29 T.C. 975 (1958)

To qualify for excess profits tax relief under Section 721 of the Internal Revenue Code of 1939, a taxpayer must demonstrate that its abnormal income resulted from exploration, discovery, research, or development activities extending over 12 months.

Summary

General Tire & Rubber Co. (formerly Textileather Corporation) sought relief under Section 721 of the 1939 Internal Revenue Code, claiming that abnormal income from the sale of its new product, Tolex, was due to research and development. The Tax Court found that the income from Tolex sales was abnormal. The court determined that the research and development of Tolex extended over more than 12 months, meeting a key requirement for relief under Section 721. However, the court disagreed with the taxpayer's calculation of the portion of income attributable to research, concluding that market factors, such as the lack of competition during wartime, also contributed. The court determined a business improvement factor for proper allocation of income.

Facts

Textileather Corporation began manufacturing coated fabrics in 1927. Textileather's most significant achievement was the development of Tolex, a leather-like, plastic-coated fabric. The company undertook an extensive research and development program, beginning in 1931, and incurred substantial costs for the research and development of Tolex. The product was developed and named Tolex by the end of 1940. Textileather's production of Tolex began in May 1942. During World War II (1942-1945), the entire output of Tolex was utilized for military and defense purposes. Textileather was the sole producer of Tolex during this period. The company filed claims for refund of excess profits taxes for the years 1942 through 1945 under Section 721 of the Internal Revenue Code of 1939, which the IRS denied.

Procedural History

Textileather Corporation filed claims for a refund of excess profits taxes, which were denied by the Commissioner of Internal Revenue. The company then filed a petition with the United States Tax Court. During the proceedings, Textileather merged with General Tire & Rubber Company, which was substituted as the petitioner. The Tax Court heard the case and issued its decision.

Issue(s)

1. Whether the taxpayer derived net abnormal income of the class specified by Section 721(a)(2)(C) of the 1939 Code during the years 1942, 1943, 1944, and 1945.

2. Whether the abnormal income was attributable to prior years so as to entitle taxpayer to the relief accorded by Section 721.

Holding

1. Yes, because the income derived by the taxpayer from the sale of Tolex during the years in issue constituted abnormal income under the statute.

2. Yes, because the taxpayer’s net abnormal income was attributable to research and development expenditures, but not to the extent claimed by the taxpayer.

Court’s Reasoning

The court analyzed Section 721 of the 1939 Code to determine if the taxpayer qualified for excess profits tax relief. The court first found the sales of Tolex generated abnormal income, as defined by the statute. The court found that the research and development of Tolex extended over 12 months, satisfying one requirement under the statute. The court held that the income was attributable, in part, to research and development. However, the court rejected the taxpayer’s argument that all income from Tolex sales was attributable to its research, holding the income was also attributable to other factors. The court noted that during the early war years, 1942 and 1943, Textileather had no effective competition in producing marketable high molecular weight vinyl fabrics. The court used the business improvement factor to determine the proper allocation of income. The court ultimately adjusted the taxpayer’s claimed income due to research and development, finding that the net abnormal income attributable to research and development was lower than what the taxpayer claimed.

Practical Implications

This case is significant because it clarifies the requirements for demonstrating “abnormal income” under Section 721 of the 1939 Code, particularly in the context of research and development. Legal professionals should note that even if a product’s development stems from research, other factors, such as market conditions and a lack of competition, may impact the allocation of income for tax relief purposes. The court’s use of a “business improvement” factor is an important example. Subsequent cases in the area have continued to interpret and apply the principles established in this case when addressing the allocation of abnormal income to prior years in the context of research and development. For example, the factors used in the determination of income allocation may influence future applications of similar tax laws.

