12 T.C. 618 (1949)

A taxpayer is entitled to excess profits tax relief under Section 721(a)(2)(C) of the Internal Revenue Code when abnormal income results from research and development extending over more than 12 months, even if the final product is not entirely new, and the income is attributable to prior years.

Summary

Keystone Brass Works, previously a plumbing fittings manufacturer, sought excess profits tax relief for 1944, arguing that its income from producing bronze bushings for Rolls-Royce aircraft engines was abnormal and attributable to extensive research and development in prior years. The Tax Court agreed in part, holding that a portion of Keystone's 1944 income qualified for relief under Section 721(a)(2)(C) because it stemmed from significant research and development activities necessitated by stringent specifications. However, the court also found that other factors, such as efficient management and increased demand, contributed to the income, limiting the amount attributable to prior years.

Facts

Prior to 1941, Keystone manufactured plumbing fittings. Due to wartime restrictions, its copper supply was cut off, forcing it to cease normal production. Packard Motor Car Co. approached Keystone to produce bronze bushings for Rolls-Royce aircraft engines. The specifications required an unusual degree of hardness, chilled castings in permanent molds, and extremely tight machine tolerances. Keystone had no prior experience with such specifications and had to develop new tools, molds, casting machines, furnaces, techniques, and processes through extensive experimentation and research from 1942 through part of 1944. Despite receiving substantial orders, Keystone initially suffered losses due to high tooling costs and scrap production.

Procedural History

Keystone filed its income and excess profits tax returns for 1942 and 1944. The Commissioner determined a deficiency in Keystone's income tax for 1942 and in income and excess profits tax for 1944. Keystone petitioned the Tax Court, arguing it was entitled to relief under Section 721(a)(2)(C) due to abnormal income attributable to prior years.

Issue(s)

Whether Keystone is entitled to relief under Section 721(a)(2)(C) of the Internal Revenue Code because it had abnormal income, as defined in that section, attributable to prior years, due to research and development of tangible property.

Holding

Yes, in part, because Keystone's income in 1944 was partially attributable to extensive research and development efforts over multiple years. However, some income was also due to efficient management, increased demand, and the use of new machinery.

Court's Reasoning

The court reasoned that Keystone's situation fit the intent of Section 721, which was designed to provide relief when a taxpayer's increased profits were attributable to internal changes and developments rather than external factors. The court emphasized that Keystone had to overcome significant technological challenges to meet Packard's stringent specifications, requiring substantial research and development. The court cited *W. B. Knight Machinery Co., 6 T.C. 519*, noting that Keystone's work was a "radical departure" from its prior manufacturing processes. However, the court also found that not all of Keystone's income was solely attributable to research and development, stating that "Some part of such income was due to efficient management and the skillful use of machinery in the plant, as well as the use of new machinery and equipment acquired by petitioner without which it could not have produced the quantity produced in 1944." The court also noted that increased demand for engines also contributed to the revenue. The court determined the specific amounts of 1944 income attributable to 1943 and 1942 based on the evidence presented.

Practical Implications

This case clarifies that Section 721 relief is available even if the end product isn't entirely new, provided that substantial research and development is required to achieve the final result. It emphasizes the importance of detailed record-keeping to demonstrate the extent and duration of research and development efforts. Furthermore, this case highlights the necessity of showing a direct link between the research and development activities and the abnormal income, while acknowledging that other factors may also contribute. This informs how tax practitioners should advise clients on documenting their activities to support claims for abnormal income relief in similar situations.

