Arlington-Renton Dairy Co. v. Commissioner, 18 T.C. 84 (1952)

To qualify for excess profits tax relief under Section 722(b)(4) of the Internal Revenue Code due to a change in business character, a taxpayer must demonstrate that the change caused an inadequate base period net income and establish a fair and just amount representing normal earnings that would result in a greater excess profits credit than already used.

Summary

Arlington-Renton Dairy Co. sought relief from excess profits taxes under Section 722(b)(4) of the Internal Revenue Code, arguing that its new plant, constructed in 1937, constituted a change in the character of its business, making its average base period net income an inadequate standard of normal earnings. The Tax Court denied the relief, finding that the dairy failed to prove that the new plant significantly restricted sales or earnings during the base period, or that an earlier construction would have resulted in a level of earnings sufficient to justify a larger excess profits credit than the one it used based on invested capital. The court emphasized that merely showing a change in business character is insufficient; the taxpayer must also demonstrate that the change negatively impacted earnings and justify a higher constructive income.

Facts

Arlington-Renton Dairy Co. started its dairy business in 1932. By 1937, the company determined its existing plant capacity would soon be unable to meet growing demand. In September 1937, the company opened a new, larger plant. For tax years 1940-1945, the company chose to calculate excess profits tax based on invested capital, because this method yielded greater credits than calculations using base period net income and the growth formula in Section 713(f) of the Code. The company claimed the resulting tax was excessive and discriminatory, seeking relief under Section 722, specifically Section 722(b)(4).

Procedural History

The Commissioner denied the taxpayer's claim for relief under Section 722(b)(4). The taxpayer appealed this determination to the Tax Court. The Tax Court consolidated multiple dockets related to different tax years. The Tax Court reviewed the Commissioner's denial.

Issue(s)

1. Whether the taxpayer's construction of a new plant constituted a change in the character of its business under Section 722(b)(4) of the Internal Revenue Code.
2. Whether the taxpayer demonstrated that its average base period net income was an inadequate standard of normal earnings *because* of the change in the character of its business.

3. Whether the taxpayer proved that a fair and just amount representing normal earnings would result in an excess profits credit greater than the credit it actually used based on invested capital.

Holding

1. Yes, because Section 722(b)(4) defines a change in the character of the business to include "a difference in the capacity for production or operation."
2. No, because the taxpayer failed to prove that the new plant significantly restricted sales or earnings during the base period.
3. No, because the taxpayer did not establish constructive earnings of such magnitude as to result in higher credits than those employed by it based on invested capital.

Court's Reasoning

The court acknowledged that the construction of the new plant constituted a change in the character of the business under Section 722(b)(4). However, the court emphasized that this alone does not automatically entitle the taxpayer to relief. The court stated that the taxpayer had to show its average base period net income was an inadequate standard of normal earnings "because" of the new plant, and it had to demonstrate "what would be a fair and just amount representing normal earnings." The court found that the taxpayer's actual growth from 1932 to 1939 demonstrated steady growth even before the new plant was constructed. The court reasoned that the new plant enabled growth to *continue*, but it didn't cause a substantial increase in growth compared to what would have happened anyway. The court was not persuaded that constructing the plant two years earlier (in 1935 instead of 1937) would have resulted in a substantially higher level of sales or earnings by the end of 1939. The court also rejected the argument that the dairy deliberately reduced its sales effort in 1936 and 1937 because it had reached its ceiling in productive capacity, noting evidence of a continued rise in new customers and retail routes. The court stated: "A basic fallacy in petitioner's position is the premise that in applying the push-back rule we must assume not only that the new plant was constructed in 1935 rather than in 1937, but also that the new plant commenced business in 1935 with the level of sales that was in fact reached in 1937 when the plant actually began operation."

Practical Implications

This case clarifies that merely demonstrating a change in the character of a business is insufficient to qualify for excess profits tax relief under Section 722(b)(4). Taxpayers must provide concrete evidence that the change directly caused an inadequate base period net income and must establish a realistic and justifiable amount representing normal earnings. The

