Sommerfeld Machine Company, Petitioner, v. Commissioner of Internal Revenue, Respondent, 15 T.C. 453 (1950)

A company is entitled to relief from excess profits tax under Internal Revenue Code section 721(a)(2)(C) when it receives income from the manufacture and sale of products developed over a period exceeding 12 months, subject to adjustments for deductible expenses and the business improvement factor.

Summary

Sommerfeld Machine Company sought a redetermination of deficiencies in income, declared value excess profits, and excess profits tax. The Tax Court addressed whether the company qualified for relief from excess profits tax under Section 721(a)(2)(C) of the Internal Revenue Code due to income derived from lathes developed over several years. The court also considered the deductibility of compensation paid to the company's officer-stockholders and deductions for travel and sales commissions. The Tax Court held that Sommerfeld Machine Company was entitled to relief under Section 721(a)(2)(C), subject to certain adjustments, found portions of officer compensation excessive, and upheld the deductions for travel expenses and sales commissions where justified by evidence. The decision emphasizes the importance of R&D extending beyond a year for relief from excess profit tax.

Facts

Sommerfeld Machine Co., a Pennsylvania corporation, manufactured glass forming machinery and engaged in general machine shop work. In 1936, the company decided to design and produce heavy-duty lathes and began research and development, incurring expenses from 1936-1939. The company expanded its plant and installed new machinery to facilitate lathe production. The first lathes were sold in 1940, with sales increasing significantly in subsequent years. Karl and Frank Sommerfeld, the brothers who ran the company, received salaries and bonuses. The Commissioner of Internal Revenue challenged the deductions for salaries paid to the brothers and disallowed a portion of "miscellaneous" expenses.

Procedural History

Sommerfeld Machine Company filed returns and claimed deductions for officer compensation and miscellaneous expenses. The Commissioner of Internal Revenue issued a notice of deficiency, disallowing portions of the claimed deductions and challenging the company's eligibility for relief under Section 721 of the Internal Revenue Code. Sommerfeld Machine Company then petitioned the Tax Court for a redetermination of the deficiencies.

Issue(s)

1. Whether Sommerfeld Machine Company was entitled to relief from excess profits

tax under Internal Revenue Code Section 721(a)(2)(C) due to income from the manufacture and sale of lathes developed in prior years.

2. Whether the compensation paid to Sommerfeld Machine Company's officer-stockholders was reasonable and deductible.

3. Whether deductions for travel expenses and sales commissions were justified.

Holding

1. Yes, because Sommerfeld Machine Company engaged in research and development of lathes over a period exceeding 12 months and derived income from their manufacture and sale, entitling it to relief under Section 721(a)(2)(C), subject to adjustments.

2. No, in part, because portions of the compensation paid to the officer-stockholders were excessive.

3. Yes, because the deductions for travel expenses and sales commissions were justified by the evidence submitted.

Court's Reasoning

The Tax Court reasoned that Sommerfeld Machine Company had indeed engaged in research and development, leading to the creation of its principal product, the lathes. The court relied on *W. B. Knight Machinery Co.*, 6 T.C. 519, and *Keystone Brass Works*, 12 T.C. 618. The court considered several factors to determine the reasonableness of officer compensation, including prior salaries, the nature of duties performed, the increased demands of the business, the success of operations, and dividend history. The court analyzed adjustments to the net sales figure, including the renegotiation rebate, which it considered either an offset against gross sales or an exclusion from gross income. The court noted that it was necessary to attribute some part of the petitioner's income from the developed product to its activities of manufacture and sale, as opposed to pure development. The court rejected the Commissioner's argument that the business improvement factor should be applied to abnormal income rather than net abnormal income, citing *W.B. Knight Machinery Co.* The court found payment of the contested travel and commission expenses was substantiated by testimony, allowing its deductibility as ordinary and necessary business expenses.

Practical Implications

This case provides guidance on eligibility for relief from excess profits tax under Section 721 of the Internal Revenue Code, particularly for companies engaged in research and development. It highlights the importance of demonstrating that the company engaged in research and development over a substantial period (more than 12 months) that led to the creation of a product generating abnormal income. It informs tax planning and litigation strategies for companies seeking similar relief, emphasizing the need to maintain detailed records and documentation to support claims for deductions and adjustments. It also underscores the importance of determining reasonable compensation for officer-stockholders, as excessive compensation may be disallowed as a deduction. It also provides an example of how to calculate the business improvement factor when seeking relief under Section 721. The court's emphasis on "direct costs and expenses" of sales is a reminder that these must be factored in when calculating net abnormal income.