23 T.C. 242 (1954)

A taxpayer may be granted relief from excess profits taxes if a change in the character of its business during or immediately prior to the base period resulted in abnormally low earnings during that period, even if the full benefits of that change were not realized until later.

Summary

Morgan Construction Company, a manufacturer of rolling mills and related equipment, sought relief from excess profits taxes under Section 722(b)(4) of the Internal Revenue Code of 1939. The company argued that its development and introduction of the Morgoil bearing, a new product for steel mills, constituted a change in the character of its business, entitling it to a higher excess profits credit. The Tax Court agreed, holding that the Morgoil bearing's development, which occurred before and during the base period, significantly impacted the company's earnings. The court determined that if the company had two more years of experience in the Morgoil bearing business, its base period earnings would have been higher and granted a portion of the requested relief. The case highlights how new product innovation can affect tax liability during periods of economic adjustment.

Facts

Morgan Construction Company manufactured rolling mills and related machinery. In 1931, it developed the Morgoil bearing, a new type of bearing designed for steel mill rolls, and introduced it to the trade in 1932. This bearing was a significant improvement over existing designs. The company experienced challenges with the large-scale production and early implementation of these bearings, which led to higher operating expenses during the base period of 1936-1939, which were the reference years for calculating excess profits taxes. Despite the challenges, the Morgoil bearing eventually became a significant part of Morgan's business. The company's sales of rolling mills and Morgoil bearings grew substantially during the late 1930s. Morgan filed claims for relief under Section 722 of the Internal Revenue Code, arguing that the new bearing represented a change in the character of its business that warranted a higher excess profits credit.

Procedural History

Morgan Construction Company filed claims for refund of excess profits taxes for the years 1941 to 1945, claiming relief under Section 722 of the Internal Revenue Code of 1939. The Commissioner of Internal Revenue considered and rejected the claims. The company then brought its case before the United States Tax Court, seeking a review of the Commissioner's decision and a determination of its entitlement to relief under Section 722(b)(4). The Tax Court heard evidence, including testimony and documents, and issued a ruling.

Issue(s)

1. Whether the development and commercialization of the Morgoil bearing constituted a “change in the character of [the] business” within the meaning of Section 722(b)(4) of the Internal Revenue Code of 1939.

2. If a change in the character of the business occurred, whether that change occurred “during or immediately prior to the base period,” thereby entitling Morgan to relief.

3. If relief was warranted, whether the company’s base period net income should be adjusted and by how much.

Holding

1. Yes, because the introduction of the Morgoil bearing was a significant change in Morgan’s business, introducing a new product line that altered its operations and earnings potential.

2. Yes, because even though the Morgoil bearing was introduced before the base period, its full commercialization and impact on earnings, particularly the large-scale production and solving of issues with early implementations, happened throughout and up to the end of the base period.

3. Yes, because with two more years’ experience the company would have seen reduced operating costs and improved performance, resulting in increased average base period net income by $35,000, and the Tax Court adjusted accordingly.

Court’s Reasoning

The court relied on Section 722(b)(4), which allowed for excess profits tax relief when the business had undergone a change in character. The court recognized that “the invention, development, and sale of the Morgoil bearings constituted a change in the character of petitioner’s business.” The court found the development of Morgoil bearings qualified as a business character change under the statute, because the new product was substantially different from existing products. The court further noted that the change took place

