7 T.C. 529 (1946)

A taxpayer is entitled to excess profits tax relief under Section 721 of the Internal Revenue Code for abnormal income resulting from research and development, calculated by comparing income from a specific class of products to the average income from the same class in prior years.

Summary

Rochester Button Company sought relief from excess profits tax under Section 721 of the Internal Revenue Code, arguing that a portion of its income was attributable to research and development of new plastic buttons. The Tax Court held that Rochester Button was entitled to relief to the extent that its gross income from plastic buttons exceeded 125% of the average gross income from the same class of products for the four preceding years, after deducting direct costs, including selling expenses. This case clarifies how to calculate abnormal income for excess profits tax purposes when derived from long-term research and development efforts.

Facts

Rochester Button Co. manufactured buttons, primarily for the clothing trade. The company invested in research and development to create plastic buttons as a substitute for vegetable ivory buttons. Research efforts resulted in several new products, including "Niesac," "Robulith," "Duo Horn," and improved "Technoid" buttons. These new products led to increased profits in the tax year in question. The company sought to exclude a portion of its income from excess profits tax, claiming it was attributable to prior years' research and development expenditures.

Procedural History

Rochester Button Co. contested the Commissioner of Internal Revenue's determination of a deficiency in excess profits tax for the fiscal year ended October 31, 1941. The Commissioner disallowed a deduction claimed by the company for abnormal income attributable to other years. The Tax Court reviewed the Commissioner's decision.

Issue(s)

1. Whether Rochester Button is entitled to relief from excess profits tax under Section 721(a)(2)(C) of the Internal Revenue Code for the year involved.
2. If so, what is the amount of relief to which Rochester Button is entitled?

Holding

1. Yes, Rochester Button is entitled to relief from excess profits tax because it demonstrated that its increased income was attributable to long-term research and development efforts.

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2. The amount of relief is the excess of the gross income from the specified class of products over 125% of the average gross income from the same class for the four prior years, less direct costs and expenses.

Court's Reasoning

The Tax Court reasoned that the term "abnormal" in Section 721 is defined by the statute itself, not by its ordinary meaning. The court emphasized that if income of the type specified in subsection (a)(2) is present, it should be recognized in applying the relief measures granted by the statute. The court stated, "* * * the statute means just what it says — that any income of the type or class specified in subsection (a) (2) of section 721 is to be recognized in applying the relief measures which the statute grants."

The court determined that it was necessary to compute the abnormal income and net abnormal income by reference to each "separate class of income." The court further specified how to calculate the amount of income attributed to prior years versus improvements in general business conditions. The court determined that direct costs of selling were deductible in proportion to the share of abnormal income to total profits.

Practical Implications

This case provides guidance on how to apply Section 721 of the Internal Revenue Code to claims for excess profits tax relief. It clarifies that the focus should be on the *class* of income (e.g., income from research and development) and provides a methodology for calculating the amount of income attributable to prior years versus improvements in general business conditions. This methodology includes analyzing the company's historic sales data and research expenditures. The ruling offers a framework for analyzing similar cases involving claims for tax relief based on long-term projects that generate abnormal income. It emphasizes the importance of maintaining clear records of research and development expenditures, as well as sales data for different product categories.

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