16 T.C. 456 (1951)

A taxpayer is not entitled to excess profits tax relief under Section 722 of the Internal Revenue Code based on allegedly unaggressive management during the base period, as poor management is an internal factor, not a temporary economic circumstance.

Summary

Foskett & Bishop Co. sought relief from excess profits tax for 1941, 1942, 1943, and 1945 under Section 722 of the Internal Revenue Code, arguing that its base period income was an inadequate reflection of normal earnings due to various factors, including allegedly unaggressive management. The Tax Court denied the relief, holding that the company failed to demonstrate that its excess profits tax was excessive or discriminatory. The court reasoned that the alleged unaggressive management was an internal factor, not a temporary economic circumstance, and therefore did not qualify for relief under the statute. The court further held that allowing relief based on a hypothetical change in management would be inconsistent with the principles underlying Section 722.

Facts

Foskett & Bishop Co., primarily engaged in installing pipes in non-residential buildings, paid excess profits tax for the years 1941, 1942, 1943, and 1945. The company's president from 1932 through the base period (1936-1939), W.C. Jacques, was allegedly unaggressive due to a throat ailment. The company claimed that under more aggressive management, it would have secured a larger percentage of contracts bid upon and achieved higher sales volume. The company's excess profits credit was computed on the invested capital method. The company sought to reconstruct its base period net income to reflect the impact of more aggressive management.

Procedural History

The Commissioner of Internal Revenue disallowed Foskett & Bishop Co.'s applications for relief under Section 722 for the tax years in question. Foskett & Bishop Co. then petitioned the Tax Court for a redetermination of its excess profits tax liability. The Tax Court upheld the Commissioner's disallowance, finding that the company had not established its right to relief under the cited provisions of Section 722.

Issue(s)

1. Whether Foskett & Bishop Co. was entitled to relief under Section 722(b)(2) because its business was depressed due to temporary economic circumstances unusual to the taxpayer or its industry.

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2. Whether Foskett & Bishop Co. was entitled to relief under Section 722(b)(3) because its business was depressed due to conditions prevailing in its industry, subjecting it to a profits cycle differing from the general business cycle.

3. Whether Foskett & Bishop Co. was entitled to relief under Section 722(b)(5) because of "any other factor" resulting in an inadequate standard of normal earnings during the base period.

Holding

1. No, because allegedly unaggressive management does not constitute a temporary economic circumstance.

2. No, because the company failed to demonstrate that conditions in its industry caused its profits cycle to differ materially from the general business cycle, and the alleged difference was due to non-cyclical factors.

3. No, because allowing relief based on a hypothetical change in management would be inconsistent with the principles underlying Section 722, particularly subsection (b)(4), which addresses changes in management during or immediately prior to the base period.

Court's Reasoning

The court reasoned that the company's claim of unaggressive management was an internal factor, not a temporary economic circumstance as required by Section 722(b)(2). The court quoted the Commissioner's Bulletin on Section 722, stating that the cause of the depression must be external to the taxpayer and not brought about primarily by a managerial decision. The court found that poor management was not a temporary circumstance because the company's management was allegedly subpar throughout the period 1922-1939. Regarding Section 722(b)(3), the court found no evidence that the company's profits cycle differed from the general business cycle due to conditions prevailing in its industry. Instead, any differences were attributed to non-cyclical factors such as the quality of management. As for Section 722(b)(5), the court held that allowing relief based on a hypothetical improvement in management during the base period would be inconsistent with Section 722(b)(4), which provides relief for actual changes in management during or immediately before the base period. The court concluded that it could not retroactively substitute new management for the company during the base period, as that would be speculative and unauthorized by the statute. The court stated: "To consider what other management would have done during the base period would be speculative and would be tantamount to changing the character of petitioner's business during the base period by substituting new management for petitioner in the base period which petitioner itself did not do. Such a result we do not think is authorized by Section 722 (b) (5)."

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Practical Implications

This case clarifies that Section 722 relief is not available for factors within a company's control, such as management decisions. It highlights the distinction between internal and external factors in determining eligibility for relief from excess profits tax. Taxpayers seeking relief under Section 722 must demonstrate that their inadequate base period earnings were the result of temporary economic circumstances beyond their control. The case also emphasizes the importance of consistency within the subsections of Section 722, suggesting that relief under subsection (b)(5) cannot be granted if it would undermine the principles underlying the other subsections. The decision reinforces the idea that courts will not engage in speculative reconstructions of base period income based on hypothetical changes in a company's operations.

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