*19 T.C. 535 (1952)*

A taxpayer seeking relief from excess profits tax must demonstrate that their average base period net income is an inadequate standard of normal earnings due to specific, qualifying factors outlined in Section 722 of the Internal Revenue Code.

**Summary**

Huguet Fabrics Corporation sought relief from excess profits tax for the fiscal year ending September 30, 1941, arguing its average base period net income was an inadequate measure of normal earnings under Section 722 of the Internal Revenue Code. Huguet claimed it had changed its business character by entering a new market with a new product (nylon fabrics). The Tax Court denied relief, finding Huguet failed to prove a substantial change that directly resulted in increased earnings during the base period. The court emphasized that Huguet did not adequately demonstrate its shift to selling nylon fabrics directly to undergarment manufacturers rather than through jobbers.

**Facts**

Huguet Fabrics Corporation, incorporated in 1936, manufactured silk fabrics. The company experienced losses in 1938 and low earnings in 1939 and 1940, attributed to competition from rayon and reduced demand for luxury items. In 1939, Huguet began experimenting with nylon, a new synthetic fiber. By July 1940, Huguet began producing nylon fabrics for sale. For the fiscal year ended September 30, 1941, Huguet paid an excess profits tax of $22,040.33.

**Procedural History**

Huguet filed a claim for relief under Section 722(a) and (b) of the Internal Revenue Code, which was disallowed by the Commissioner. The Tax Court initially promulgated an opinion, then granted Huguet's motion for reconsideration and vacated the original decision. The Tax Court then issued the current opinion, upholding the Commissioner's disallowance.

**Issue(s)**

1. Whether Huguet is entitled to relief from excess profits tax for its fiscal year ended September 30, 1941, under Section 722 of the Internal Revenue Code.
2. Whether Huguet proved that its average base period net income was an inadequate standard of normal earnings under Section 722(b).
3. Whether Huguet demonstrated a change in the character of its business within the meaning of Section 722(b)(4).

**Holding**

1. No, because Huguet failed to establish that the tax computed without the

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benefit of Section 722 results in an excessive and discriminatory tax and failed to establish what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income.
2. No, because Huguet did not sufficiently demonstrate that its average base period net income was an inadequate standard of normal earnings under any of the factors listed in section 722(b).
3. No, because Huguet did not prove that its entry into nylon fabrics constituted a substantial change in the character of its business as required by Section 722(b)(4).

**Court's Reasoning**

The court reasoned that to qualify for relief under Section 722, Huguet had to prove its tax was excessive and discriminatory and establish a fair amount representing normal earnings. The court emphasized that not every change in business operations qualifies for relief; it must be a "substantial" change that is "reflected in an increased level of earnings which is directly attributable to such change." The court found Huguet's evidence was insufficient to prove that it entered a "new and different market" by selling nylon fabrics directly to undergarment manufacturers. The court noted conflicting testimony and stipulations regarding sales channels and customers. The court stated: "A change in the character of the business for the purposes of section 722 (b) (4) must be substantial in that the nature of the operations of the business affected by the change is regarded as being essentially different after the change from the nature of such operations prior to the change… A change in the character of the business, to be considered substantial, must be reflected in an increased level of earnings which is directly attributable to such change." The court concluded that Huguet's evidence showed only a potential "mere substitution of raw materials" rather than a fundamental shift in its business. The court found Huguet had not demonstrated that any qualifying change occurred during the base period under any of the factors listed in Section 722(b)(1)-(5).

**Practical Implications**

The case illustrates the high burden of proof for taxpayers seeking excess profits tax relief under Section 722. It underscores the need for concrete evidence demonstrating a substantial change in the character of the business and a direct causal link between that change and increased earnings during the base period. This case serves as a cautionary tale regarding the importance of thorough documentation and consistent evidence when claiming relief under complex tax provisions. It highlights that ambiguous evidence and conflicting testimony can undermine a taxpayer's claim, even if there is some evidence of change.

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