23 T.C. 372

A taxpayer may be granted relief from excess profits tax if their average base period net income is an inadequate standard of normal earnings due to a temporary economic depression unusual for that specific taxpayer.

Summary

Ainsworth Manufacturing Corp. sought relief from excess profits taxes under Section 722(b)(2) of the Internal Revenue Code, arguing its base period income was depressed due to the sudden loss of major contracts with Ford and Chrysler for brakeshafts and adjustable windshields. The Tax Court agreed, finding that the abrupt cancellation of these contracts in 1937 and 1938 constituted a temporary economic circumstance unusual for Ainsworth, significantly depressing its earnings. The court granted Ainsworth relief, allowing for a constructive average base period net income to be used for tax calculation, acknowledging the temporary and unusual nature of the economic downturn caused by the lost contracts.

Facts

Ainsworth Manufacturing Corp. was a mass producer of brakeshafts and adjustable windshields, primarily for Ford and Chrysler.

By 1936, sales reached $9,176,666, with 70% from brakeshafts and adjustable windshields, and 64% specifically from adjustable windshields for Ford and Chrysler.

In April 1937, Ford and Chrysler unexpectedly informed Ainsworth they would discontinue using mechanical brakes and adjustable windshields for their 1938 models.

Ainsworth had recently invested in a new plant designed for mass production of these parts.

The loss of these contracts caused a dramatic drop in sales in 1938, resulting in a net loss of $45,951 compared to an average net income of $1,179,691 in the preceding three years.

Ainsworth quickly adapted, developing new products and processes to recover from this loss.

Procedural History

Ainsworth Manufacturing Corp. claimed relief from excess profits tax under Section 722 of the Internal Revenue Code for tax years 1941-1945.

The Commissioner of Internal Revenue disallowed these claims.

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Ainsworth petitioned the United States Tax Court for review of the Commissioner's decision.

The Tax Court reviewed the claims under Section 722(b)(2), (b)(4), and (b)(5).

Issue(s)

1. Whether Ainsworth's average base period net income was an inadequate standard of normal earnings under Section 722(b)(2) because its business was depressed due to temporary economic circumstances unusual for Ainsworth?

2. Whether the discontinuance of brakeshaft and adjustable windshield business by Ford and Chrysler constituted a temporary economic circumstance under Section 722(b)(2)?

Holding

1. Yes, because the sudden loss of major contracts for brakeshafts and adjustable windshields constituted a temporary economic depression unusual for Ainsworth, making its average base period net income an inadequate standard of normal earnings.

2. Yes, because the unexpected and abrupt cancellation of major contracts by Ford and Chrysler in 1937 and 1938 represented a temporary economic circumstance that significantly depressed Ainsworth's business during the base period.

Court's Reasoning

The court focused on Section 722(b)(2), which allows relief if a taxpayer's base period income is depressed due to "temporary economic circumstances unusual in the case of that taxpayer."

The court found that the sudden discontinuance of orders from Ford and Chrysler for brakeshafts and adjustable windshields was a "devastating blow" to Ainsworth's business, causing a significant and temporary drop in earnings in 1938 and 1939.

The court noted that this event was "externally caused" and had "repercussions on the volume of sales" for Ainsworth, fitting the definition of "economic" circumstances provided by the Bureau of Internal Revenue.

The court emphasized the temporary nature of the depression, as Ainsworth successfully adapted and recovered its earnings after the base period by transitioning to new products. The court stated, "the unusual falling off of those earnings was due primarily to the loss of the brakeshaft and adjustable windshield business formerly received from Ford and Chrysler; that falling off was temporary and peculiar to the petitioner… and it was unusual in that nothing even closely comparable in cause, magnitude, and effect had ever occurred in the petitioner's

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history.”

The court distinguished “severe competition” from the “temporary economic circumstances” required for relief, finding that while Ainsworth also claimed a price war, the primary basis for relief was the lost contracts.

The court determined a “fair and just amount” for constructive average base period net income to be $850,000, granting Ainsworth relief under Section 722(b)(2).

Practical Implications

This case clarifies the application of Section 722(b)(2) for businesses experiencing temporary economic downturns due to external, unusual circumstances.

It demonstrates that the sudden loss of major customer contracts can qualify as a “temporary economic circumstance” for excess profits tax relief, even if the overall economy is not in general depression.

Taxpayers seeking relief under similar provisions must demonstrate that the economic depression was: 1) temporary, 2) unusual for their specific business, and 3) the cause of an inadequate base period income.

This case highlights the importance of documenting the specific, external events that caused a temporary depression in business earnings to support claims for tax relief under analogous statutes.

Later cases applying Section 722 and similar relief provisions often cite Ainsworth for the principle that temporary, company-specific economic shocks can justify adjustments to base period income for tax purposes.

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