***The R.K.O. Theatres, Inc. v. Commissioner*, 24 T.C. 1275 (1955)**

A taxpayer may be eligible for excess profits tax relief under Section 722(b)(4) of the Internal Revenue Code of 1939 if they can demonstrate that a change in the character of their business during or immediately prior to the base period resulted in an inadequate reflection of normal earnings.

Summary

The case involves R.K.O. Theatres, Inc., seeking relief from excess profits taxes under Section 722 of the Internal Revenue Code of 1939, specifically arguing that a change in the character of its business warranted a constructive average base period net income. R.K.O. argued that the introduction of a new product line led to an inability to compete. The Tax Court held that R.K.O. was entitled to relief under Section 722(b)(4) because of the introduction of new and more successful ram-type lathes that significantly improved its market position during the base period. The court considered factors such as growth in market share, an improved product line, and the impact on dealer networks.

Facts

R.K.O. Theatres, Inc. manufactured plain turret lathes based on old designs. In 1929, the company hired Oskar Kylin to develop a new line of ram-type Universal turret lathes. This development took several years. The new lathes were an entirely new product compared to the old ones. The company's market share grew significantly during the base period (1936-1939). While the petitioner experienced steady growth except for the slump year of 1938. Petitioner sought relief because its average base period net income did not reflect its improved earning potential during the base period.

Procedural History

The case originated as a petition to the Tax Court of the United States. The petitioner sought relief under section 722, Internal Revenue Code of 1939, for excess profits taxes. The Tax Court reviewed the petitioner's claims and evidence, ultimately deciding on the basis of section 722(b)(4), after rejecting other bases for relief. The decision of the Tax Court constitutes the only stage of the procedural history outlined in this case brief.

Issue(s)

1. Whether the taxpayer's incorporation date constituted a commencement of business such that it should be entitled to relief?
2. Whether the introduction of a new product line constituted a change in the character of the business for purposes of excess profits tax relief?

Holding

1. No, because the incorporation was a mere continuation of an existing business, not a commencement.
2. Yes, because the new line of ram-type lathes represented an entirely new product that fundamentally changed the business and its competitive position, thereby entitling the taxpayer to relief.

Court's Reasoning

The court applied Section 722(b)(4) of the Internal Revenue Code of 1939, which allows for excess profits tax relief when a taxpayer's base period net income is an inadequate measure of normal earnings due to a change in the character of the business. The court distinguished between the incorporation of the existing business and a true commencement. It emphasized that the new ram-type lathes were not simply an improved version of the old lathes but a new type of product altogether. The court noted the significant growth in market share during the base period, showing that the taxpayer attained its normal competitive position by the end of the base period. The court also mentioned the impact on the distribution system, as the inability to offer the new lathes had damaged its dealer network, which improved when the new line was established.

The court rejected the argument for relief based on "new management."

The court considered, but did not explicitly delineate, the relevance of an increased ratio of equity to borrowed capital.

The court's decision reflects that it considered all the various points raised by both sides and took them into account in its ultimate conclusion.

Practical Implications

This case is crucial for tax practitioners dealing with excess profits tax claims, or any similar situation where a business's tax burden is impacted by its business's base period income. It establishes a precedent for what constitutes a

