Arrow Tool and Die Company v. Commissioner, 18 T.C. 705 (1952)

A taxpayer seeking relief from excess profits tax under Section 722 must demonstrate not only eligibility under specific provisions (e.g., 722(c)(2) or (c)(3)), but also a fair and just representation of normal earnings for a constructive average base period net income, failing which, relief will be denied.

Summary

Arrow Tool and Die Company, formed after 1939, sought relief from excess profits tax under Section 722(c)(2) and (c)(3) of the Internal Revenue Code, arguing its invested capital was an inadequate standard for determining excess profits. The Tax Court denied relief. While the company argued it would have been successful during the base period years (prior to 1940) had it been in operation, the court found the company failed to prove it would have been profitable or even remained in business during those years, especially considering the skepticism of aircraft manufacturers to subcontracting assembly jig construction. Without establishing a fair and just amount representing normal earnings, the court held Arrow Tool and Die failed to meet the requirements for relief under Section 722(a).

Facts

- Arrow Tool and Die Company was organized after December 31, 1939.
- The company sought to compute its excess profits tax credit using the invested capital method but requested relief under Section 722(c)(2) and 722(c)(3) of the Internal Revenue Code.
- The company specialized in aircraft assembly jig tooling.
- Aircraft manufacturers were generally of the opinion that assembly jig construction was not suitable for subcontracting during the base period years (prior to 1940).
- Arrow Tool and Die argued that its skill and efficiency would have allowed it to secure contracts during the base period years despite the opposition.

Procedural History

The Commissioner assessed excess profits tax against Arrow Tool and Die Company. The company petitioned the Tax Court for relief under Section 722 of the Internal Revenue Code. The Tax Court reviewed the case and ruled in favor of the Commissioner, denying the relief sought by Arrow Tool and Die.

Issue(s)

1. Whether Arrow Tool and Die Company is entitled to relief under Section 722(c)(2) or 722(c)(3) of the Internal Revenue Code.
2. Whether Arrow Tool and Die Company has established a fair and just amount representing normal earnings for use as a constructive average base period net income as required by Section 722(a).

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Holding

1. No, because the court did not need to determine if Arrow Tool and Die met the requirements of section 722(c) as they failed to meet the requirements of section 722(a).
2. No, because the company failed to prove it would have made a profit or remained in business during the base period years.

Court's Reasoning

The court reasoned that to qualify for relief under Section 722, a taxpayer must demonstrate both eligibility under one of the provisions of subsection (c) and establish a fair and just amount representing normal earnings for a constructive average base period net income, as required by Section 722(a). The court found that Arrow Tool and Die failed to prove it would have been profitable or even remained in business during the base period years. The court noted that the company's projections were based on unsubstantiated assumptions and that aircraft manufacturers were hesitant to subcontract jig construction during the base period, primarily for economic reasons. The court emphasized that the company's success was largely due to the wartime emergency and that its profits were the type the excess profits tax was designed to cover. The court stated, "Excess profits taxes were imposed not only to raise revenue, but to take the 'excess profits out of war.' Petitioner's excess profits are exactly the type of profits such taxing provisions were intended to cover." Because the company failed to show facts that could be used to establish a fair and normal profit during the base period, the court concluded that it had not established a basis for reconstruction of a base period net income under Section 722(a).

Practical Implications

This case highlights the stringent requirements for obtaining relief from excess profits tax under Section 722. It emphasizes that taxpayers must provide concrete evidence and reasonable assumptions to demonstrate what their normal earnings would have been during the base period years. The decision shows that a mere theoretical possibility of success is insufficient. Taxpayers need to convincingly demonstrate financial viability during the base period. This case serves as a cautionary tale for businesses seeking such relief, emphasizing the need for robust documentation and persuasive evidence of pre-war potential, especially when arguing against prevailing industry practices. This case is often cited when the IRS challenges a taxpayer's projections for base period earnings, requiring detailed substantiation rather than speculative claims.

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