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KIMBLE GLASS COMPANY AND OWENS-ILLINOIS GLASS COMPANY, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket Nos. 59484, 64203.
United States Tax Court
Filed March 31, 1961.

1. Held, Kimble Glass meets the requirements of section 435(e) (1)(B), 1939 Code, and is entitled to compute its average base period net income under section 435(e)(2).
2. Held, Kimble Glass satisfied the requirements of section 433 (b)(18), so that in determining its excess profits net income for 1948 and 1949, it is entitled to exclude losses which it realized from its **Kaylo** products business.
3. Held, in computing excess profits credit of Owens-Illinois there should be excluded Kaylor losses realized by or allocated under part II to Kimble Glass, and there should be included profits of the television tube business realized by Owens-Illinois.
4. Held, each petitioner's liability for 1950 excess profits tax imposed under section 430 is a liability to be taken into account in computing its net capital addition for 1951 under section 435(g).
5. Held, the Commissioner properly determined the deduction for depletion of feldspar mined by petitioner in accordance with sections 23(m) and 114(b)(4)(A) (iii).

Roswell Magill, Esq., Henry de Kosmian, Esq., and Donald M. Hawkins, Esq., for the petitioners.

Frank W. Hardy, Esq., for the respondent.

The Commissioner determined deficiencies in income tax for the years 1950 and 1951, as follows:

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Each petitioner claims that there was overpayment of tax. Kimble Glass has received a tentative carryback refund of $210,845.11. It claims an additional carryback refund of $837,634.01 for 1950 and a refund of $1,925.56 for 1951. Owens-Illinois claims a refund of not less than $179,417.51 for 1951.

The issues are:

(1) Whether Kimble Glass Company meets the requirements of section 435(e)(1) (B) so as to be entitled to compute its average base period net income under section 435(e)(2), 1939 Code.

(2) Whether Kimble Glass Company is entitled to exclude its **Kaylo** losses for 1948 and 1949 in the computation of its average base period net income.

(3) Whether in computing the average base period net income of Owens-Illinois, there should be included television bulb profits realized by Owens-Illinois,

and there should be excluded **Kaylo** losses realized by Kimble Glass or allocated

Some of the questions in these cases relate to certain transactions between Owens and Kimble which grew out of the production of two distinct and different lines of products, namely, **Kaylo** products, and the manufacture of television bulbs.

Kaylo Products.

In the latter part of 1939, because of increased competition in the glass container business, Owens began to extend its production to other products. In the latter part of 1939, it began developing roofing tile made of lime, silica sand, and asbestos, which product originally was given the trade name 'Microporite,' which was changed to **Kaylo.** **Kaylo** is not glass. Owens began producing **Kaylo** products in 1941 at its plant located in Berlin, New Jersey. **Kaylo** can be used as roof deck slabs, structural wall panels, and fire doors. It was believed that **Kaylo** also could be used as a heat-insulating material, such as a covering for pipes. For the manufacture of **Kaylo** products, Owens acquired the Berlin Plant, which was a sand-lime-brick plant, and another plant at Sayreville, New Jersey.

During the 1940's, Owens also made blocks and insulators of glass. These products and **Kaylo** products are used in the building and construction industry. Owens produced glass blocks and insulators at its plants at Muncie, Indiana, and Columbus, Ohio. It called this division of its business the Insulux Products Division. **Kaylo** products and glass blocks and insulators are different products than glass bottles and containers, and are sold in different markets.

As stated above, Owens brought about the organization of a new corporation (now called Kimble) on December 23, 1947. On December 24, 1947, Ownes made a written offer to subscribe for all of the authorized capital stock of Kimble, 10,000 shares of common stock, to be paid for by the transfer of certain properties, subject to liabilities, which offer was accepted by Kimble. As of the end of 1947, the 10,000 shares of stock of Kimble was issued to Owens in exchange for the stipulated properties. Thereafter, Kimble was a wholly owned subsidiary of Owens.

