***Kratz Corp. v. Commissioner*, 24 T.C. 759 (1955)**

To establish a higher constructive average base period net income, a taxpayer must demonstrate that a new product or service would have resulted in a profitable operation with an increased level of earnings, directly attributable to the change, during the base period for excess profits tax calculation.

Summary

The Kratz Corporation sought a redetermination of its excess profits tax, arguing for a higher constructive average base period net income (CABPNI) than allowed by the Commissioner. The central issue was whether Kratz could prove, based on hypothetical scenarios of expanded production of a new extruded plastic strip for the Ford Motor Company, that its CABPNI should be increased. The Tax Court analyzed the evidence to determine what Kratz's profits would have been during the base period if its new product had been available to the wider Ford line. The court found that while Kratz had demonstrated a potential for increased sales, it had not provided sufficient proof that the expanded production would have been profitable enough to justify the requested CABPNI increase. The court used a "push-back" analysis based on what Ford would have done had the strip been available earlier in the base period.

Facts

Kratz Corporation manufactured an extruded plastic strip. In 1939, Ford officials indicated they would use the strip on the entire Ford line (Fords, Mercurys, and Lincolns) if Kratz could produce in sufficient quantities. Kratz, however, could only produce enough for the Lincoln. Ford was "plastic-minded" and the court believed that Ford would have used the strip during the entire base period if it had been available. Kratz started producing the new extruded strip in the fall of 1939, and supplied it for the Lincoln car. Kratz also manufactured injection-molded plastic knobs and escutcheons for Ford starting in 1937. The IRS determined Kratz's CABPNI to be $29,204.23, significantly higher than the actual average base period loss.

Procedural History

The case originated in the United States Tax Court. The Commissioner of Internal Revenue determined the taxpayer's excess profits tax liability. Kratz contested the Commissioner's determination, seeking a higher CABPNI and filing a petition with the Tax Court. The Tax Court heard the case and issued a ruling, allowing for a CABPNI higher than the IRS but lower than what Kratz sought. The court then reviewed its own decision.

Issue(s)

1. Whether Kratz Corporation demonstrated that its CABPNI should be higher than

that determined by the Commissioner, based on the potential for increased sales of the extruded plastic strip.

2. Whether the increased sales of the injection-molded plastic knobs and escutcheons produced a satisfactory showing of increased profit to justify increased CABPNI.

Holding

1. Yes, because the court determined that the use of the plastic strip on a larger scale for the Ford line during the base period would have led to increased sales and earnings for Kratz.

2. No, because Kratz did not provide sufficient evidence to prove that this new product resulted in a profitable operation with an increased level of earnings directly attributable to this change.

Court's Reasoning

The court applied the "push-back rule", determining how Kratz's income would have been if its products had been available earlier. The court dismissed the conjecture advanced by respondent that Henry Ford, Sr. would have resisted the introduction of an item as comparatively insignificant as the strip in question. The court determined that Kratz had shown that the extruded strip would have been used on more Ford vehicles during the base period if available, increasing sales. The court used a reconstruction of the CABPNI based on this expanded use. The court considered the impact of the potential decreased percentage of profits from increased production. The court also reviewed the profits shown during the last 6 months of 1939 for the plastic strip. Ultimately, the court found that while expanded sales could be assumed, sufficient evidence of the profitability of the expanded sales, related to Ford's production, was lacking. Regarding the injection-molded plastics, the court found a lack of evidence that these sales resulted in a profitable operation.

Practical Implications

This case is critical for tax professionals dealing with excess profits tax computations and the establishment of CABPNI. The decision highlights the importance of providing strong evidence of profitability when arguing for a higher CABPNI based on the expansion of a product or service. Specifically, the court's determination of a specific CABPNI amount based on the "push-back" approach provides insight into how future cases might be handled. The case emphasizes that the taxpayer must do more than just show increased sales. The taxpayer must provide financial data, such as profit margins or operating profits that clearly demonstrate the increased earnings directly tied to the new product or expanded production. The need for robust financial documentation and a clear causal link between new products, sales, and earnings is essential.

