitate a stock purchase agreement benefiting Leeds and Madan personally. Therefore, the debt could not be included in Emeloid's borrowed invested capital.

Facts

Emeloid Co., a plastics manufacturer, was equally owned and managed by Myron Leeds and Edward Madan. In 1942, the company took out single premium life insurance policies on Leeds and Madan, with the company as the beneficiary. These policies were financed by a $97,500 loan from a bank, secured by the policies themselves. Later, a trust agreement was established, stipulating that the insurance proceeds would be used to purchase the stock of the first of Leeds or Madan to die, ensuring the survivor could maintain control of the company.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Emeloid's excess profits tax, disallowing the inclusion of the $97,500 loan in its borrowed invested capital. Emeloid petitioned the Tax Court, arguing the loan should be included. The Tax Court upheld the Commissioner's determination.

Issue(s)

Whether the $97,500 loan obtained by Emeloid to purchase life insurance policies on its principal stockholders constitutes borrowed invested capital under Section 719 of the Internal Revenue Code, thus entitling Emeloid to a larger excess profits credit.

Holding

No, because the loan, while bona fide, was not incurred for a legitimate business purpose of Emeloid, but rather for the personal benefit of its stockholders, Leeds and Madan.

Court's Reasoning

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The Tax Court relied on Treasury Regulations 112, Section 35.719-1, which requires indebtedness to be both bona fide and incurred for business reasons to qualify as borrowed invested capital. While the loan was bona fide, the court found it was primarily for the personal benefit of Leeds and Madan, not for a business purpose of Emeloid. The court emphasized that the trust agreement, directing the insurance proceeds to be used for a stock purchase, demonstrated that the true purpose of the insurance policies was to enable the surviving stockholder to buy out the deceased stockholder's interest, rather than to provide working capital or protect the company during a period of adjustment. The court quoted *Hart-Bartlett-Sturtevant Grain Co. v. Commissioner, 182 F.2d 153*, stating that the borrowed sums were "never actually invested as a part of petitioner's working capital, they were never utilized for the earnings of profits and they were never subject to the risk of petitioner's business."

Practical Implications

This case clarifies that for debt to qualify as borrowed invested capital, it must serve a genuine business purpose for the corporation itself, not merely benefit its shareholders. This decision highlights the importance of scrutinizing transactions in closely held corporations to determine whether they are truly for the benefit of the business or are disguised attempts to provide personal benefits to the owners. *Emeloid* is often cited in cases involving tax benefits claimed by closely held corporations where the line between corporate and shareholder interests is blurred. Later cases have applied this principle to disallow deductions or credits where the primary motivation was found to be shareholder benefit rather than corporate advantage.

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