26 T.C. 1167 (1956)

A taxpayer is entitled to excess profits tax relief under Section 722(b)(4) of the Internal Revenue Code if the average base period net income is an inadequate measure of normal earnings because the taxpayer changed the character of its business during the base period, even if those changes were not fully operational during the base period.

Summary

Bergstrom Paper Company sought relief from excess profits taxes, arguing that changes in its business during the base period rendered its average net income an inadequate standard of normal earnings. The company had installed a new filtration plant and committed to new cone-type cookers, improving its production capacity and product quality. Additionally, it contracted to sell steam, a new product. The Tax Court held that these changes constituted a 'change in the character of its business' under Section 722(b)(4) of the Internal Revenue Code, entitling Bergstrom to relief, even though the steam sales had not yet begun during the base period. The court emphasized that changes in production capacity and the introduction of new products are key factors.

Facts

Bergstrom Paper Company manufactured paper, primarily using wastepaper pulp. The company's filtration system using sand and rock was becoming inadequate due to increased impurities in the water. The ink removal process using drum cookers was also insufficient, affecting the whiteness and quality of the final product. In 1938, the company decided to build a new filtration plant using flocculation, and replace its drum cookers with new cone-type cookers. The new filtration plant, completed in 1939, solved the water issues. The cone-type cookers were a new technology, authorized in December 1938, and installed through 1941. In August 1939, Bergstrom contracted to sell steam to Kimberly-Clark, although the actual supply didn't start until the taxable years. The Commissioner denied the excess profits tax relief, triggering this litigation.

Procedural History

Bergstrom Paper Company filed claims for excess profits tax relief under Section 722 of the Internal Revenue Code for the years 1941, 1942, and 1943, which the Commissioner disallowed. The case was heard by the United States Tax Court.

Issue(s)

1. Whether the installation of a new filtration plant and the commitment to install new cone-type cookers resulted in a "difference in its capacity for production" entitling Bergstrom to relief under Section 722(b)(4).

2. Whether the contract to supply steam constituted a “difference in the products or services furnished” entitling Bergstrom to relief under Section 722(b)(4).

Holding

1. Yes, because the filtration plant and the new cookers represented a significant change in the company’s production capacity.

2. Yes, because the steam supply contract constituted a difference in services provided, even if the service did not actually commence until after the end of the base period.

Court’s Reasoning

The court relied on Section 722(b)(4) of the Internal Revenue Code, which addresses situations where a taxpayer’s average base period net income is an inadequate measure of normal earnings because of a “change in the character of its business” during the base period. The term “change in the character of the business” specifically includes a difference in the capacity for production. The court found that the new filtration plant and the cone cookers increased the company’s capacity to produce a higher quality product more efficiently. The court emphasized that Section 722(b)(4) must be interpreted sympathetically to bring about the relief intended by Congress. The court further reasoned that the new steam contract resulted in the offering of a new service. The court recognized that the delivery of steam did not actually begin during the base period, but this was not fatal to the claim. The court distinguished the case from one where the taxpayer was simply preparing to engage in a new business, and the court emphasized that the changes should be considered in light of their impact on the taxpayer’s future earnings.

Practical Implications

This case provides guidance on interpreting “change in character of business” under the excess profits tax law. It shows that improvements in production capacity and the introduction of new products or services can qualify for relief even if they are not fully operational during the base period. It highlights the importance of considering commitments made prior to January 1, 1940, as indicative of a business change. The decision suggests that taxpayers should proactively document plans for business changes during the base period to support claims for excess profits tax relief. It also demonstrates the courts’ willingness to apply the law in a way that provides relief when the taxpayer has made significant investments to improve their business.