16 T.C. 1281 (1951)

A taxpayer seeking relief from excess profits taxes due to an industry-wide depression must demonstrate that the industry's profits cycle differed materially in both length and amplitude from the general business cycle.

Summary

Avey Drilling Machine Company sought relief from excess profits taxes for 1940-1942, arguing its industry was depressed due to unusual economic conditions and a variant profits cycle. Avey claimed European war preparations depressed the machine tool industry and a flood interrupted production. The Tax Court denied relief, holding Avey failed to prove the industry's cycle differed materially from the general business cycle or that its average base period net income was an inadequate standard of normal earnings when compared to its invested capital credits. The court found the taxpayer did not demonstrate that European war preparations significantly depressed its business.

Facts

Avey, an Ohio corporation, manufactured precision drilling machines. It sought relief under Section 722 of the Internal Revenue Code from excess profits taxes for 1940-1942. Avey's excess profits credits were computed using the invested capital method. It argued that a 1937 flood interrupted production, and European war preparations depressed the machine tool industry, as European countries began manufacturing their own precision drilling machines.

Procedural History

Avey filed applications for relief under Section 722, which were denied by the Commissioner. Avey then petitioned the Tax Court for review of the Commissioner's decision.

Issue(s)

1. Whether Avey's normal production was interrupted by an unusual event (the 1937 flood) justifying relief under Section 722(b)(1)?

2. Whether Avey's business was depressed by unusual economic conditions in its industry (machine tool) due to European war preparations, qualifying it for relief under Section 722(b)(2)?

3. Whether Avey's industry was subject to a profits cycle differing materially from the general business cycle, entitling it to relief under Section 722(b)(3)(A)?

4. Whether Avey changed the character of its business during the base period by introducing new motor-driven machines, thereby qualifying for relief under Section

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722(b)(4)?

Holding

1. No, because even if the flood loss were fully restored to income, Avey's excess profits credit would not exceed the credit computed on the invested capital method.

2. No, because Avey failed to prove that a fair and just amount representing normal earnings would produce a credit greater than the credits computed on the invested capital method.

3. No, because Avey did not demonstrate that its profits cycle differed materially in both length and amplitude from the general business cycle.

4. No, because the introduction of new machines constituted improvements rather than a fundamental change in the character of Avey's business.

Court's Reasoning

The court reasoned that for Section 722(b)(1) relief, the flood damage did not sufficiently depress earnings relative to the invested capital credit. Under Section 722(b)(2), even if European war preparations depressed the industry, Avey didn't prove a sufficient normal earnings level for a greater credit. Regarding Section 722(b)(3)(A), the court emphasized that for relief, the industry's profits cycle had to differ materially from the general business cycle in both length and amplitude. The court found Avey's fluctuations closely matched those of general business. For Section 722(b)(4), the court determined that introducing motor-driven machines was an improvement, not a fundamental change of business, as the machines still served the same purpose and were sold to similar customers. The court stated that "a change in character, within the intent of the statute, must be a substantial departure from the preexisting nature of the business." The dissent argued that the introduction of self-powered machines was a significant difference in the product offered.

Practical Implications

This case clarifies the stringent requirements for obtaining relief from excess profits taxes under Section 722 of the Internal Revenue Code. It highlights that taxpayers must provide concrete evidence demonstrating a direct causal link between the alleged abnormality and a significant depression of earnings. Specifically, it emphasizes the importance of demonstrating a material difference in both the length and amplitude of an industry's business cycle compared to the general economic cycle. It also establishes a high bar for proving a "change in the character of the business," requiring more than just product improvements. Later cases cite this ruling as precedent for interpreting the scope of Section 722 and the burden of proof required for taxpayers seeking relief.

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