Cities Service Co. v. Commissioner, 1947 Tax Ct. Memo LEXIS 15 (T.C. 1947)

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A deduction is considered ‘abnormal’ for excess profits tax purposes if it arises from circumstances markedly different from regular business operations and is not simply an increase in a typical expense.

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Summary

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Cities Service Co. sought to adjust its base period income for excess profits tax purposes, claiming certain expenditures were abnormal. The company incurred expenses correcting defects in its Janitrol heaters and developing its Kathabar air-conditioning equipment. The Tax Court held that the Janitrol expenses qualified as abnormal deductions because they stemmed from a unique design flaw, while the Kathabar expenses were part of ongoing development costs and not abnormal. The court also addressed deductions for contributions to employee profit-sharing trusts, finding them to be reasonable compensation and deductible. Finally, the court ruled on the proper method for annualizing income for a short tax year.

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Facts

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Cities Service Co. manufactured and sold Janitrol heaters and was developing Kathabar air-conditioning equipment. The Janitrol heaters, a new model introduced in 1937, had a design defect that posed a potential safety hazard. The company initiated a program to replace the defective parts in all units sold, incurring significant expenses. The Kathabar equipment was under development since 1934, and the company faced corrosion issues that led to further expenditures. In 1941, Cities Service established employee profit-sharing trusts for executives and sales employees, contributing substantial amounts. Because the parent company filed a consolidated return, Cities Service had to file a short-year return covering only January to November 1941.

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Procedural History

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The Commissioner of Internal Revenue disallowed certain deductions claimed by Cities Service, including the Janitrol and Kathabar expenses and the contributions to the employee profit-sharing trusts. The Commissioner also challenged the method used to calculate excess profits net income for the short tax year. Cities Service appealed to the Tax Court.

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Issue(s)

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1. Whether the expenditures to correct defects in the Janitrol heaters constituted abnormal deductions under Section 711(b)(1)(J)(i) of the Internal Revenue Code.

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2. Whether the expenditures related to the development of the Kathabar equipment constituted abnormal deductions.

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3. Whether the contributions to the employee profit-sharing trusts were deductible as ordinary and necessary business expenses.

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4. Whether the taxpayer properly computed its excess profits net income for the short tax year.

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Holding

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1. Yes, because the Janitrol expenses were attributable to a basic design defect, making them different from ordinary servicing expenses.

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2. No, because the Kathabar expenses were part of the ongoing development and experimentation process.

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3. Yes, because the contributions constituted reasonable compensation for services rendered.

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4. Yes, because the taxpayer followed the method prescribed by Section 711(a)(3)(A) of the code.

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Court’s Reasoning

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The court reasoned that the Janitrol expenses were abnormal because they stemmed from a unique design flaw not normally encountered. The court distinguished these expenses from regular servicing costs, referencing *Green Bay Lumber Co., 3 T.C. 824*, emphasizing that remedial statutes should be construed reasonably to provide intended relief. Regarding the Kathabar expenses, the court found they were part of continuous development and experimentation, and thus not abnormal. For the profit-sharing trusts, the court distinguished *Lincoln Electric Co., 6 T.C. 37*, noting the employees’ rights were substantial and the contributions were reasonable compensation. The court found that the potential for recapture of contributions by the company was contingent on the Commissioner’s actions and did not negate deductibility. Finally, the court determined the taxpayer properly annualized its income under Section 711(a)(3)(A), as its books accurately reflected its income. The court stated, “Since the expenditures here were of one special type, limited to one certain model of heater, they can not be said to have been caused by sales of any other product, and any changes in the size of petitioner’s business which did not affect, contribute to, or cause in any way the abnormal expenditure involved are immaterial.”

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