The Herald Press, Inc. v. Commissioner, 22 T.C. 678 (1954)

A change in the operation of a business, such as the adoption of new technology that significantly reduces costs and improves production, can qualify a taxpayer for relief from excess profits tax if their average base period net income is an inadequate standard of normal earnings.

Summary

The Herald Press, Inc. sought relief from excess profits tax under Section 722(b)(4) of the Internal Revenue Code, arguing that its average base period net income was an inadequate standard of normal earnings because the installation of new photo-mechanical equipment in 1939 constituted a change in the operation of its business. The Tax Court agreed that the new equipment, which significantly reduced labor costs and improved the quality of press plates, represented a change in operations. The court found that this change increased the company's earning capacity and rendered its base period income an inadequate measure of normal earnings, thereby entitling it to relief. The court also addressed the issue of unused excess profits credit carry-overs and applied the variable credit rule.

Facts

In October 1938, The Herald Press ordered photo-composing equipment for $13,248.49, which was installed around March 1, 1939. This equipment allowed the company to produce zinc press plates mechanically, eliminating the hand-transfer process. The new process required less than one-third of the time and about half the labor force compared to the old method, leading to significant operating economies and a superior product. The company also replaced four old offset presses with three new ones, but this replacement did not result in a demonstrable increase in production.

Procedural History

The Herald Press petitioned the Tax Court for relief from excess profits tax under Section 722(b)(4). The Commissioner opposed the petition. The Tax Court considered the evidence presented by both sides to determine whether the installation of the photo-mechanical equipment constituted a change in the operation of the business and whether this change resulted in an increased earning capacity.

Issue(s)

1. Whether the installation of photo-mechanical equipment to produce zinc press plates constituted a change in the operation of the taxpayer's business within the meaning of Section 722(b)(4)?
2. Whether this change resulted in an increased earning capacity such that the taxpayer's average base period net income was an inadequate standard of

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normal earnings?
3. Whether the taxpayer was entitled to an unused excess profits credit carry-over from the years ended June 30, 1941 and 1942?

Holding

1. Yes, because the new equipment significantly reduced labor costs, accelerated production, and improved the quality of the product.
2. Yes, because the reduced labor force and increased efficiency resulted in substantial operating economies, thereby increasing earning capacity.
3. No for the year ended June 30, 1941, due to the two-year carry-over limit and failure to make a formal claim. The court held that a carry-over from 1942 may be warranted depending on a Rule 50 recomputation, subject to the variable credit rule.

Court’s Reasoning

The court reasoned that the installation of the photo-mechanical equipment was a significant change in operations because it led to

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