29 T.C. 562 (1957)

To qualify for excess profits tax relief under Section 721 of the Internal Revenue Code of 1939, a taxpayer must demonstrate that abnormal income derived during the taxable years resulted from research and development activities extending over a period of more than 12 months.

Summary

L. E. Carpenter & Company (Carpenter) sought excess profits tax relief under Section 721 of the Internal Revenue Code of 1939, claiming that its income from manufacturing tent material for the government was attributable to prior research and development in fabric impregnation. The U.S. Tax Court ruled against Carpenter, finding that the company's wartime income did not stem from its pre-war research and development activities. The court determined that Carpenter's existing skills and equipment were adapted to produce tent material, and there was no direct link between its pre-war business (book cloth) and its wartime activities (flameproof duck). The court emphasized that the company failed to demonstrate that the income resulted from any research or development extending over more than 12 months.

Facts

L. E. Carpenter & Company, incorporated in 1925, produced pyroxylin-coated fabrics (book cloth) before 1941. In 1941, the company began producing tent material for the government, which required flameproof, waterproof, and weatherproof properties. Carpenter's income substantially increased during the war years (1942-1945) due to government contracts. Carpenter claimed that this income was abnormal and should be attributed to its pre-war research and development in fabric impregnation. Prior to producing tent material, Carpenter had not produced any fabric treated to the government's specifications. Carpenter entered into contracts with other companies to supply them with chemical formulations and methods of application.

Procedural History

Carpenter filed claims for refund of excess profits taxes for 1942-1945, citing Section 721. The Commissioner of Internal Revenue disallowed the claims. The case was brought before the U.S. Tax Court, which reviewed the claims, assessing whether Carpenter could attribute its wartime income to pre-war research.

Issue(s)

1. Whether the income derived by L.E. Carpenter & Company during the taxable years of 1942-1945, from the production of tent material for the Government, was abnormal income within the meaning of Section 721(a)(2)(C) of the Internal Revenue Code of 1939?

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Holding

1. No, because the court determined the income derived from tent material production did not result from exploration, discovery, prospecting, research, or development extending over a period of more than 12 months.

Court's Reasoning

The court focused on whether Carpenter's income from producing tent material for the government resulted from pre-existing research and development. The court analyzed: the machinery used, finding it was standard equipment, not developed by Carpenter; the impregnation method, finding that the "bath method" was well known and not developed by Carpenter; and the chemical formula, which was a different formula from that used in pre-war products. The court emphasized that Carpenter's skills and the machinery it had were easily converted to the wartime effort, but this did not mean that the firm had engaged in any development. The court found that the petitioner failed to prove a causal relationship between its pre-war activities and its wartime income. "We simply do not believe that petitioner could have come up with the same formula within 2 weeks as a result of its general research and development in pyroxylin impregnation of book cloth prior to 1941."

Practical Implications

This case underscores the necessity for taxpayers seeking relief under Section 721 (or similar provisions) to provide strong evidence linking current income to prior qualifying research and development. It is not enough to show that a company adapted existing skills and equipment, or that they possessed the capacity to develop a product. The court's reasoning suggests that businesses must demonstrate a direct causal connection between their prior research and the abnormal income. This case is a cautionary tale for businesses seeking tax relief: documentation of the research and development activities that led to the income is critical for establishing eligibility for the relief. Later cases would rely on the precedent established here to demand direct causation, the research and development must be linked to the abnormal income.

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