13 T.C. 905 (1949)

Taxpayers seeking excess profits tax relief under Section 721 of the Internal Revenue Code can attribute net abnormal income resulting from research and development to prior years, even if accurate expenditure records were not kept, provided a reasonable allocation based on the events in which the income had its origin is made.

Summary

Popper Morson Corporation sought to attribute abnormal income from magnesium smelter construction in 1943 to prior years (1936-1943) due to research and development expenses. The Tax Court held that the income was indeed attributable to research extending back to 1936. The Court found that the income stemmed from the commercialization of a process developed over several years. Despite imperfect records, the Court allowed the allocation of income to prior years based on reasonable estimates, adjusted for expenditures not directly related to magnesium smelting research.

Facts

Popper Morson Corporation (petitioner) engaged in research beginning in 1936, which led to a process for smelting magnesium. In 1943, the petitioner constructed four magnesium smelter furnaces for Ford Motor Co. and performed two related dismantling contracts. This generated net income of $165,400.69. After a renegotiation settlement with the government of $55,195.43, the petitioner claimed $110,205.26 as net abnormal income attributable to research and development from 1936-1943.

Procedural History

The Commissioner of Internal Revenue denied the petitioner’s claim for relief under Section 721, arguing that the research did not extend over 12 months and that the petitioner failed to demonstrate what portion of the income resulted from the process versus other factors (manufacturing and installation). The Tax Court reviewed the Commissioner’s decision.

Issue(s)

1. Whether the income received by petitioner from the contracts in question comes within the class set forth in section 721 (a) (2) (C) of the Internal Revenue Code?
2. Whether the net abnormal income realized during the year 1943 is attributable to other years; and to what extent?

Holding

1. Yes, because the evidence showed that the process from which petitioner received

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income in 1943 relates back to research begun in 1936.

2. Yes, because the income was derived from a process developed over several years of research and development and the taxpayer's allocation of expenditures, after certain adjustments, was reasonable.

Court's Reasoning

The court rejected the Commissioner's arguments. The court reasoned that the research extended over more than 12 months, beginning in 1936. The court addressed concerns about high prices, low operating costs, and increased volume (factors that could negate attributing income to prior years per Treasury Regulations). The court found that the renegotiation settlement addressed high prices, the operating costs were normal, and the increased volume argument was inapplicable, as the petitioner was selling services, not manufactured goods.

The Court distinguished *Ramsey Accessories Manufacturing Corporation*, noting that petitioner was not a manufacturing business. The Court highlighted that the income resulted from the commercialization of the petitioner's own developed process due to the personal services and ability of its engineers. Although accurate records were not kept, the Court accepted a reasonable estimate of expenditures, stating, "a taxpayer's books are not kept with prophetic vision as to the future requirements of income tax legislation." The Court adjusted the petitioner's estimate by eliminating expenditures related to acquiring existing knowledge, which were not deemed research and development expenses.

Practical Implications

This case provides guidance on applying Section 721 and its associated regulations. It clarifies that taxpayers can attribute abnormal income resulting from research and development to prior years, even with imperfect records, using reasonable allocation methods. The decision emphasizes the importance of demonstrating the link between the abnormal income and the prior research efforts.

Practically, this means that taxpayers should maintain as detailed records as possible regarding research and development expenses. However, the case provides recourse when such records are lacking, permitting the use of reasonable estimates. Furthermore, the case underscores that the IRS cannot simply dismiss abnormal income as solely attributable to factors such as increased demand if the taxpayer can demonstrate a clear connection to prior research and development activities. Later cases may cite this to allow carryback of losses in similar R&D intensive scenarios.

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