19 T.C. 163 (1952)

A taxpayer's deliberate decision to undertake contracts outside its normal business operations, resulting in financial losses, does not constitute grounds for relief under Section 722 of the Internal Revenue Code.

Summary

Granite Construction Company sought a refund of excess profits tax, claiming its tax burden was excessive and discriminatory under Section 722 of the Internal Revenue Code. The company argued that losses incurred from taking on projects outside its usual geographic area during 1932-1935 impaired its capital and credit, preventing it from securing large contracts during the base period (1936-1939). The Tax Court denied the refund, holding that the company's business downturn was a result of its own managerial decisions, not external events that would qualify it for relief under Section 722.

Facts

Granite Construction primarily engaged in street paving, highway construction, and related work. From 1922-1929, the company confined its operations to central coastal California. In 1931, under new majority stock control, it expanded its operations geographically to secure more contracts due to the Depression. The company undertook projects in Utah and Yosemite National Park (1932-1935). These projects resulted in significant losses due to unforeseen difficulties like weather, altitude, and regulatory requirements, reducing the company's equity capital significantly.

Procedural History

Granite Construction filed claims for refund of excess profits tax for the years 1940-1944 under Section 722 of the Internal Revenue Code. The Commissioner of Internal Revenue disallowed the claims. Granite Construction then petitioned the Tax Court for review.

Issue(s)

1. Whether the taxpayer's normal production, output, or operation was interrupted or diminished in the base period because of the occurrence of events unusual and peculiar in the experience of such taxpayer, as required by Section 722(b)(1)?
2. Whether the taxpayer's business was depressed in the base period because of temporary economic circumstances unusual in the case of such taxpayer, as contemplated by Section 722(b)(2)?
3. Whether the taxpayer changed the character of its business and if the average base period net income does not reflect the normal operation for the entire base period of the business as described under Section 722(b)(4)?

4. Whether the taxpayer qualifies for relief under Section 722(b)(5) based on a combination of factors?

Holding

1. No, because the company's decision to undertake contracts outside its normal field of operations does not constitute an event of the sort contemplated by Section 722(b)(1).
2. No, because the alleged temporary economic depression was primarily brought on by the company's internally determined decision to undertake contracts outside its normal sphere, and its average net profits were actually greater in the base period than in the long-term period.
3. No, because the company did not change the character of its business through a change in management to which an increase in net profits was directly attributable as contemplated by Section 722(b)(4).
4. No, because the claim for relief under Section 722(b)(5) is based on a combination of factors already rejected under other subsections.

Court's Reasoning

The court reasoned that Section 722 is primarily concerned with physical rather than economic events, such as floods or strikes, not economic maladjustments. The court quoted the Commissioner's bulletin, stating that relief under Section 722(b)(2) is not available when earnings were reduced due to the taxpayer's own business policies. The court emphasized that the statute was not designed to counteract errors of business judgment or to underwrite unwise business policies. Regarding Section 722(b)(4), the court found that the company's reversion to its old policy did not represent a substantial and permanent change resulting in increased earnings solely attributable to the change. The court found an inconsistency between the argument that the move outside the local market was a temporary policy, and also a change in character of the company. Finally, the court rejected the claim under Section 722(b)(5) because it was a combination of factors already considered and rejected under other subsections, which would violate the statutory limitations.

Practical Implications

This case clarifies that Section 722 relief is not a remedy for poor managerial decisions. Taxpayers cannot claim relief for financial difficulties that arise from their own strategic choices, even if those choices lead to losses. The case reinforces the principle that Section 722 is intended to address external events impacting a business, not internal decisions. Later cases have cited this decision to reinforce the boundaries of Section 722 relief, emphasizing that it's not a safety net for risky business ventures or poor judgment. The case serves as a reminder that careful documentation of external factors causing economic hardship is crucial when seeking Section 722 relief.

