***Hess Brothers, Inc. v. Commissioner*, 16 T.C. 402 (1951)**

To receive excess profits tax relief under the "constructive average base period net income" provision of the Internal Revenue Code, the taxpayer must prove that, even after adjustments, the constructive income would result in greater tax credits than those based on invested capital.

Summary

The case concerns Hess Brothers' attempt to claim relief under Section 722 of the Internal Revenue Code of 1939. Hess Brothers sought relief from excess profits taxes, arguing that a change in its business – specifically, the opening of a new store – during the base period entitled it to a recalculation of its average base period net income. The Tax Court acknowledged that the opening of the store qualified as a change, allowing for a push-back rule to simulate operations two years earlier. However, the court found that, even with adjustments, the company's projected income did not generate excess profits credits exceeding those based on invested capital, thus denying relief.

Facts

Hess Brothers operated two stores in Baltimore, one selling children's shoes and the other, ladies' and men's shoes. In February 1937, it opened a new store specializing in ladies' shoes. Hess Brothers calculated its excess profits credits using the invested capital method. The company argued that the opening of the new store and the commitment to add a building entitled it to a reconstruction of its average base period net income under the two-year push-back rule. The company claimed that if the changes had been made earlier, sales would have been greater, resulting in higher profits. Hess Brothers also claimed that they were entitled to relief because of inadequate seating space and that the disruption of business during the period when alterations, incident to adding a building, were being made, restricted sales.

Procedural History

Hess Brothers initially filed for relief under Section 722 of the Internal Revenue Code of 1939. The Commissioner denied relief. Hess Brothers then sought review in the Tax Court.

Issue(s)

1. Whether the opening of a new store constituted a "change in the character of the business" under Section 722(b)(4) of the Internal Revenue Code.

2. Whether the company's projected constructive average base period net income, accounting for lost sales and appropriate operating profit ratios, would result in higher excess profits credits than those calculated based on invested capital.

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Holding

1. Yes, because the opening of the new store and the commitment to add a building qualified as a change in the character of the business under Section 722(b)(4).

2. No, because, even with adjustments, the projected constructive income did not generate excess profits credits exceeding those based on invested capital.

Court's Reasoning

The court recognized that the opening of the new store represented a change in the character of the business, triggering the possibility of relief under Section 722(b)(4). The court also agreed that the taxpayer was entitled to apply the two-year push-back rule, meaning the business would be assessed as if the changes were made two years prior. However, the court was not persuaded by the taxpayer's projections of increased sales and profits. The court found that the company had failed to establish a sufficiently high level of earnings, even after correction of abnormalities, to justify relief. Specifically, the court questioned the use of a 13% profit ratio and found the assumption that officers' salaries would remain constant to be unrealistic. The court concluded that even when applying a maximum income ratio to the increased sales projections and adjusting for the transition to the Howard Street store, the resulting constructive average base period net income would not yield excess profits credits exceeding the invested capital credits.

Practical Implications

This case underscores the importance of detailed and well-supported financial projections when seeking tax relief based on a "constructive average base period net income." Attorneys and accountants should be prepared to provide rigorous, factual support for any claims about increased sales, costs, or operating profit ratios. The court's skepticism regarding the profit ratio and the impact on officer salaries demonstrates that projections must be grounded in the company's actual past experience, not speculation. The case suggests that the IRS and the courts will scrutinize evidence regarding lost sales, abnormal expenses, and appropriate profit margins. For businesses, this case demonstrates the requirements for receiving excess profits tax relief including proof that the change caused the business to not reach its full earning potential during the tax period.

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