8 T.C. 1278 (1947)

A taxpayer seeking relief from excess profits tax under Section 722(b)(4) of the Internal Revenue Code must demonstrate that a change in the character of its business during the base period, such as a substantial increase in production capacity, resulted in an inadequate standard of normal earnings.

Summary

National Grinding Wheel Co. sought relief from excess profits tax, arguing that its increased production capacity during the base period (1936-1939) made its average base period net income an inadequate measure of normal earnings. The Tax Court acknowledged the increased capacity but found insufficient evidence that this capacity would have translated into increased sales throughout the base period, except for a brief period in 1937. The court allowed a small amount of relief, recognizing that some additional sales might have been made in 1937 with greater capacity.

Facts

National Grinding Wheel Co. manufactured and sold grinding wheels, with about 85% of its products made to customer specifications. The company significantly increased its production capacity during the base period by adding kilns and ovens to its plant. While the company's management aggressively pursued sales, the company's sales did not always match its production capacity, and inventories of finished goods increased.

Procedural History

National Grinding Wheel Co. filed an application for relief from excess profits tax under Section 722(b)(4) of the Internal Revenue Code for the taxable year 1940. The Commissioner of Internal Revenue denied the application. The Tax Court reviewed the Commissioner's decision.

Issue(s)

1. Whether National Grinding Wheel Co. changed the character of its business during the base period within the meaning of Section 722(b)(4) due to a substantial increase in its capacity for production.
2. Whether the taxpayer's average base period net income is an inadequate standard of normal earnings because of the change in the character of the business.

Holding

1. Yes, because the company substantially increased its capacity for production during the base period by adding kilns and ovens.

2. No, for most of the base period, but yes, in a limited sense, because the court found some evidence that increased capacity would have resulted in higher sales during a portion of 1937.

Court's Reasoning

The Tax Court found that National Grinding Wheel Co. did increase its production capacity, thus changing the character of its business. However, the court emphasized that to justify relief, the company needed to prove that its increased capacity would have translated into increased sales throughout the base period. The court noted that the company's management was already aggressively pursuing sales and that sales lagged behind production capacity in several years. The court stated, "Unless there is sufficient reason to believe that greater capacity in each year of the base period would have resulted in greater sales in each, then there is no reason urged for using other than actual earnings for that year." The court did find credible evidence that the company experienced delays in filling orders during the spring and summer of 1937 due to capacity constraints, leading to some lost sales. Relying on *Cohan v. Commissioner, 39 F.2d 540*, the court estimated a fair amount of relief, increasing the constructive average base period net income by $2,000.

Practical Implications

This case highlights the importance of demonstrating a direct link between increased production capacity and increased sales when seeking relief from excess profits tax under Section 722(b)(4). Taxpayers must provide specific evidence that capacity constraints limited their sales during the base period. It illustrates that simply increasing capacity is not enough; the taxpayer must show that the increased capacity would have been utilized and would have resulted in higher earnings. This case is a reminder of the high burden of proof required to obtain relief under Section 722 and the importance of detailed evidence to support claims of lost sales due to capacity limitations.

