*27 T.C. 507 (1956)*

A change in the type of equipment a company manufactures can constitute a change in the character of its business, entitling it to excess profits tax relief under the Internal Revenue Code if it can demonstrate that its average base period net income is an inadequate standard for its normal earnings.

**Summary**

Franks Manufacturing Corporation sought excess profits tax relief under Section 722 of the Internal Revenue Code of 1939, arguing that a change in the character of its business during the base period warranted a higher constructive average base period net income. The United States Tax Court agreed, finding that the company's shift to manufacturing portable rotary drilling rigs and telescoping derricks constituted a qualifying change. The court determined a constructive average base period net income of $30,000, significantly higher than the Commissioner's initial assessment of $8,700, to ensure a fair calculation of the company's excess profits tax credit for the relevant years.

**Facts**

Franks Manufacturing Corporation, an Oklahoma corporation, was formed in 1934, succeeding a partnership that began manufacturing oil well servicing equipment in 1931. Initially, the company manufactured well servicing units, and later spudders and core drills. In 1936, Franks began designing and manufacturing portable rotary drilling units and telescoping derricks, which it began selling in 1937. The company's sales of rotary drilling units and derricks increased during the base period (1936-1939). In 1940, the company received large orders from the Russian government for its portable rotary drilling units, significantly increasing its production.

**Procedural History**

Franks filed for excess profits tax relief under Section 722 for the years 1940-1945. The Commissioner of Internal Revenue initially allowed a partial relief, determining a constructive average base period net income of $8,700 for 1941 but disallowing claims for other years. The company appealed to the United States Tax Court, which considered whether the company qualified for relief based on a change in business character and the appropriate amount of the constructive average base period net income.

**Issue(s)**

1. Whether the change in Franks Manufacturing Corporation's business, specifically the introduction of portable rotary drilling units and telescoping derricks, constituted a change in the character of its business under Section 722(b)(4) of the Internal Revenue Code of 1939.

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2. If so, what was a fair and just amount representing the company's constructive average base period net income.

**Holding**

1. Yes, because the shift to manufacturing and selling portable rotary drilling rigs and telescoping derricks represented a change in the character of its business.
2. The Court determined the amount to be $30,000.

**Court's Reasoning**

The Court found that the company changed the character of its business by adding the manufacture of portable rotary drilling rigs and telescoping derricks. The Court noted that the production of these items was a substantial departure from the company's prior focus on well servicing equipment and spudders. The Court recognized that, even though the Commissioner acknowledged the company's change, the Commissioner failed to establish a fair and just amount for the company's constructive average base period net income. The Court reviewed the evidence of the company's sales and the economic conditions during the relevant period. It considered the development and adoption of the new products, as well as the company's increase in sales and plant capacity. The Court, therefore, determined that the amount of $30,000 would place the company's base period operations under the changed conditions on a normal basis. The Court emphasized that a fair and just reconstruction of the base period earnings was required to ensure that the excess profits tax credit reflected the impact of the company's changes. The court considered whether the business would have developed a higher earning level at an earlier date and thus, the impact of the business changes on earnings.

**Practical Implications**

This case highlights the importance of defining what constitutes a "change in the character of the business" for excess profits tax relief. The case provides a roadmap for demonstrating such a change: evidence of new products, changes in sales volume, and increased plant capacity. The court's methodology for reconstructing the base period earnings provides a framework for arguing for a fair and just determination of the excess profits tax credit. This case is instructive for businesses seeking excess profits tax relief based on business model or product changes. It demonstrates that the courts are willing to consider the impact of strategic business decisions on base period earnings. Subsequent cases citing this ruling would likely focus on similar fact patterns, particularly the development or introduction of new and distinct products or services. The court's emphasis on a "fair and just" amount also provides guidance to taxpayers seeking to substantiate their own claimed constructive average base period net income.

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