***16 T.C. 478 (1951)***

To qualify for excess profits tax relief under Section 722 of the Internal Revenue Code, a taxpayer must demonstrate that unusual events interrupted or diminished normal production, output, or operation during the base period, resulting in an inadequate standard of normal earnings.

**Summary**

The Matheson Company sought excess profits tax relief under Section 722(b)(1) and (5) of the Internal Revenue Code for 1941 and 1942, arguing that the illness and death of its founder, coupled with management issues and litigation, diminished its normal operations. The Tax Court denied relief, holding that the company failed to prove that these events interrupted or diminished normal production or that its average base period net income was an inadequate standard of earnings. The Court also rejected the claim for abnormal deduction under Section 711(b)(1)(J)(i).

**Facts**

The Matheson Company (old corporation) was formed in 1928. Its primary business was transferring compressed gases from large to small containers for sale. Adam Matheson, the founder, managed the company until he suffered a stroke in April 1936. After the stroke, William Dugan, an employee, took over day-to-day operations. Florence Matheson, Adam's wife, owned a significant portion of the company stock and was a known drug addict. Leo McLaughlin, an attorney, became involved in the company's management, leading to internal disputes and litigation. A new corporation (petitioner) was formed in 1940 through a merger involving an interim holding company, acquiring the assets of the old corporation.

**Procedural History**

The Commissioner of Internal Revenue denied The Matheson Company's application for excess profits tax relief for 1941 and 1942, assessing deficiencies. The Matheson Company petitioned the Tax Court for review, contesting the Commissioner's determination.

**Issue(s)**

1. Whether the illness and death of Adam Matheson, management difficulties, and related litigation constituted unusual events that interrupted or diminished normal production, output, or operation during the base period under Section 722(b)(1) of the Internal Revenue Code.

2. Whether the average base period net income was an inadequate standard of normal earnings due to other factors affecting the business under Section 722(b)(5) of the Internal Revenue Code.

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3. Whether the compensation paid to the Mathesons during the base period years should be disallowed as a deduction under Section 711(b)(1)(J)(i) of the Internal Revenue Code because it was an abnormal deduction.

**Holding**

1. No, because the Matheson Company failed to demonstrate that the alleged events interrupted or diminished normal production, output, or operation during the base period.

2. No, because the earnings during the base period were considered normal and, in fact, better than normal, precluding relief under Section 722(b)(5).

3. No, because the compensation paid to the Mathesons was not abnormal in class, and the company failed to demonstrate that the alleged abnormality was not a consequence of a change in the manner of operation of the business.

**Court's Reasoning**

The Tax Court reasoned that the events cited by the Matheson Company were primarily management issues rather than physical events as contemplated by Section 722(b)(1). The court found no evidence that these events interrupted or diminished normal production, noting that Dugan continued to manage the business effectively after Matheson's stroke. The court emphasized that the company's net income during the base period was not an inadequate standard of normal earnings, especially considering the losses incurred in prior years. Regarding the compensation deduction, the court found that management compensation was a normal business expense and that the company had not shown the payments were unreasonable, especially given Matheson's past services and Mrs. Matheson's actions to protect the company's interests. The court stated,

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