19 T.C. 615 (1952)

To qualify for excess profits tax relief under Section 722 of the Internal Revenue Code, a taxpayer must demonstrate that the tax results in an excessive and discriminatory burden and establish a fair and just amount representing normal earnings for use as a constructive average base period net income.

Summary

East Texas Theatres, Inc., sought relief under Section 722 of the Internal Revenue Code for excess profits taxes during 1941-1945. The company, operating a chain of movie theaters, argued that acquisitions of new theaters, candy and popcorn sales, and oil royalties during the base period years warranted a reconstructed average base period net income. The Tax Court found that the company qualified for relief due to changes in its business, but rejected the IRS's argument that abnormal income should be excluded. The court ultimately determined a constructive average base period net income for the petitioner.

Facts

East Texas Theatres operated a chain of movie theaters in East Texas. During the base period years (1936-1939), the company acquired additional theaters, remodeled existing ones, commenced selling candy and popcorn, and began receiving oil royalties from a leased property. The IRS challenged the company's application for relief under Section 722, arguing that its excess profits tax was not excessive or discriminatory and that the company's base period income was abnormally high.

Procedural History

The Commissioner of Internal Revenue denied East Texas Theatres' applications for relief under Section 722. The company then petitioned the Tax Court, arguing that the Commissioner's disallowance was erroneous.

Issue(s)

1. Whether East Texas Theatres qualified for relief under Section 722(b)(4) of the Internal Revenue Code due to changes in the character of its business during the base period years.

2. Whether the income received by East Texas Theatres during the base period was abnormal and should be excluded from the calculation of its constructive average base period net income.

Holding

1. Yes, because the changes to the capacity and character of the business made the

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tax excessive and discriminatory.

2. No, because the IRS failed to demonstrate the existence and amount of any abnormal income.

Court's Reasoning

The Tax Court found that the changes in the company's business operations during the base period, including the addition of new theaters, the commencement of candy and popcorn sales, and the receipt of oil royalties, constituted changes in the character of its business under Section 722(b)(4). These changes resulted in greater receipts and net income than the company would have had otherwise. The court rejected the IRS's argument that the decline in oil drilling activity in East Texas, the discontinuation of "bank night" promotions, and the company's relationship with Paramount Pictures resulted in abnormal income. The court emphasized that "in order for income of a taxpayer seeking relief under section 722 of the Code to be excluded as 'abnormal income' in arriving at a constructive base period net income it must be abnormal at least in somewhat the same sense as we held in *Premier Products Co.*, 2 T.C. 445." Because the IRS did not provide sufficient evidence to support the exclusion of any income, the court determined a constructive average base period net income for the company, adding adjustments for the changes in capacity, the commencement of candy and popcorn sales, and the receipt of oil royalty income.

Practical Implications

This case clarifies the standards for determining eligibility for excess profits tax relief under Section 722 of the Internal Revenue Code. It emphasizes the importance of demonstrating that changes in a business's operations during the base period years resulted in an inadequate standard of normal earnings. It also provides guidance on what constitutes "abnormal income" that should be excluded in the calculation of a constructive average base period net income. Later cases applying this ruling would need to carefully analyze whether income was truly "abnormal" in the sense that it was an "outstanding departure from the usual and ordinary income and expense." This case is relevant to understanding how to reconstruct income for tax purposes when a business undergoes significant changes, and it highlights the need for specific, persuasive evidence.

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