***18 T.C. 44 (1952)***

A taxpayer may be entitled to relief from excess profits tax under Section 722 of the Internal Revenue Code if its average base period net income is an inadequate standard of normal earnings due to changes in the business, such as adding new theaters, commencing confectionary sales, or altering its capital structure.

**Summary**

Jefferson Amusement Company sought relief from excess profits taxes for 1942-1945, arguing its base period net income was an inadequate standard due to several changes in its business operations during the base period years (1936-1939). These included adding new theaters, remodeling an existing theater, increasing management contracts, starting confectionary sales, changing management, and altering its capital structure. The Tax Court granted partial relief, finding some but not all of the changes justified an adjustment to the company's constructive average base period net income.

**Facts**

Jefferson Amusement Company operated a chain of motion picture theaters in Texas. During the base period: It acquired five additional theaters (1936-1937). It remodeled one theater, increasing seating capacity (1938). It increased the number of theaters for which it provided management and film booking services. It committed to building two new theaters completed in 1940. It began selling popcorn and candy in its theaters (1936). There were changes in company management. The company altered the ratio of non-borrowed to total capital.

**Procedural History**

The Commissioner of Internal Revenue determined Jefferson Amusement Company's excess profits tax liability for 1942-1945. Jefferson Amusement Company disputed the determination, claiming entitlement to relief under Section 722 of the Internal Revenue Code. The Tax Court reviewed the case, considering each alleged change to the business and its impact on the adequacy of the base period net income as a standard of normal earnings.

**Issue(s)**

1. Whether the acquisition of additional theaters during the base period constitutes a change in capacity entitling the taxpayer to relief under Section 722(b)(4)?
2. Whether the remodeling of a theater and increasing its seating capacity warrants relief under Section 722(b)(4)?
3. Whether an increase in the number of management and film booking service contracts constitutes a difference in capacity warranting relief under Section 722(b)(4)?
4. Whether a commitment to build new theaters constitutes a change in the

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character of the business under Section 722(b)(4)?
5. Whether the commencement of candy and popcorn sales constitutes a change in the products furnished under Section 722(b)(4)?
6. Whether changes in management constitute a change in the operation of the business under Section 722(b)(4)?
7. Whether a change in the ratio of non-borrowed capital to total capital justifies relief under Section 722(b)(4)?
8. Whether the relief granted under Section 722 interferes with adjustments automatically granted under Section 711(b)(1)(J)?

**Holding**

1. Yes, because the acquisition of additional theaters constitutes a difference in capacity, and the taxpayer established a reasonable basis for reconstructing normal earnings.
2. No, because the taxpayer failed to demonstrate that the remodeling resulted in a higher level of normal earnings.
3. No, because the increase was not substantial enough to constitute a significant change in the business's capacity.
4. Yes, because the commitment to build new theaters constitutes a change to which the taxpayer was committed before January 1, 1940, warranting an adjustment to the base period net income.
5. Yes, because the commencement of candy and popcorn sales is a difference in products furnished, and the taxpayer demonstrated entitlement to relief.
6. No, because the changes in management were not substantial, and the taxpayer failed to show that a higher level of earnings resulted.
7. Yes, because the change in the ratio of non-borrowed capital to total capital is a change in the character of the business, and the taxpayer provided sufficient evidence for reconstructing normal earnings.
8. No, because the adjustments under Section 711(b)(1)(J) are independent of and should not be modified by the relief granted under Section 722.

**Court's Reasoning**

The Tax Court analyzed each alleged change in the business based on the requirements of Section 722(b)(4), which allows relief if the average base period net income is an inadequate standard of normal earnings due to changes in the business's character or capacity. The court emphasized the need for the taxpayer to establish not only that a qualifying change occurred but also to provide a reasonable basis for reconstructing what normal earnings would have been absent the distorting event.

Regarding the additional theaters, the court noted that the taxpayer demonstrated increased receipts and earnings due to these additions, distinguishing them from cases where the claimed change had no positive impact on earnings. The Court stated, "By reason of the addition of theaters to its business during the base period

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petitioner thereafter had greater receipts and larger earnings than it would have had if the increase in capacity had not been made…"

Conversely, the court denied relief for the remodeling of the Pearce Theatre, finding that the taxpayer failed to show that the increased seating capacity resulted in higher earnings, as attendance actually decreased in the year following the remodeling. Similarly, the court denied relief for increased management contracts, stating, "That is the extent of petitioner's proof and that alone does not constitute a difference in capacity…[W]e are unable to conclude that the capacity for operation of its management and booking services was increased during the base period to any substantial degree."

The court allowed adjustments for the commitment to build new theaters and the commencement of candy and popcorn sales, as these were considered changes in the character of the business. Finally, the court found that the changes in the ratio of non-borrowed to total capital qualified for relief, stating that "the facts as stipulated are sufficient to compute the interest adjustment for the reconstruction of petitioner's base period earnings under the provisions of section 722 of the Code."

**Practical Implications**

This case provides guidance on the types of business changes that could justify relief from excess profits taxes under Section 722 of the Internal Revenue Code. It emphasizes that taxpayers seeking relief must demonstrate a clear connection between the business change and its impact on earnings, providing a reasonable basis for reconstructing normal earnings. It highlights the importance of providing concrete evidence of increased capacity or changes in business operations. It also confirms that automatic adjustments under other Code sections are not superseded by the granting of Section 722 relief. The case serves as a reminder that each ground for relief under Section 722 requires its own distinct factual basis and demonstration of impact on earnings.

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