Charis Corp., 21 T.C. 206 (1953)

To qualify for relief under Section 722(b)(4) of the Internal Revenue Code due to a "change in the character of the business," the taxpayer must demonstrate that the change was substantial and resulted in a higher level of earnings directly attributable to the change.

Summary

Charis Corporation sought relief from excess profits taxes, arguing that the introduction of a new product line, the "Swavis" garment, constituted a "change in the character of the business" under Section 722(b)(4) of the Internal Revenue Code. The Tax Court agreed that the addition of the Swavis garment was a substantial change. However, the court found that a shift from office fitting to home fitting and the transfer of retail offices to franchise distributors did not qualify. The court focused on whether the nature of the operations changed substantially and whether the change directly resulted in a higher level of earnings. The court ultimately granted Charis Corp. a constructive average base period net income of $15,800 in excess of its average base period net income computed without regard to section 722.

Facts

Charis Corp. manufactured foundation garments. Initially, the company produced only rigid corsets. Later, it focused on the "Charis" garment designed for women with figure problems. In 1935, Charis introduced the "Swavis" garment, which was an elastic garment designed for women without figure problems. Charis also shifted from office fittings to home fittings and transferred some company-owned retail offices to franchise distributors.

Procedural History

Charis Corp. petitioned the Tax Court for relief from excess profits taxes under Section 722(b)(4). The Tax Court considered the company's claims regarding the introduction of the Swavis garment, the shift to home fittings, and the transfer of retail offices.

Issue(s)

1. Whether the introduction of the Swavis garment constituted a "change in the character of the business" under Section 722(b)(4) of the Internal Revenue Code.
2. Whether the shift from office fitting to home fitting qualified as a "change in the character of the business."
3. Whether the transfer of retail offices to franchise distributors constituted a "change in the character of the business."

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Holding

1. Yes, because the introduction of the Swavis garment represented a substantial change in the nature of the operations and resulted in a higher level of earnings.
2. No, because the shift from office to home fitting did not meet the criteria for a qualifying change.
3. No, because the transfer of retail offices to franchise distributors did not result in a substantial change in the nature of the operations.

Court's Reasoning

The court applied a two-part test, per the respondent's Bulletin on Section 722, to determine if a change in the character of the business was substantial. First, the court examined if the nature of the operations was essentially different after the change from the nature of the operations prior to the change. Second, the court sought to determine whether a higher level of earnings was directly attributable to the change.

Regarding the Swavis garment, the court found that it was not an addition to a varied line of products. The court determined that the Swavis garment was designed for a different purpose, was sold to a different class of customers, and was, for the most part, made with a basically different material. The court relied on industry testimony indicating that the two lines were in a different category of garments, and that the introduction of the Swavis line increased earnings.

Regarding the shift from office to home fitting, the court found the second prong of the test was not satisfied. The petitioner did not demonstrate that the shift would lead to higher earnings. The court also held that the company did not meet the first prong of the test regarding the transfer of retail offices to franchise distributors. The nature of the company's operations was not essentially different after the change because most outlets were operated by franchise distributors both before and after the transfers. The court emphasized that merely the ownership of the outlets changed, not the operational model.

Practical Implications

This case is important for understanding the requirements for obtaining relief from excess profits taxes under Section 722(b)(4), and more generally, demonstrates how courts analyze whether a change in business operations warrants favorable tax treatment.

- **Substantial Change Required:** This case underscores the importance of demonstrating that a business change is significant, resulting in a fundamental difference in how the business operates.
- **Earnings Connection:** The increase in earnings must be directly attributable

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to the change. The court will examine the impact of the change on profitability.

- **Industry Standards:** Evidence of industry practices and market distinctions can be crucial in demonstrating that a new product or service represents a change in the character of the business.
- **Distinguishing this case:** This case is fact-specific, and each change must be assessed on its own merits, and that is often not an easy exercise, as demonstrated by the Tax Court's finding the introduction of the Swavis garment was a qualifying change, but that neither the shift to home fittings nor the transfer of franchise offices was a qualifying change.

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