12 T.C. 635 (1949)

A portion of abnormal income derived from research and development may be allocated to prior years if it's attributable to that research, even if increased wartime demand contributed to the income.

Summary

Pantasote Leather Co. sought relief under Section 721 of the Internal Revenue Code, claiming that abnormal income in 1941 and 1942 was attributable to its long-term research and development of specialized coated fabrics (Pantex and C. C. Textasote), primarily for military use. The Tax Court had to determine if this income resulted solely from increased wartime demand, or if a portion was attributable to the prior years of research and development. The court held that while wartime demand significantly contributed to the income, a portion was indeed attributable to the company's research efforts and could be allocated to those prior years.

Facts

Pantasote Leather Co. manufactured coated fabrics. Starting in 1931, the company engaged in research and development of Pantex and C. C. Textasote, primarily at the request of the Navy Department. Pantex was developed as a waterproof, flexible, non-adhesive fabric for parachute bags and aviator garments. C. C. Textasote was developed as a pyroxylin-coated fabric resistant to water, gasoline, and oil for aircraft coverings. Development involved overcoming significant technical challenges and extended over several years. By 1941 and 1942, sales of both products, particularly to the armed forces, increased substantially due to wartime demand.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Pantasote's income and excess profits taxes for 1942 and denied a claim for refund for 1941. Pantasote petitioned the Tax Court for relief under Section 721 of the Internal Revenue Code, arguing that a portion of its abnormal income was attributable to prior years. The Tax Court consolidated the proceedings.

Issue(s)

Whether the petitioner derived net abnormal income during the taxable years 1941 and 1942, within the class described in Internal Revenue Code section 721 (a) (2) (C), some of which can be said to be attributable to prior years, so as to entitle petitioner to the relief accorded by that section?

Holding

Yes, in part. A portion of Pantasote's abnormal income in 1941 and 1942 was

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attributable to prior years of research and development, but the majority was due to increased wartime demand. The court allocated 50% of the 1941 net abnormal income and 75% of the 1942 net abnormal income to the improved business conditions, with the remainder attributable to prior years.

Court's Reasoning

The court acknowledged that Section 721 provides relief for taxpayers with abnormal income by allowing them to allocate such income to the years to which it is properly attributable. The court recognized the difficulty in determining how much of the income was due to long-term research versus increased wartime demand. The court rejected Pantasote's argument that the unavailability of raw materials during wartime suppressed potential peacetime demand, finding the supporting testimony too speculative. However, the court also disagreed with the Commissioner's argument that the income was solely attributable to wartime demand, noting the legislative intent of Section 721 and citing Eitel-McCullough, Inc., 9 T.C. 1132. The court relied on the evidence presented by Pantasote to determine the portion of net abnormal income that arose from research and development, recognizing, "a consideration of so general a nature would still necessarily reduce in the last analysis to a matter of opinion" (Rochester Button Co., 7 T.C. 529, 553). The court emphasized common sense and judgment in light of proven facts, citing Ramsey Accessories Mfg. Corporation, 10 T.C. 482, 489, and ultimately applied Cohan v. Commissioner, to approximate the attributable amounts.

Practical Implications

This case provides guidance on how to analyze claims for relief under Section 721 of the Internal Revenue Code. It clarifies that even when wartime demand or other external factors contribute significantly to increased income, a portion of that income may still be attributable to long-term research and development efforts. The case highlights the importance of presenting detailed evidence to support the allocation of income to specific years, even when approximation and judgment are necessary. Later cases must consider the specific facts to determine if the increase in profits was "merely the realization in those years of growth (increase in profits) that would have occurred under normal conditions if there had been no war." It reinforces the principle that while speculation should be avoided, reasonable estimations based on available evidence are permissible when allocating abnormal income under Section 721.

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