***Textileather Corp. v. Commissioner*, 14 T.C. 272 (1950)**

For purposes of excess profits tax relief under section 721(a)(2)(C) of the 1939 Code, income qualifies as resulting from research and development if the research and development extends over a period of more than 12 months, even if the final product's development was contingent on external technological advancements.

Summary

Textileather Corp. sought relief from excess profits tax under the 1939 Internal Revenue Code, claiming its income from Tolex sales was "abnormal income" due to research and development extending over 12 months. The IRS disputed this, arguing the income wasn't solely from Textileather's research. The Tax Court found that the research and development qualified, even though the final product's development was contingent on an external scientific advancement (vinyl resin by Bakelite Corporation). The court determined what portion of income was attributable to research and development versus other factors like war-related demand. The court's decision provides guidance on what constitutes qualifying research and development under the Code and how to apportion income when multiple factors contribute.

Facts

Textileather began research and development in 1931 to create a new product superior to pyroxylin. They were unsuccessful until the Bakelite Corporation developed a high molecular weight vinyl resin, which Textileather used as a base. Textileather then developed the necessary plasticizers, lubricants, stabilizers, and pigments to complete Tolex, a marketable vinyl-coated fabric. The product was sold from 1942 to 1945. Income from Tolex sales during this period was considered abnormal under the Code because it was greater than 125% of the average gross income of the same class for the previous four years. The IRS contended the income was not a result of Textileather's research and development.

Procedural History

The case was heard by the United States Tax Court. The Tax Court reviewed the facts, applied the relevant provisions of the 1939 Internal Revenue Code, and determined the portion of Textileather's income attributable to research and development, and the portion to be from other factors such as increased demand and the absence of competition during the early war years.

Issue(s)

1. Whether the income derived by Textileather from the sale of Tolex was the result of research and development activities.
2. Whether the research and development extended over a period of more than 12 months.
3. If the research and development extended over 12 months, to what extent was

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the abnormal income attributable to research and development, versus other factors.

Holding

1. Yes, because Textileather's research, even though contingent on the development of vinyl resin by Bakelite Corporation, was necessary to produce Tolex.
2. Yes, because the research and development spanned from 1931 until the sale of Tolex, well over 12 months.
3. The Tax Court found that Textileather's abnormal income was not entirely due to research and development, but was partially attributable to war-related factors like increased demand and lack of competition. The court recalculated the amount of abnormal income attributable to research and development.

Court's Reasoning

The court focused on the definition of "abnormal income" under the 1939 Code. Section 721(a)(2)(C) defined it as income resulting from "exploration, discovery, prospecting, research, or development…extending over a period of more than 12 months". The court determined that Textileather's work, even if it built upon external technological advancements, qualified as research and development. The court pointed out that Textileather had been engaged in research with different types of resins, for example, before finding the Bakelite vinyl resin to work with. Furthermore, the Court found that Textileather was the first to meet the specifications for Tolex.

The court's decision was also based on the idea that the government was making the point that the product did not result from Textileather's research. The court clarified the meaning of the law, noting that the statute doesn't require "that the product resulting from the taxpayer's research and development be completely novel."

The court found that other factors also contributed to the income. "During the early war years, 1942 and 1943, petitioner was without effective competition…with its existing facilities taxpayer's market was unlimited…" The Court found that increased demand was also a factor in the increase of sales. This was due to the cessation during the war years of the production of rubber-coated fabrics. As a result, the court considered the market, for example, of low molecular weight vinyl fabrics. The court, utilizing estimated demand figures for vinyl-coated fabrics, re-calculated the income, so as to take into account the business improvement factors. Finally, the court accounted for administrative expenses and additional factors, and adjusted the income to correctly calculate it.

Practical Implications

This case provides key insights for practitioners dealing with tax issues related to

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research and development, especially regarding excess profits taxes. The court's emphasis on the fact that it is not necessary that a product be completely novel is important for businesses. The ruling helps define which expenses can be included as research and development, and provides a method for apportioning income. The focus on the length of time for research and development (over 12 months) provides a clear benchmark for determining the applicability of this tax provision. This case informs the analysis of similar cases by:

- Establishing that research and development can qualify even if it builds on external discoveries.
- Requiring careful allocation of income when multiple factors contribute to a product's success.
- Illustrating the need to consider external factors, such as market conditions, when calculating abnormal income.

Later cases applying or distinguishing this ruling may focus on the nature of the research, the length of time it spanned, the impact of external factors, and the methods used to allocate income.

For businesses, it means careful record-keeping of research expenses and demonstrating a clear link between research efforts and income generation. The case underscores the complexity of tax law and the need for expert legal and accounting advice.

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