31 T.C. 857 (1959)

To qualify for excess profits tax relief under section 722(b)(2) of the Internal Revenue Code of 1939, a taxpayer must demonstrate that its base period earnings were depressed due to temporary economic circumstances unusual in its experience and that a constructive average base period net income (CABPNI) would yield greater tax credits than those allowed under the invested capital method.

Summary
Empire Construction Company sought excess profits tax relief under section 722(b)(2), arguing that its business was depressed during the base period due to the Baltimore & Ohio Railroad's (B&O) reduced expenditures for additions and betterments, its primary customer. The Tax Court denied relief, finding that while Empire's business was affected by the B&O's economic difficulties, the impact was not solely due to temporary and unusual circumstances. The Court also held that the taxpayer failed to demonstrate that the CABPNI would provide a greater credit than that provided by the invested capital method. Moreover, the Court rejected the taxpayer's claim to exclude losses from a Pennsylvania Turnpike contract, finding the loss was due to business judgment errors rather than external economic factors.

Facts
Empire Construction Company (Empire) was a Maryland corporation specializing in heavy railroad construction. During the base period (1936-1939), Empire's primary customer, the B&O, experienced financial difficulties leading to reduced spending on construction projects. Empire filed for excess profits tax relief, arguing that the B&O's reduced spending depressed its base period earnings. Empire also sought to exclude a substantial loss from a Pennsylvania Turnpike contract completed in 1939 from the calculation of its average base period net income. The Commissioner of Internal Revenue disallowed Empire's claim, leading to this Tax Court case.

Procedural History
Empire filed for excess profits tax relief under section 722 of the Internal Revenue Code of 1939. The Commissioner denied Empire's claim, resulting in a notice of deficiency. Empire appealed to the United States Tax Court, which considered whether Empire qualified for relief under section 722(b)(2), specifically focusing on whether Empire's business was depressed due to temporary economic circumstances unusual to the company, and whether it could reconstruct its base period net income to obtain greater tax credits. The Tax Court ruled in favor of the Commissioner, denying Empire’s claim for relief.

Issue(s)
1. Whether Empire's business was depressed during the base period due to temporary economic circumstances unusual in its experience, specifically due to a decline in business from the B&O.

© 2025 SCOTUSreports.com. All rights reserved. 

2. Whether Empire demonstrated that a constructive average base period net income (CABPNI) would produce excess profits credits greater than those allowed under the invested capital method.
3. Whether Empire was entitled to exclude losses incurred on the Pennsylvania Turnpike contract in computing its CABPNI.
4. Whether, if relief under section 722 was denied, Empire could reduce accumulated earnings and profits by deferred excess profits taxes when calculating invested capital credits.

Holding
1. No, because the Court found that while Empire’s earnings were depressed in the base period, this was not solely due to temporary and unusual circumstances. The low volume of business from the B&O during the base period was caused in part by a temporary factor, namely, its disproportionately high debt and interest burden, but also because of permanent factors that affected the income of all Class I railroads.
2. No, because the Court found that Empire’s proposed reconstruction of base period earnings did not result in a CABPNI that would provide for tax credits greater than the invested capital method.
3. No, because the Court found that the loss on the Pennsylvania Turnpike contract was attributable to errors in judgment, which is not an external economic circumstance.
4. Yes, because Empire's claim for Section 722 relief was denied, the deferred tax liabilities became part of the deficiencies in excess profits taxes due.

Court's Reasoning
The Court referenced section 722(b)(2), which allows for relief when a taxpayer’s average base period net income is an inadequate measure of normal earnings because the business was depressed due to temporary economic circumstances. The Court recognized that Empire’s earnings were depressed due to a decline in the volume of business received from the B&O during the base period. It determined the decline was due to the B&O's disproportionately high interest burden in relation to its net railway operating income, which exceeded that of comparable railway groups and left it with relatively less income available for expenditures for additions and betterments, which was a temporary condition. However, the Court found that the relief was not merited because Empire failed to prove that a CABPNI would generate larger tax credits than those from the invested capital method. The court also rejected Empire's claim to exclude the Pennsylvania Turnpike contract loss, deeming the loss to have been caused by an error in judgment rather than an external economic factor.
The Court cited language from a Commissioner’s Bulletin which stated, “First, the temporary and unusual character of the circumstance or event must be clearly established. Second, the cause of the temporary depression must be shown to be external to the taxpayer, in the sense that it was not brought about primarily by a managerial decision.”

© 2025 SCOTUSreports.com. All rights reserved. 

Practical Implications
This case emphasizes the stringent requirements for claiming excess profits tax relief based on economic hardship. For attorneys, it means:
– Proving Temporary and Unusual Circumstances: Establishing that the economic factors impacting a taxpayer’s base period earnings were both temporary and unusual for that specific business is critical.
– Demonstrating Impact on Base Period: The taxpayer must show a direct causal link between the temporary economic circumstances and the depression of base period income.
– Reconstruction Requirements: Taxpayers must provide compelling evidence to support any reconstruction of base period earnings to meet the requirements for CABPNI.
– Excluding Losses: Business errors that result in losses, such as underestimating project costs, are not considered to be temporary economic circumstances.
– Application of the Invested Capital Method: This case highlights how the invested capital method may provide more favorable results than a section 722 claim.
– It clarifies that relief is unavailable if the taxpayer cannot show a CABPNI that would yield tax credits greater than those available through the invested capital method.

© 2025 SCOTUSreports.com. All rights reserved. 