14 T.C. 276 (1950)

A taxpayer seeking relief from excess profits tax based on inadequate invested capital must demonstrate both a qualifying condition under Section 722(c) of the Internal Revenue Code and establish a fair and just amount representing normal earnings.

Summary

The Danco Company sought a refund of excess profits tax, arguing its invested capital was an inadequate standard due to intangible assets and capital not being an important income factor. Danco claimed its president's expertise and reputation constituted intangible assets. The Tax Court acknowledged Danco met the qualifying conditions under Section 722(c) of the Internal Revenue Code. However, Danco failed to adequately demonstrate what its normal earnings would have been during the base period, instead proposing a percentage of its later sales. Therefore, the Tax Court denied the refund, holding that a fair and just representation of normal earnings must be established to qualify for relief.

Facts

The Danco Company, an Ohio corporation, was formed in April 1940, engaging in fabricating sheet metal to customer specifications. C. George Danielson, Danco's president, had extensive experience in the sheet metal business and brought established customer relationships from his previous employment at Artisan Metal Works Co. Danco secured a significant portion of its business from Picker X-ray Corporation, manufacturing metal cabinets for Army X-ray units. During 1942 and 1943, Danco's sales to Picker represented over 87% of its total sales. Danco filed applications for relief under Section 722(c) of the Internal Revenue Code, which were disallowed by the Commissioner.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Danco's excess profits tax for 1942 and 1943 and disallowed Danco's applications for relief under Section 722(c) of the Internal Revenue Code. Danco petitioned the Tax Court, challenging the Commissioner's determination and seeking a refund of excess profits tax paid.

Issue(s)

1. Whether Danco's excess profits tax credit based on invested capital was an inadequate standard due to intangible assets making important contributions to income under Section 722(c)(1) of the Internal Revenue Code.
2. Whether Danco's business was of a class in which capital was not an important income-producing factor under Section 722(c)(2) of the Internal Revenue Code.
3. Whether Danco established a fair and just amount representing normal

earnings to be used as a constructive average base period net income under Section 722(a) of the Internal Revenue Code.

Holding

1. Yes, because Danielson's contacts and reputation constituted intangible assets that made important contributions to Danco's income, though not includible in equity invested capital.
2. Yes, because Danco's business was of a class where the normal profit greatly exceeded the normal return on invested capital, indicating the invested capital method was inadequate.
3. No, because Danco's proposed method of computing constructive average base period net income (20% of net sales in 1942 and 1943) was not a fair and just representation of normal earnings during the base period.

Court's Reasoning

The court found that Danielson's expertise, contacts, and reputation were instrumental in securing business for Danco. The court cited E.P.C. 36, stating that ownership of the intangible asset is not required by Section 722(c)(1), as long as the asset contributes significantly to income. The court stated, "In E. P. C. 35 (1949-1 C. B. 134), the Council held that ownership of the intangible asset, in a strict legal sense is not required by section 722 (c) (1)." While acknowledging this qualified Danco under Section 722(c)(1), the court emphasized that merely qualifying for relief is insufficient. Citing the Senate Committee on Finance, the court stated that capital is "not an important income producing factor if the business is of a type showing a high return on invested capital." The court found Danco also qualified under Section 722(c)(2). The court stated "the mere existence of the qualifying features of section 722 (c) does not establish a taxpayer's right to relief. The petitioner must further demonstrate the inadequacy of its excess profits credit based upon invested capital by establishing under section 722 (a) a fair and just amount representing normal earnings to be used as a constructive average base period net income." The court rejected Danco's proposal to use 20% of its 1942 and 1943 sales as its constructive average base period net income. The court reasoned that Section 722(a) contemplates a fixed amount representing normal earnings, not a percentage applied to sales from year to year.

Practical Implications

This case clarifies the requirements for obtaining relief under Section 722(c) of the Internal Revenue Code. It emphasizes that demonstrating a qualifying condition (intangible assets or capital not being an important factor) is only the first step. Taxpayers must also provide sufficient evidence to establish a realistic and justifiable constructive average base period net income. This case also clarifies that "intangible assets" under the statute are not limited to assets "owned" by the corporation, and may include the value of key employees' reputations and contacts.

The case highlights the importance of providing detailed financial data and comparisons with similar businesses during the base period to support a claim for relief. It serves as a reminder that a mere showing of high profits during the excess profits tax years is not enough; the taxpayer must demonstrate what its normal earnings would have been under normal business conditions.

