***Farrel-Birmingham Co. v. Commissioner*, 13 T.C. 87 (1949)**

When a taxpayer's business undergoes a significant change during or immediately prior to the base period for excess profits tax calculation, the Tax Court can reconstruct the taxpayer's base period income to reflect a normal earning level, considering the time lag for the new business to reach its full potential.

Summary

The case concerns a company, Farrel-Birmingham Co., that sought relief from excess profits taxes, arguing a change in its business character—specifically, the development and sale of Morgoil bearings—during its base period. The court addressed whether this change occurred during or immediately before the base period, allowing for reconstruction of income. The court determined that the change in character did occur during the base period and that the company's profits were abnormally low due to research, experimentation, and manufacturing costs associated with this new product. The court reconstructed the company's base period income by estimating the increased net income the company would have realized had these changes occurred earlier, thereby entitling the company to a reduction in excess profits taxes.

Facts

Farrel-Birmingham Co. manufactured Morgoil bearings. The company experienced a change in the character of its business through the invention, development, and sale of these bearings. While smaller bearings were well-established by 1935, the larger bearings, from which the major profits were derived, found no market until 1935. The development of these larger bearings, including correcting design defects, extended into late 1939, the final year of the base period. The company incurred significant research, experimentation, and new machinery costs to improve the bearings' performance. The company's profits on bearing sales were abnormally low during the base period due to these costs.

Procedural History

The case was heard by the United States Tax Court. The taxpayer, Farrel-Birmingham Co., sought relief from excess profits taxes under Section 722(b)(4) of the Internal Revenue Code. The Commissioner of Internal Revenue initially denied the company's claim. The Tax Court reviewed the case, considered the evidence presented, and ultimately determined that the company was entitled to relief, leading to a reconstruction of the base period income.

Issue(s)

1. Whether the development and sale of Morgoil bearings constituted a change in the character of the company's business within the meaning of Section 722(b)(4) of the Internal Revenue Code.

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2. Whether the change in the character of the business occurred

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