***Hess Brothers, Inc. v. Commissioner*, 16 T.C. 403 (1951)**

To obtain excess profits tax relief under Section 722(b)(4) of the Internal Revenue Code of 1939, a taxpayer must not only establish a qualifying factor (e.g., change in the character of the business) but also demonstrate that the change would have resulted in increased earnings sufficient to justify relief.

Summary

Hess Brothers, Inc., sought excess profits tax relief, claiming a change in its business entitled it to a reconstructed average base period net income under Section 722(b)(4) due to the opening and expansion of a new store. While the Tax Court acknowledged a qualifying factor—the expansion of a store—it denied relief because Hess Brothers failed to convincingly demonstrate that the changes resulted in a sufficient increase in earnings during the base period to justify relief under Section 722. The court scrutinized the evidence presented on projected sales, profit margins, and officers' salaries, finding the taxpayer's estimations overly optimistic and unsupported by the financial data. The court emphasized the taxpayer's burden to prove a constructive level of earnings that would yield excess profits credits exceeding those based on invested capital.

Facts

Hess Brothers operated two stores in Baltimore selling children's and men's shoes. In February 1937, it opened a new store specializing in ladies' shoes (Howard Street store). During the base period, the company's sales increased, but the opening of the Howard Street store did not result in a substantial increase in overall sales because sales of ladies' shoes at the Howard Street store were largely offset by declines at the original stores. Hess Brothers sought relief, arguing that if the Howard Street store had been open two years earlier, sales would have been higher, and that the new store required expansion to accommodate customers.

Procedural History

Hess Brothers, Inc. computed its excess profits credits using the invested capital method. It applied for relief under Section 722(b)(4) of the Internal Revenue Code of 1939 due to the change in its business due to the opening and expansion of the Howard Street store. The Commissioner denied the relief, and Hess Brothers petitioned the Tax Court.

Issue(s)

1. Whether the changes to Hess Brothers' business, including the opening and expansion of the Howard Street store, constituted a change in the character of the business that would qualify for excess profits tax relief under Section 722(b)(4).

2. Whether Hess Brothers had demonstrated that these changes would have resulted

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in a sufficiently high level of earnings during the base period to justify excess profits tax relief.

Holding

1. Yes, the changes to the business did qualify for consideration under 722(b)(4), however, this alone does not constitute sufficient proof of a claim for relief.

2. No, because even after permissible correction of abnormalities, the taxpayer failed to establish a level of earnings that would lead to larger credits than the ones actually employed.

Court's Reasoning

The court first acknowledged that the opening and subsequent expansion of the Howard Street store qualified as a change in the character of the business under Section 722(b)(4). However, the court found that Hess Brothers failed to establish that this change, if it had occurred two years earlier as permitted by the "push-back" rule, would have resulted in sufficient increased earnings during the base period to justify relief. The court was skeptical of the taxpayer's projections regarding increased sales and profit margins. It questioned the assumption that officers' salaries would remain constant and noted that the taxpayer's evidence of past earnings did not support the level of profits claimed. The court emphasized that because the company's credits were determined using the invested capital method, Hess Brothers needed to show that the constructive average base period net income would result in higher credits than those based on invested capital. Ultimately, the court found that even after making permissible corrections for abnormalities, the company's income would not be high enough.

Practical Implications

This case highlights the importance of providing solid, verifiable financial data when seeking excess profits tax relief. Attorneys should advise clients that merely demonstrating a qualifying event under Section 722(b)(4) is insufficient. The taxpayer bears the burden of proving not just that changes occurred, but that those changes would have generated a specific level of increased earnings. This involves carefully analyzing the taxpayer's base period financials, including sales figures, profit margins, and operating expenses. Taxpayers should be prepared to justify assumptions about expenses, such as officers' salaries, and show that the reconstructed income calculations are consistent with the actual financial performance. This case further underscores the need for detailed documentation to support claims for excess profits tax relief, particularly when dealing with complex issues like the allocation of costs or reconstruction of sales figures.

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