27 T.C. 230 (1956)

To obtain relief under Section 722 of the 1939 Internal Revenue Code due to a change in the character of a business, a taxpayer must not only demonstrate that such a change occurred during the base period but also establish a fair and just constructive average base period net income exceeding the standard average base period net income.

Summary

Central Bag Company sought relief from excess profits taxes under Section 722 of the Internal Revenue Code of 1939, arguing that it had changed the character of its business by expanding into new bag manufacturing during the base period. The Tax Court found that while Central Bag did change its business, it failed to establish a fair and just amount for its constructive average base period net income. The court emphasized that the burden was on the taxpayer to prove its entitlement to relief and to substantiate its claimed constructive income, which Central Bag could not do. The court also noted that the taxpayer could not utilize the growth formula under section 713 in conjunction with a claim under section 722, and rejected the taxpayer's reconstructed sales figures, as they were based on assumptions not supported by evidence.

Facts

Central Bag Company, a Missouri corporation, began as a used bag business in 1928, and expanded to include the manufacture and sale of new bags in May 1937, which occurred during its base period. The company faced difficulties in its new bag business. The company sought relief under Section 722 of the Internal Revenue Code of 1939 for the fiscal years ending September 30, 1943, 1944, 1945, and 1946, claiming that it had changed the character of its business during the base period. The used bag business involved buying, cleaning, repairing, and selling various types of used bags. Management began to manufacture new bags due to a perceived saturation point in the used bag market. In developing the new bag business, the company faced production and selling challenges. These included securing the correct sizing, uniformity, and appropriate printing methods. The company continued the used bag business after entering the new bag business. The company had a larger productive capacity for new and used bags than the actual volume sold during the base period.

Procedural History

Central Bag Company filed applications for relief under Section 722 of the Internal Revenue Code of 1939. The Commissioner of Internal Revenue disallowed the company's claims for relief. The case was brought before the United States Tax Court. The Tax Court ruled that Central Bag had changed the character of its business. The court found however that Central Bag failed to demonstrate a fair and

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just amount for its constructive average base period net income and thus was not entitled to relief.

Issue(s)

1. Whether Central Bag Company changed the character of its business during the base period within the meaning of Section 722(b)(4) of the Internal Revenue Code of 1939?

2. Whether Central Bag Company established a fair and just amount representing normal earnings to be used as its constructive average base period net income?

Holding

1. Yes, because the company expanded its business into new bag manufacturing, which constituted a change in the character of the business.

2. No, because Central Bag Company failed to provide sufficient evidence to support its claim of a fair and just constructive average base period net income.

Court’s Reasoning

The court acknowledged that Central Bag had changed the character of its business. The court relied on section 722(b)(4), which provides relief if a taxpayer changed the character of its business during the base period. The Tax Court, however, found that merely showing a change in business character was insufficient for relief under Section 722. The court found that the taxpayer had the burden of proving a “fair and just” amount. The court emphasized the taxpayer’s failure to provide adequate evidence. The court found that the company could not utilize the growth formula and that the sales reconstructions contained several assumptions not supported by evidence. Central Bag’s reconstruction efforts and push-back rules were deemed insufficient due to lack of proof. The court rejected Central Bag’s reconstructed sales figures, as they were based on assumptions not supported by evidence, especially regarding demand and the company’s ability to sell.

Practical Implications

This case underscores the stringent evidentiary requirements under Section 722 of the Internal Revenue Code of 1939. Taxpayers seeking relief due to a change in business character must not only demonstrate that change but also provide credible evidence to support the determination of a fair and just constructive average base period net income. This requires detailed financial analysis, verifiable sales figures, and supportable assumptions, and an understanding that the courts will review reconstructed figures skeptically. The case highlights the burden of proof on the taxpayer, and the need to show why their standard base period income does not represent fair earnings. Furthermore, the ruling emphasizes that relief cannot be secured under both Section 713 and Section 722. Tax practitioners should focus on

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providing strong documentary evidence and should be wary of reconstructions.

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