Mount Airy Knitting Co. v. Commissioner, 11 T.C. 212 (1948)

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To qualify for excess profits tax relief under Section 722(b)(4) of the Internal Revenue Code based on a change in business character, the taxpayer must demonstrate that the change occurred during the base period and impacted the normal operation of the business during that period.

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Summary

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Mount Airy Knitting Co. sought a refund based on a reconstructed average base period net income, arguing a change in its business character under Section 722(b)(4) due to a shift from silk to nylon hosiery production. The Tax Court denied the claim, finding that the change to nylon did not occur during the relevant base period. Although the company experimented with nylon, it did not manufacture nylon hosiery for sale until after the base period. The court emphasized that both the change in product and its occurrence during the base period are necessary conditions for relief under Section 722(b)(4).

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Facts

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Mount Airy Knitting Co. primarily manufactured full-fashioned silk hosiery before 1939. In 1939, the company began experimenting with nylon yarn, a new material provided in limited quantities by DuPont. Due to wartime restrictions, silk became unavailable, and Mount Airy temporarily produced hosiery from rayon and cotton. The company's nylon experiments resulted in only a few dozen pairs of hosiery in 1939, which were returned to DuPont for testing and ultimately rejected. Mount Airy did not commercially produce or sell nylon hosiery until after the close of its base period.

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Procedural History

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Mount Airy Knitting Co. petitioned the Tax Court for a redetermination of its excess profits tax liability for certain tax years. The Commissioner of Internal Revenue had previously determined a deficiency in the company's excess profits tax. The Tax Court reviewed the case and issued its opinion denying the relief sought by the petitioner.

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Issue(s)

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Whether Mount Airy Knitting Co. is entitled to relief under Section 722(b)(4) of the Internal Revenue Code, based on a change in the character of its business, specifically a change in the nature of its product from silk to nylon hosiery, during its base period.

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Holding

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No, because the change from silk to nylon hosiery production did not occur during Mount Airy's base period, as the company did not commercially manufacture or sell nylon hosiery until after the base period.

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Court's Reasoning

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The Tax Court reasoned that Section 722(b)(4) requires both a change in the character of the business and that the change occur during the base period. The court acknowledged the potential for a change in product to qualify under the statute. However, the court found that Mount Airy's shift to nylon hosiery did not occur during the base period. The company's limited experimentation with nylon, resulting in a few rejected pairs, did not constitute a commercial change in its product line. The court emphasized that nylon yarn was not commercially available during the base period, and Mount Airy did not manufacture nylon hosiery for sale to customers until after the close of that period. Since both elements were necessary, and the change did not occur during the base period, the claim for relief was denied. The Court stated, “For petitioner to sustain its claim for relief under section 722 (b) [(4), it is essential that it establish (a) that there was a change in the character of its business by a change in the nature of its product furnished, and (b) that such change occurred prior to the close of its base period. Both of these conditions must be met.”

