27 T.C. 940 (1957)

A company can qualify for excess profits tax relief under Section 722 of the Internal Revenue Code if it can demonstrate that base period earnings were depressed due to temporary economic circumstances or substantial base period changes in management or operation resulting in higher earnings later in the period.

Summary

In this case, the U.S. Tax Court addressed whether Lever Brothers Co. (as a transferee of The Pepsodent Co.) was entitled to excess profits tax relief under Section 722 of the Internal Revenue Code of 1939. The court considered whether Pepsodent's base period earnings were depressed due to temporary economic circumstances or due to substantial changes in management and operations. The court found that Pepsodent's base period earnings were indeed depressed due to several factors, including criticism of its products, challenges to its sales practices, and changes in advertising. The court held that Pepsodent qualified for relief under Section 722(b)(4), due to substantial changes in management and operations. The court determined a constructive average base period net income for Pepsodent, which allowed for a reduced excess profits tax liability.

Facts

The Pepsodent Co. manufactured and sold dentifrices. William Ruthrauff developed the original formula for Pepsodent toothpaste. Douglas Smith and Albert D. Lasker purchased the patent and business. Kenneth Smith, Douglas Smith's son, succeeded his father as president. During the base period, approximately 75% of Pepsodent's products were sold to ultimate consumers through independent retail druggists, and 25% through chain stores, department stores, and other retailers. Pepsodent faced criticism due to the abrasiveness of its toothpaste formula and changed the formula in 1930. In 1935, Pepsodent adopted a new formula, which proved unsatisfactory. In 1936, numerous complaints about the separation and hardening of the toothpaste in the tubes led to changes in the formula. In 1937, Formula 99 was adopted to eliminate decalcifying effects, and in 1939, the American Dental Association approved the formula. Pepsodent also faced challenges from retail druggists regarding sales practices. Charles Luckman, who joined Pepsodent in 1935 as a sales manager, was promoted through various positions, ultimately becoming general manager. Pepsodent also undertook to control the retail prices of its products through fair trade agreements and, later, a del credere plan.

Procedural History

Lever Brothers Company, as a transferee of The Pepsodent Co., filed claims for excess profits tax relief under Section 722 of the Internal Revenue Code of 1939 for the years 1942, 1943, and 1944. The Commissioner of Internal Revenue denied relief. The case was heard by the U.S. Tax Court, which made findings of fact, and rendered a decision.

Issue(s)

1. Whether the petitioner qualifies for excess profits tax relief under the provisions of Section 722(b)(2) or Section 722(b)(4) of the Internal Revenue Code of 1939.

2. If the petitioner qualifies for relief, what is the determination of a fair and just amount representing normal earnings to be used as a constructive average base period net income under Section 722?

Holding

1. Yes, because the court found that Pepsodent qualified for relief under Section 722(b)(4), due to substantial changes in management and operation during the base period.

2. The court determined that a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purpose of computing the petitioner's excess profits credit for 1942, 1943, and 1944, is $646,000.

Court's Reasoning

The court found that Pepsodent's base period earnings were depressed, and that the depression was attributable to criticism of the company's products, complaints about the quality of toothpaste, changes in sales practices and the loss of effectiveness of its advertising. The court focused on the changes in the company's management, particularly Luckman's rise through the ranks. The court pointed to the development and adoption of Formula 99, which addressed criticism of the product and the changes made to comply with fair trade practices, as key operational changes. The court also considered the actions taken to build goodwill with retailers. The court concluded that these changes, taken together, warranted relief under Section 722(b)(4). The court then determined a constructive average base period net income, considering all these factors, to determine a fair tax credit.

Practical Implications

This case is significant because it illustrates how a company can qualify for excess profits tax relief by demonstrating base period earnings depression due to specific operational or management changes. The ruling emphasizes that the court will look at the totality of the circumstances. It highlights the importance of the push-back rule, and how courts will look at base period events and the economic impact when determining excess profits tax liabilities. The case reinforces the need for businesses to maintain detailed records to support claims for relief. In future tax cases, this case will serve as precedent for the factors courts consider when evaluating whether a taxpayer is entitled to excess profits tax relief under Section 722, and what constitutes a “fair and just” amount for the constructive average base period net income.

