26 T.C. 1141 (1956)

Under section 722 of the Internal Revenue Code of 1939, a taxpayer seeking excess profits tax relief based on changes in business character must demonstrate that the changes resulted in increased earnings sufficient to exceed the relief already available under alternative methods, and that a “fair and just amount” can be used as a constructive average base period net income.

Summary

Hall Lithographing Co. sought relief from excess profits taxes under section 722 of the Internal Revenue Code of 1939, arguing that changes in management and the acquisition of a competitor’s business altered the character of its business during the base period. The court held that Hall Lithographing was not entitled to relief because it failed to prove that the changes resulted in increased earnings sufficient to provide a higher excess profits credit than the one it already received under the invested capital method. The court emphasized the taxpayer’s burden of proving not only that its base period income was an inadequate measure of normal earnings, but also of establishing a “fair and just” amount that would result in a greater tax benefit. The court found that the evidence presented was insufficient to reconstruct base period earnings that would entitle the company to additional tax relief.

Facts

Hall Lithographing Co., incorporated in 1889, operated a lithographing, letterpress, and stationery business. During the base period (1936-1939), the company underwent changes including a change in management with the hiring of a general manager in 1936, who implemented several operational improvements. In 1938, the company acquired the printing business of a competitor, Crane and Company. Hall Lithographing claimed that these events constituted changes in the character of its business, entitling it to relief from excess profits taxes under section 722(b)(4) of the Internal Revenue Code of 1939.

Procedural History

Hall Lithographing Co. filed for excess profits tax relief for the years 1941-1945 under section 722. The Commissioner of Internal Revenue denied the relief. The company then petitioned the United States Tax Court.

Issue(s)

1. Whether the change in management and the acquisition of a competitor’s business constituted a “change in the character of the business” under section 722(b)(4) of the Internal Revenue Code of 1939.
2. Whether Hall Lithographing Co. proved that, as a direct result of the alleged changes, there were increased earnings and that its average base period net income was an inadequate standard of normal earnings.

3. Whether the company established a “fair and just amount” for a constructive average base period net income that would result in an excess profits credit higher than the credit under the invested capital method.

Holding

1. No, because the changes made did not, on their own, meet the conditions of 722(b)(4).
2. No, because the company did not establish that its changes caused increased earnings.
3. No, because Hall Lithographing Co. did not present adequate evidence to support a constructive average base period net income that would have resulted in a greater excess profits credit than it already received under the invested capital method.

Court’s Reasoning

The court recognized that section 722 of the Internal Revenue Code of 1939 was designed to provide relief from excess profits taxes where the standard methods yielded inequitable results. Under section 722(b)(4), a taxpayer must demonstrate that changes to the character of its business caused its average base period net income to be an inadequate standard of normal earnings. The court acknowledged the changes in management and acquisition of a competitor. The court reasoned that the company failed to prove that its operations were not adequately accounted for by base period income, specifically because it received significant credits under the invested capital method. The court was not persuaded that the evidence presented supported a “fair and just amount representing normal earnings” that would have resulted in a higher excess profits credit, because the taxpayer failed to establish a fair and just income to be used to determine a fair and just amount, and because the numbers used were arbitrary and unsupported. The court found that the company’s efforts to reconstruct its base period income were speculative.

Practical Implications

This case underscores the high evidentiary burden placed on taxpayers seeking relief under section 722, and similar provisions. The taxpayer must demonstrate the inadequacy of the standard methods of calculating the tax and must show that the alleged changes in business character directly caused increased earnings. The taxpayer must also present sufficient evidence for the court to calculate a reasonable “fair and just amount” for a constructive average base period net income. This case is a reminder that even demonstrating a change in business character is not sufficient to obtain relief if that change does not lead to increased earnings or, if it does, those increases cannot be reliably quantified and tied to the relief sought. Attorneys should ensure they have a detailed evidentiary basis for any claims made under such relief provisions and that the proposed adjustments are clearly tied to the events asserted.