Universal Button Fastening & Button Co. v. Commissioner, 8 T.C. 1174 (1947)

For purposes of excess profits tax relief under Section 721, 'abnormal income' derived from research and development is determined by comparing the total income from that class to 125% of the average income from the same class during the base period years, considering all items within that class together rather than individually.

Summary

Universal Button sought relief from excess profits tax, arguing that income from new button types developed through prior research constituted 'abnormal income' attributable to earlier years. The Tax Court held that the determination of abnormal income should be based on the entire class of income derived from research and development, not individual products. The court also outlined how to calculate direct costs, the impact of improved business conditions, and the allocation of abnormal income to prior years.

Facts

Universal Button Fastening & Button Co. engaged in ongoing research and development of new button types and materials. In the tax year in question, income from certain products ("Robulith," "Duo-Horn," "Technoid" (wash) and "Niesac") exceeded 125% of the average income from those products during the base period years (1936-1939). Income from another product ("Technoid" (mottled)) fell below this threshold. The company sought to exclude the income from the first four products from its excess profits tax calculation under Section 721 of the Internal Revenue Code.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency in Universal Button's excess profits tax. Universal Button petitioned the Tax Court for a redetermination, arguing it was entitled to relief under Section 721. The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether, for purposes of Section 721 excess profits tax relief, 'abnormal income' from research and development should be determined by considering the entire class of such income, or by evaluating individual products separately.

2. How should 'direct costs' related to the abnormal income be calculated for purposes of the Section 721(a)(3) deduction?

3. How should the impact of improved business conditions on abnormal income be

determined and factored into the Section 721 calculation?

4. How should abnormal income be allocated to prior years for the purpose of calculating the tax adjustment under Section 721(c)?

Holding

1. No, because the statute defines “abnormal income” by reference to the total derived from any class, and does not refer to individual items within a class.

2. Direct costs should be calculated based on the proportion of total selling expenses attributable to the abnormal income, relative to the company’s total gross merchandising profit.

3. The impact of improved business conditions should be determined by comparing sales of standard products during the base period years to sales of the same products during the tax year.

4. Abnormal income should be allocated to prior years in proportion to the company’s research and experimental expenditures in each of those years.

Court’s Reasoning

The court reasoned that Section 721 defines ‘abnormal income’ as exceeding 125% of the average gross income of the ‘same class’ for the base period. The statute explicitly states that income from research and development constitutes a ‘separate class of income.’ Therefore, the court concluded that the comparison must be made for the entire class, not for individual items within that class. The court stated, “Nowhere does the legislation refer to individual items within a class. The abnormal income is defined only by reference to the total derived from any class.”

Regarding direct costs, the court found a lack of specific evidence but used the available data on selling expenses and gross merchandising profit to estimate the deductible amount, referencing the principle in *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) that allows reasonable estimations when exact figures are unavailable.

The court determined the impact of improved business conditions by comparing sales of a standard product (vegetable ivory buttons) between the base period and the tax year, as this provided the most accurate measure of general economic improvement.

Finally, the court allocated abnormal income to prior years based on the relative amounts spent on research and experimentation in each of those years, mirroring the approach taken in *W. B. Knight Machinery Co., 6 T.C. 519 (1946)*.

Practical Implications

This case clarifies how to apply Section 721 to businesses with income derived from research and development. It emphasizes that the ‘abnormal income’ determination must be made at the class level, requiring taxpayers to aggregate all income within the research and development class. This decision provides a framework for calculating deductions for direct costs and accounting for improved business conditions, offering practical guidance for taxpayers seeking excess profits tax relief. It also highlights the importance of maintaining detailed records of research and development expenditures to facilitate the allocation of income to prior years. Later cases would cite this for clarifying the boundaries of what constitutes a “class of income” under the statute.

