20 T.C. 84 (1953)

A taxpayer can establish a constructive average base period net income for excess profits tax purposes if it demonstrates that it changed the character of its business during the base period, and its average base period net income doesn't reflect normal operations for the entire base period.

Summary

W. J. Voit Rubber Corp. sought relief from excess profits taxes under Section 722 of the Internal Revenue Code, arguing that its average base period net income was an inadequate standard of normal earnings due to a change in the character of its business. The company transitioned from manufacturing all-rubber balls to rubber-covered fabric carcass balls suitable for official athletic contests. The Tax Court agreed that this change, coupled with initial production difficulties and abnormal expenses, warranted the establishment of a constructive average base period net income. The court determined a fair and just amount representing normal earnings to be $60,000.

Facts

W. J. Voit Rubber Corp. was incorporated in 1935. Its predecessor company had financial difficulties and went into receivership, then bankruptcy. The petitioner purchased the assets of the bankrupt company. Initially, the petitioner manufactured all-rubber balls (beach balls, play balls, etc.). In late 1937, the company began manufacturing rubber-covered fabric carcass balls, suitable for official athletic contests. These new balls experienced initial production difficulties, resulting in customer returns and replacements at company expense. The company also started manufacturing rubber-covered softballs (1935), camelback (late 1937), and tennis balls (1939). Sales of milled and calendered goods, mechanical, and miscellaneous goods were normal during the base period.

Procedural History

W. J. Voit Rubber Corp. filed excess profits tax returns for fiscal years 1941-1946 and sought relief under Section 722 of the Internal Revenue Code, claiming its average base period net income was an inadequate standard of normal earnings. The Commissioner of Internal Revenue contested this claim. The Tax Court reviewed the case and determined that the taxpayer was entitled to relief, establishing a constructive average base period net income.

Issue(s)

Whether the petitioner changed the character of its business during the base period within the meaning of Section 722(b)(4) of the Internal Revenue Code, thereby entitling it to use a constructive average base period net income for excess profits tax purposes.

Holding

Yes, because the petitioner's transition from manufacturing all-rubber balls to rubber-covered fabric carcass balls represented a significant change in product type, manufacturing methods, market, and pricing, and because the initial production difficulties and abnormal expenses associated with the new product line prevented the petitioner's base period net income from reflecting its normal earnings potential.

Court's Reasoning

The court reasoned that the petitioner's shift to rubber-covered fabric carcass balls constituted a "difference in the products" under Section 722(b)(4). The court emphasized that these new balls were "a new product, made by different manufacturing methods, offered for sale in a different market and at a considerably higher price, and in competition with official athletic balls of other manufacturers not previously competitors." The court also considered that the petitioner experienced "unusual and abnormal expenses and losses" due to defective balls and customer dissatisfaction, preventing it from reaching a normal earnings level by the end of the base period. While the Commissioner argued that the new balls were merely "improved products," the court disagreed, emphasizing their distinct characteristics and impact on the petitioner's business.

The court cited testimony from Thomas Edkins as the best available evidence of the quantities of returns and the cost of replacements or repairs, even though the petitioner kept no records of returned merchandise. Regarding the 2-year rule, the court stated that "One of the purposes of the 2-year rule was to permit taxpayers to overcome losses incurred in the initial development of a new or changed business and to establish within an assumed additional 2 years a normal earnings level." E. P. C. S. 5 and 6, 1946-2 C. B. 122, 123

Practical Implications

This case illustrates how a company that significantly alters its product line and encounters initial challenges can obtain relief from excess profits taxes by demonstrating that its base period earnings are not representative of its true earning capacity. It highlights the importance of documenting the nature and extent of the business change, the difficulties encountered, and the abnormal expenses incurred. The court's willingness to rely on witness testimony when formal records are unavailable also provides a practical point for taxpayers in similar situations. This case emphasizes that the 2-year rule under Section 722(b)(4) is intended to provide relief for businesses that need additional time to overcome initial hurdles and reach a normal earnings level. Later cases involving similar claims must establish a clear causal link between the change in business character and the inadequacy of base period earnings.

