6 T.C. 519 (1946)

When a company develops a new product line that is distinct from its existing products, income derived from the new product may be considered abnormal income attributable to prior years' development efforts for excess profits tax purposes.

Summary

W.B. Knight Machinery Co. sought to exclude a portion of its 1940 income from excess profits tax, arguing it was attributable to development expenses from 1936-1939 related to a new milling machine. The Tax Court held that the income from the new machine line qualified as abnormal income under Section 721 of the Internal Revenue Code, as it resulted from significant development efforts. The court determined the amount of net abnormal income and how much was attributable to prior years, allowing the exclusion, but adjusted the taxpayer's calculation method to properly reflect the statute's requirements.

Facts

W.B. Knight Machinery Co. manufactured milling machines. From 1936 to 1940, the company invested significantly in developing a new type of milling machine (Models 20, 30, and 40) because it considered its existing machines outmoded. These new machines were designed to perform a wider range of functions with greater efficiency than the older models (Nos. 1, 1 1/2, 2-B, 3-B, and 4). The company continued to sell the old models during the tax years in question. The new machines were considered commercially successful in 1940.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the company's 1940 excess profits tax. W.B. Knight Machinery Co. challenged this determination in the Tax Court, arguing it was entitled to exclude abnormal income attributable to prior development expenses under Section 721 of the Internal Revenue Code.

Issue(s)

Whether the income derived from the sale of the new milling machines (Models 20, 30, and 40) in 1940 qualifies as abnormal income resulting from the development of tangible property under Section 721(a)(2)(C) of the Internal Revenue Code, thus allowing the exclusion of net abnormal income attributable to prior years' development expenses from the company's excess profits tax calculation.

Holding

Yes, because the expenditures from 1936 to 1939 resulted in the creation of new machines that performed functions and operations the old machines could not, representing a significant development of tangible property, and the income derived

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from their sale qualifies for relief under Section 721 of the Internal Revenue Code.

Court’s Reasoning

The Tax Court focused on whether the creation of the new milling machines was a routine activity or a radical departure from the company’s previous manufacturing methods. The court found that the new machines were, in fact, new and different, designed to do work that the old machines could not. The court noted, "The facts as stipulated and adduced at the hearing demonstrate that the new No. 20, No. 30, and No. 40 Knight millers were new machines which were created, designed, and perfected to do work, both in kind and extent, which the old machines could not perform." The court rejected the Commissioner’s argument that the company merely improved existing products, emphasizing the significant innovations and capabilities of the new machines. While the taxpayer properly attributed development costs to prior years, the Tax Court adjusted the calculation of net abnormal income to align with the statutory formula, determining the portion attributable to prior years after accounting for improvements in general business conditions.

Practical Implications

This case provides guidance on how to apply Section 721 of the Internal Revenue Code to exclude abnormal income for excess profits tax purposes. It clarifies that income from a new product line can qualify as abnormal income if it results from significant development efforts extending over more than 12 months. The case emphasizes the importance of demonstrating that the new product represents a radical departure from existing products and capabilities. It also highlights the need to correctly calculate net abnormal income according to the statutory formula, properly accounting for improvements in general business conditions that may have contributed to the increased income. This case informs tax planning and litigation strategies for companies seeking to utilize Section 721.

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