16 T.C. 749 (1951)

A new business commencing during the base period for excess profits tax calculations is entitled to relief under Section 722(b)(4) of the Internal Revenue Code if its average base period net income does not reflect normal operations for the entire base period or the earning level it would have reached if it had commenced business two years earlier.

Summary

Del Mar Turf Club, a race track, sought relief from excess profits taxes for the fiscal year ending September 30, 1941, under Section 722 of the Internal Revenue Code. The Turf Club argued that its average base period net income was an inadequate standard of normal earnings because it commenced business during the base period. The Tax Court held that Del Mar was entitled to relief under Section 722(a) and 722(b)(4), finding its initial development period extended beyond the base period. The court reconstructed the average base period net income to $125,000, reflecting the earning level the business would have reached had it started two years earlier. Relief was denied under sections 722(b)(2) and 722(b)(5).

Facts

Del Mar Turf Club was incorporated in California in 1936 and began conducting horse racing meets in 1937. California law legalized and regulated horse racing. The Turf Club's excess profits tax return for the year ending September 30, 1941, showed a tax of $39,967.29, later adjusted to $41,576.78. This was calculated using an average base period net income of $39,766.31. The Turf Club applied for relief, claiming a constructive average base period net income significantly higher. California law dictated a limited amount of racing days.

Procedural History

The Commissioner of Internal Revenue disallowed Del Mar's application for relief under Section 722 of the Internal Revenue Code. Del Mar Turf Club then petitioned the Tax Court for a redetermination of its excess profits tax liability for the year ending September 30, 1941.

Issue(s)

1. Whether Del Mar Turf Club is entitled to relief under Section 722(b)(2) of the Internal Revenue Code because its business was depressed due to temporary economic circumstances or unusual events.

2. Whether Del Mar Turf Club is entitled to relief under Section 722(b)(4) of the Internal Revenue Code because it commenced business during the base period and its average base period net income does not reflect normal operation for the entire base period.

Holding

1. No, because the limitation on racing days was a normal condition of the business, not a temporary economic event.

2. Yes, because Del Mar Turf Club's average base period net income did not reflect its normal operation, and it had not reached the earning level it would have attained if it had started two years earlier.

Court's Reasoning

The court reasoned that the number of racing days allotted to Del Mar was within the discretion of the California Horse Racing Board and was not an unusual or temporary economic event. Regarding Section 722(b)(4), the court found that Del Mar Turf Club experienced an initial development period of approximately five years, longer than the base period. This was due to factors like its location and competition from established racing circuits. "*In addition to the usual development problems experienced by all commercial race tracks in California, petitioner had other problems to face.*" The court determined that Del Mar's average base period net income was not representative of its normal earning potential. Citing *East Texas Motor Freight Lines*, the court allowed post-1939 data to inform the determination of whether the petitioner qualified for relief. The court reconstructed the average base period net income to $125,000, using a growth index based on older tracks' experiences and considering factors like average daily handle and reconstructed expenses.

Practical Implications

This case provides guidance on applying Section 722(b)(4) to businesses that commenced operations during the excess profits tax base period. It demonstrates that businesses with longer initial development periods may qualify for relief if their base period income does not accurately reflect their normal earning potential. This ruling emphasizes that courts can consider post-base period events to determine if a taxpayer qualifies for relief under Section 722(b), focusing on whether the business had sufficient time to mature. Further, the Tax Court provides a methodology for reconstructing income based on industry-specific metrics like average daily handle.

