28 T.C. 201 (1957)

Under the excess profits tax, a taxpayer is entitled to a constructive average base period net income if it can demonstrate that its normal earnings were inadequately represented by its average base period net income due to a change in the character of its business.

Summary

Davenport Hosiery Mills, Inc. sought relief from excess profits taxes, arguing that its shift from silk to nylon hosiery constituted a change in the character of its business, entitling it to a "constructive average base period net income" under Section 722 of the Internal Revenue Code of 1939. The court agreed, finding that the transition to nylon hosiery represented a significant difference in products and production capacity. The court determined that the taxpayer was entitled to relief, but adjusted the requested amount of constructive income based on the evidence presented, and established a constructive average base period net income for the relevant years.

Facts

Davenport Hosiery Mills, Inc. manufactured women's full-fashioned hosiery. During the base period (1936-1939), the company primarily produced silk hosiery. In late 1938, Davenport began to experiment with nylon hosiery. By 1939, the company started receiving shipments of nylon yarn from DuPont and produced over 19,000 pairs of nylon hosiery, selling some to DuPont and some to employees. During this period, Davenport made significant investments in new equipment, including preboarding machines and air conditioning, to accommodate the production of nylon hosiery. By the end of 1939, Davenport had made the decision to convert its entire production to nylon hosiery, although this conversion was not completed until after World War II. The Commissioner of Internal Revenue disallowed the company's claim for relief under Section 722 of the 1939 Code.

Procedural History

Davenport Hosiery Mills filed claims for refunds of excess profits taxes for the years 1940 through 1945. The Commissioner of Internal Revenue disallowed these claims, leading Davenport Hosiery Mills to petition the U.S. Tax Court for relief under Section 722. The Tax Court heard the case, considered the evidence, and issued a decision.

Issue(s)

1. Whether the shift from silk to nylon hosiery constituted a "change in the character of the business" under Section 722(b)(4) of the Internal Revenue Code of 1939, specifically a "difference in the products furnished."

2. Whether the nylon hosiery manufactured in 1939 was "furnished" during the base

period, even though it was not widely sold to the public until 1940.

Holding

1. Yes, because the court found that nylon hosiery was a substantially different product from silk hosiery, constituting a “difference in the products furnished” under the statute.

2. Yes, because the taxpayer supplied nylon hosiery to its employees and DuPont during the base period, which qualified as “furnishing” the product.

Court’s Reasoning

The court focused on whether the change to nylon hosiery constituted a “difference in the products.” The court referenced the Treasury’s interpretation of this term, but found the facts of Davenport’s case aligned with the concept of “new product.” The court highlighted that nylon hosiery differed significantly from silk hosiery in terms of consumer market, manufacturing processes, and end product characteristics. The court found that Nylon hosiery was substantially different from silk, not a trivial or routine change. The court also determined that the nylon hosiery produced and sold in 1939 was “furnished” during the base period, even though the widespread commercial release was delayed.

The court then addressed the appropriate level of relief under Section 722. The court recognized that Congress provided no precise formula for determining constructive average base period net income. It determined that it was reasonable to assume that if Davenport had made its change 2 years sooner, it would have had access to a certain quantity of nylon yarn. Using this and other evidence, the court calculated a constructive average base period net income for Davenport that it considered fair and just.

Practical Implications

This case provides guidance for taxpayers seeking relief from excess profits taxes based on a change in the character of their business. It emphasizes the importance of: demonstrating substantial differences between the new and old products; providing concrete evidence of investments made to accommodate the change; and demonstrating that the base period net income did not accurately represent normal earnings. The court’s willingness to consider the “push-back rule” – treating a change as if it had occurred earlier – has implications for how courts should analyze cases involving external limitations such as the actions of a supplier. The case illustrates the potential impact of shifts in product type on tax liabilities, particularly in periods of economic or technological transformation.

