***Fawn v. Commissioner*, 12 T.C. 1052 (1949)**

When a business commenced operations immediately prior to the base period for excess profits tax calculation, and a change in production capacity occurred, a taxpayer is entitled to relief under section 722(b)(4) of the 1939 Code, and a constructive average base period net income should be determined using appropriate market and financial data.

Summary

The Tax Court addressed the calculation of constructive average base period net income for excess profits tax purposes under section 722(b)(4) of the 1939 Code. The petitioner's hardware business was commenced immediately prior to the base period, and there was a change in the capacity for production in the wholesale steel warehouse. The court considered several factors in dispute: the projected 1939 sales level if the steel warehouse had started operations earlier, the net profit margin on steel sales, and the appropriate index to back-cast hardware sales. The court determined the appropriate figures and recalculated the petitioner's constructive average base period net income, finding the Commissioner's initial assessment to be incorrect.

Facts

The petitioner, Fawn, operated a hardware business commencing immediately prior to the tax base period. In May 1940, Fawn commenced a wholesale steel warehouse. The petitioner sought relief under section 722 (b) (4) of the 1939 Code, arguing that their average base period net income was an inadequate standard because of the commencement of hardware business and the change in production capacity of their steel business. The respondent, the Commissioner, conceded that petitioner was entitled to relief under section 722(b)(4). The parties disagreed on how to calculate a constructive average base period net income.

Procedural History

The case was heard by the Tax Court to determine the correct method and values to be used in computing Fawn's constructive average base period net income for excess profits tax purposes. The court examined the evidence and arguments presented regarding several disputed factors that directly impacted the calculation.

Issue(s)

1. Whether the petitioner's 1939 sales level for steel should be set at $600,000 or $250,000, as determined by the Commissioner.
2. Whether the average net profit margin on steel sales should be 12% (as supported by the evidence) or a lower percentage (as calculated by the Commissioner).
3. Whether the wholesale hardware sales index or another index is the

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appropriate index to be used for back-casting petitioner's 1939 hardware sales to the prior base period years.

Holding

1. Yes, because the court found persuasive evidence supporting a 1939 sales level of $600,000.
2. Yes, because evidence supported a 12% average net profit.
3. Yes, because the wholesale hardware sales index more accurately reflected the petitioner's business experience during the base period.

Court's Reasoning

The court considered three factors: (1) the 1939 sales level the petitioner would have achieved if its steel warehouse had begun operations on January 1, 1938, (2) the average net profit margin, and (3) the proper index for back-casting the 1939 hardware sales. The court relied on testimony from the petitioner's president and sales manager, and an expert witness, Desmond. These witnesses provided estimates of the potential sales volume the petitioner could have achieved if its warehouse had begun operations earlier. The court determined that the testimony of Desmond provided strong support for $600,000 in 1939 steel sales. The court found evidence for a 12% profit margin. The court also found that the wholesale hardware sales index provided a more accurate representation of petitioner's base period business. Based on these conclusions, the court recalculated the petitioner's constructive average base period net income.

The court stated, "We are satisfied that the record justifies our finding that if petitioner's steel warehouse had been placed in operation on January 1, 1938, its 1939 sales of steel would have reached $600,000."

Practical Implications

This case highlights the importance of providing sufficient evidence when arguing for adjustments to excess profits tax calculations. The court's decision emphasizes the need to present credible market data and expert testimony when determining constructive average base period net income under Section 722(b)(4). The decision affects how the Tax Court analyzes similar cases by emphasizing a careful evaluation of the facts and by requiring taxpayers to provide the necessary evidence to support their claims. Further, the case demonstrates how specific business practices and market conditions should be considered when reconstructing financial data for tax purposes. Any business that started operations shortly before a tax base period or underwent significant changes in capacity during that period should understand that these circumstances are relevant and can impact the tax treatment of that business. Businesses, particularly those with potentially complex financial histories, should carefully document their operational changes and market conditions to support claims for tax relief.

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