***18 T.C. 1078 (1952)***

To claim a refund under Section 721 I.R.C. based on abnormal income, a taxpayer must prove what portion of the income is attributable to the development of the formula or process and to which prior years it is allocable.

**Summary**

Keystone Macaroni Manufacturing Company sought a refund of excess profits taxes under Section 721 I.R.C., arguing that its increased income from spaghetti sauce sales was due to a unique formula developed over several years. The Tax Court denied the refund because Keystone failed to demonstrate a direct link between the formula's development and the increased income. Furthermore, the court found a lack of evidence indicating what portion of the increased income was specifically attributable to the formula's development versus general wartime demand for canned goods.

**Facts**

Keystone Macaroni Manufacturing Company produced pasta products under the "San Giorgio" trade name.
Prior to 1940, Keystone sold spaghetti sauce manufactured by another company. In September 1940, Keystone began producing its own spaghetti sauce using a formula developed by its president, Girolamo Guerrisi, starting in 1938.
Guerrisi experimented with the sauce, gathering feedback from friends. He also collaborated with a research chemist from American Can Company for canning experiments. The chemist's report indicated the sauce was of excellent quality but differed from typical sauces.
Keystone installed canning equipment in its plant between April and September 1940, after which it began manufacturing and selling its own spaghetti sauce.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in Keystone's income and excess profits taxes for the fiscal years ending August 31, 1945, and 1946.
The Commissioner also disallowed Keystone's claims for refund of excess profits taxes for 1943, 1944, and 1945 under Section 721 I.R.C.
Keystone contested only the disallowance of the claims for refund in the Tax Court.

**Issue(s)**

Whether Keystone proved that its abnormal income in the taxable years was due to the formula and processes developed for spaghetti sauce and allocable to prior years (1938-1940), thus entitling it to a refund under Section 721(a)(2)(C) I.R.C.

**Holding**

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No, because Keystone failed to demonstrate what portion of its income from spaghetti sauce sales resulted specifically from the development of its formula and to which prior years that income was attributable.

## Court's Reasoning

The court acknowledged that Keystone developed a spaghetti sauce formula. However, it found no evidence that the formula gave Keystone a commercial advantage over competitors. The court noted the lack of evidence demonstrating a greater public demand or potential sales value based on the unique characteristics of Keystone's sauce.

The court highlighted that Keystone already had spaghetti sauce sales before manufacturing its own, suggesting the increase in sales after 1940 could not be solely attributed to the new formula shortly after its introduction.

The court pointed out that the increased sales of spaghetti sauce coincided with a general increase in consumption of spaghetti products and a growing wartime demand for canned foods.

Quoting from the regulations, the court stated that "To the extent that any items of net abnormal income in the taxable year are the result of high prices, low operating costs, or increased physical volume of sales due to increased demand for or decreased competition in the type of product sold by the taxpayer, such items shall not be attributed to other taxable years."

Keystone failed to separate out the impact of its formula from general economic and wartime trends.

The court emphasized that to be entitled to relief under Section 721(a)(2)(C), Keystone had to show not only abnormal income reasonably attributable to the formula's development but also the specific amounts attributable to prior years.

## Practical Implications

This case highlights the importance of providing concrete evidence linking increased income to specific innovations or developments when seeking tax relief under Section 721 I.R.C.

Taxpayers must demonstrate a direct causal relationship between the innovation and the abnormal income, separating it from other market factors like general demand or wartime conditions. The case emphasizes the need for detailed financial records and market analysis to support claims for tax refunds based on abnormal income.

The ruling underscores the Commissioner's discretion in determining the allocation of abnormal income to prior years. Taxpayers must provide a clear and reasonable basis for such allocation, grounded in the events that gave rise to the income.

Later cases citing Keystone Macaroni emphasize the taxpayer's burden of proof in substantiating claims for abnormal income and demonstrating its direct link to specific research or development efforts. It serves as a cautionary tale against attributing general economic gains to specific innovations without sufficient evidence.

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