***Smith's Heating System, Inc. v. Commissioner*, 20 T.C. 552 (1953)**

A taxpayer seeking relief from excess profits tax under Section 722 of the 1939 Internal Revenue Code must establish a fair and just amount for constructive average base period net income, and this requires more than mere assertion of the ultimate fact, especially when based on post-base-period experiences.

Summary

Smith's Heating System, Inc. (the taxpayer) sought relief from excess profits taxes, claiming its invested capital was abnormally low, which led to an excessive and discriminatory tax. The taxpayer requested the court to determine its constructive average base period net income (CABPNI), arguing that its actual earnings in 1945, a post-base-period year, demonstrated the potential for significantly higher earnings during the base period if the taxpayer had sufficient working capital. The Tax Court held that the taxpayer failed to provide sufficient evidence to support its CABPNI calculation, emphasizing that the evidence presented must demonstrate what the taxpayer's normal earnings would have been during the base period, not based on the abnormal conditions of the excess profits tax period. The court also found that the taxpayer's CABPNI calculations relied too heavily on conditions that arose after the base period.

Facts

The taxpayer, a corporation that began operations after the base period years, sought to establish a CABPNI under Section 722 of the 1939 Internal Revenue Code. The taxpayer's invested capital was found to be abnormally low. It argued that if it had existed during the base period and had sufficient working capital, it would have made significantly more sales, increasing its profits. The taxpayer presented a CABPNI of $76,807.10 based on its projections. The IRS contended the taxpayer failed to demonstrate that it could have operated at a profit in the base period. The primary evidence supporting the taxpayer's claim was its earnings in 1945. The taxpayer had a patent license, which was deemed an intangible asset that contributed to income, thus the taxpayer was eligible to seek relief under sections 722 (a), 722 (c) (1), and 722 (c) (3) of the 1939 Code.

Procedural History

The case was initially brought before the Tax Court. The Commissioner allowed an excess profits credit based on total invested capital. The taxpayer sought relief under sections 722 (a), 722 (c) (1), and 722 (c) (3). The Tax Court reviewed the evidence and arguments, and, ultimately, sided with the Commissioner, denying the taxpayer's claim for relief and entering a decision for the respondent.

Issue(s)

1. Whether the taxpayer established a fair and just amount for constructive average

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base period net income (CABPNI) to result in a credit exceeding the amount computed by the invested capital method.

Holding

1. No, because the taxpayer failed to provide sufficient evidence to support its calculation of CABPNI, especially in light of the economic conditions during the base period and relied too heavily on the experience in a post-base-period year, which was influenced by unusual market factors.

Court's Reasoning

The court applied the legal standard that the taxpayer had the burden of proving a fair and just CABPNI. The court emphasized that the taxpayer's proposed CABPNI was based on assumptions about increased sales and operational efficiencies in the base period. The court reasoned that the taxpayer's assumptions were not supported by sufficient evidence, particularly in light of the pre-existing, and differing, economic conditions of the base period. Specifically, the court found that the taxpayer's projected sales volume of 1,718 curers, based on sales in the post-war year of 1945, was unsupported. Moreover, the court noted that the taxpayer's assumptions disregarded the realities of the market, including the competitive market for the product, the need to offer incentives to buyers, and the limited ability of buyers to pay for the product. The court quoted from the case *Tin Processing Corporation* to underscore the necessity for constructive income to align with the same operating conditions as those of the business.

Practical Implications

This case underscores the importance of presenting credible evidence to support claims for excess profits tax relief. When seeking relief under Section 722, taxpayers must demonstrate a reasonable basis for their CABPNI calculations. Lawyers should advise clients to gather and present robust, verifiable data, focusing on the conditions of the base period years and avoiding reliance on post-base-period experiences influenced by atypical market dynamics. It highlights the need to consider all relevant economic factors and the potential impact of intangible assets. Lawyers should also consider the necessity of comparing the taxpayer's actual operations in the base period with the reconstructed income, considering similar operating conditions. This case influences tax practice in similar cases and is cited in other cases regarding reconstruction of income for tax purposes.

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