14 T.C. 1021 (1950)

A change in a business's operations that significantly impacts its earning capacity, rendering its actual base period earnings an inadequate standard, qualifies as a 'change in the character of the business' under Section 722(b)(4) of the Internal Revenue Code, even if occurring after December 31, 1939, provided it's related to pre-1940 financial experiences and not attributable to war economy conditions.

Summary

Wisconsin Farmer Co. sought relief from excess profits tax, arguing that a new contract with an insurance company, effective February 10, 1940, constituted a 'change in the character' of its business. The Tax Court agreed, finding that the contract, which increased commission income and granted profit-sharing privileges, significantly altered the company's earning capacity. The court held that while events after December 31, 1939, are generally excluded from constructive income calculations, this change could be considered because it was related to pre-1940 operations and not caused by the war. The court determined a constructive average base period net income, allowing a partial refund of excess profits tax.

Facts

Wisconsin Farmer Co. published a farm paper, generating income from advertising, subscriptions, and commissions on low-cost accident insurance policies sold to subscribers. From 1930 to February 1940, the company acted as a sub-agent for National Casualty Co. In January 1940, Wisconsin Farmer Co. entered into a contract with Mutual Benefit Health & Accident Association (Association), effective February 10, 1940. This new contract made Wisconsin Farmer Co. a direct agent, increased commissions, and granted profit-sharing privileges. The company applied for relief under Section 722(b)(4) and (b)(5) of the Internal Revenue Code, which was initially denied.

Procedural History

The Commissioner of Internal Revenue disallowed Wisconsin Farmer Co.'s application for relief under Section 722. The company then petitioned the Tax Court, contesting the Commissioner's decision. The Tax Court reviewed the case and the relevant provisions of the Internal Revenue Code.

Issue(s)

1. Whether the new contract with Association constituted a 'change in the character' of Wisconsin Farmer Co.'s business under Section 722(b)(4) of the Internal Revenue Code.

2. Whether a change occurring after December 31, 1939, can be considered in determining a constructive average base period net income under Section 722(a) of

the Internal Revenue Code.

Holding

1. Yes, because the new contract significantly increased commission income and granted profit-sharing privileges, altering the company's earning capacity.

2. Yes, because the change was related to the company's pre-1940 financial experiences and was not attributable to conditions arising from the war economy.

Court's Reasoning

The Tax Court reasoned that a 'change in the character of the business' under Section 722(b)(4) must be substantial, with the operations being essentially different after the change. The court considered the principles outlined in Regulations 112, section 35.722-3(d), emphasizing that the change must lead to an increased level of earnings directly attributable to it. The court found the new contract with Association met this standard due to the increased commission and profit-sharing. Although Section 722(a) generally excludes post-1939 events, the court stated: "Therefore, we have concluded that a change in the character of a taxpayer's business occurring during its base period but after December 31, 1939, may be regarded and related to the petitioner's financial experiences and earnings prior to January 1, 1940, in the determination of a constructive average base period net income under the provisions of section 722 (a) as has been done in the instant case." The court calculated a constructive average base period net income of $45,000, based on pre-1940 data and the increased commission rate, but excluding the profit-sharing element due to lack of pre-1940 data.

Practical Implications

This case clarifies the definition of a 'change in the character of the business' for purposes of Section 722 excess profits tax relief. It establishes that a substantial change in a business's operations that significantly increases earning capacity can qualify, even if occurring late in the base period. However, the case also highlights the limitations imposed by Section 722(a), emphasizing that post-1939 events can only be considered to the extent they relate to pre-1940 experiences and are not attributable to war-related economic changes. Later cases would need to carefully analyze whether post-1939 changes truly reflect pre-war business operations or were influenced by war conditions to properly determine eligibility for tax relief.

