Del Mar Turf Club v. Commissioner, 16 T.C. 766 (1951)

A new business that commenced operations during the base period for calculating excess profits tax may be granted relief under Section 722(b)(4) of the Internal Revenue Code if its average base period net income does not reflect normal operation for the entire base period due to its initial development phase.

Summary

Del Mar Turf Club sought relief from excess profits taxes, arguing its base period net income was an inadequate standard of normal earnings. The Tax Court denied relief under Section 722(b)(2) related to temporary economic circumstances but granted relief under Section 722(b)(4). The court found that because the Turf Club commenced business in 1937, its average base period net income did not reflect normal operation for the entire base period due to the business's initial development. The court then reconstructed the Club's average base period net income to reflect what it would have earned had it commenced business earlier.

Facts

Del Mar Turf Club commenced business in 1937 and operated a horse racing track. During the base period (1937-1940), the Club's operations were limited to a maximum of 25 racing days per season. The Club argued that it was entitled to 39 racing days but was limited due to an erroneous interpretation of the California statute by the California Horse Racing Board. The Club further argued its net income increased each year during the base period with the exception of 1939.

Procedural History

Del Mar Turf Club petitioned the Tax Court for relief from excess profits taxes for the fiscal year ended September 30, 1941. The Commissioner denied the relief. The Tax Court considered the petition under Section 722(b)(2) and Section 722(b)(4) of the Internal Revenue Code.

Issue(s)

1. Whether Del Mar Turf Club's business was depressed in the base period due to temporary economic circumstances unusual to the Turf Club under Section 722(b)(2) of the Internal Revenue Code?
2. Whether Del Mar Turf Club's average base period net income reflects the normal operation for the entire base period under Section 722(b)(4) of the Internal Revenue Code, considering it commenced business in 1937?

Holding

1. No, because the limitation on racing days was not a temporary economic event unusual to the Turf Club.

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2. Yes, because the Turf Club's average base period net income of $39,766.31 is an inadequate standard of normal earnings because it does not reflect the normal operation of the business in a fully developed state for the entire base period; that it did not reach by the end of the base period the earning level that would have been reached by the end of the base period if the business had been commenced in 1935 instead of 1937, and that, as a consequence, petitioner qualifies for relief under section 722 (b) (4).

Court's Reasoning

Regarding Section 722(b)(2), the court reasoned that the number of racing days allotted to the Turf Club was within the discretion of the Racing Board and not shown to be an abuse of discretion. Therefore, the Board's actions were considered normal and usual conditions. The court stated that the petitioner must show that the cause of depression was a temporary economic event unusual in the case of petitioner. The court noted that the petitioner had failed to meet this requirement.

Regarding Section 722(b)(4), the court observed the Turf Club's handle, gross revenue, and net profit increased during the base period years, indicating a development period. The court compared the Turf Club's development to other California tracks and determined it had an initial development period of approximately five years. This, combined with other challenges such as its location and competition with eastern tracks, led the court to conclude that the average base period net income was an inadequate standard of normal earnings. The court stated, "* * * the average base period net income does not reflect the normal operation of the business in a fully developed state for the entire base period; that it did not reach by the end of the base period the earning level that would have been reached by the end of the base period if the business had been commenced in 1935 instead of 1937, and that, as a consequence, petitioner qualifies for relief under section 722 (b) (4)." The court then reconstructed the base period income using the experience of other established tracks to arrive at a constructive average base period net income.

Practical Implications

This case clarifies the application of Section 722(b)(4) for new businesses seeking relief from excess profits taxes. It demonstrates that a business commencing operations during the base period can argue its average base period net income is not representative of its normal earning potential due to the initial development phase. It highlights the importance of demonstrating the business's growth trajectory and comparing it to established businesses in the same industry. The court's approach to reconstructing the base period income provides a practical method for determining a fair and just amount representing normal earnings, based on factors such as the average daily handle and comparisons to similar businesses. This case emphasizes the importance of considering post-1939 events to determine whether a petitioner qualifies under Section 722(b), but not to reconstruct the

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average base period net income.

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