The chief reason of Owens for organizing Kimble was to transfer to it the two divisions of Owens engaged in making glass blocks and insulators, and **Kaylo** products. Owens believed that it would be profitable and efficient to have the production of products used in the construction business carried on by a separate corporation, and that **Kaylo** products could be marketed through the same outlets which distributed glass blocks. In accordance with that plan, Owens transferred as of the end of 1947, in exchange for Kimble's stock, the assets (subject to certain liabilities) used in its glass block and insulator and **Kaylo** divisions. Such assets included cash and prepaid items, and notes and accounts receivable; and the plants at or near Columbus, Ohio, Muncie, Indiana, Sayreville, New Jersey, and Berlin, New Jersey, together with the machinery, equipment, fixtures, raw materials, finished goods, work in process, supplies, and machine parts located at and belonging to each plant.

Kimble made no sales during 1946 and 1947, and did not get into any productive business until after the end of 1947.

Kimble produced **Kaylo** products at the two New Jersey plants, and glass blocks and insulators at the plants in Muncie and Columbus. Within a short period of time, after a relatively small production of glass blocks and insulators at the Columbus plant, such production there was discontinued, and on June 15, 1948, Kimble sold the Columbus plant, with its machinery, equipment, and assets to Owens for cash at their book value, $1,736,459.19. No gain or loss was reported from this transaction by either Kimble or Owens.

Kimble carried on the production of glass blocks and insulators at the Muncie plant where such production is still carried on.

Kimble was unable to manufacture **Kaylo** products at a sufficiently low cost so as to sell it at a profit. More efficient manufacturing processes were essential. Moreover, contrary to original expectations, it was found that it was not possible to market **Kaylo** through glass block distribution channels. It was concluded that the problem of producing **Kaylo** profitably could best be solved by combining the more experienced research personnel of Owens (who had participated in the initial development of **Kaylo)** with the production personnel, who then could devote undivided attention to the problems involved, and that in the meantime efforts to market **Kaylo** products should be curtailed.

It was decided that the **Kaylo** business should be transferred back to Owens. Therefore, on July 1, 1949, Kimble sold to Owens the assets used in the **Kaylo** business, including the two plants in New Jersey, for $11,631,741.46, the book value of the assets, which was paid partly in cash and partly by cancellation of amounts owed by Kimble to Owens. No gain or loss was reported by either Kimble or Owens from this transaction. As of June 30, 1949, Kimble discontinued the **Kaylo** business, and no losses from such business were sustained by Kimble after that date.

The period during which Kimble produced **Kaylo** was from January 1, 1948, through June 30, 1949. Kimble produced only **Kaylo** products at the two plants in New Jersey in Berlin and Sayreville, and it maintained a separate sales organization to sell **Kaylo** products.

Kaylo is classifiable in major group 32, subgroup 329, of the Standard Industrial Classification Manual of the Bureau of the Budget of the United States. All other products produced by Kimble, namely, glass blocks, glass insulators, differed substantially from **Kaylo,** as did television bulbs which Kimble produced after June 30, 1949. Glass blocks, insulators, and television bulbs are classified in major group 32, subgroup 322, of the above-named manual.

Kimble sustained losses from the production and sale of **Kaylo** products which amounted to $2,335,152.17 during 1948, and $1,161,859.66 during the first 6 months of 1949; a total loss of $3,497,011.83.

After the sale on July 1, 1949, by Kimble to Owens of the assets used in the **Kaylo** business, Owens sustained losses in 1949, 1950, and 1951 from its conduct of the **Kaylo** business, in the respective amounts of $978,616.77, $2,338,204.48, and $2,123,607.01. Subsequently, however, Owens' operations were more successful and recently Owens has conducted its **Kaylo** business at a profit.

As determined by the respondent, Kimble's excess profits net income for 1949 was $3,116,615.65. It sustained a loss for 1948 of $2,107,561.75. The net amount of Kimble's excess profits net income for 1948 and 1949 was, therefore, $1,009.053.90.

As defined by section 433(b)(18), 1939 Code, Kimble's aggregate excess profits net income, i.e., the net amount of its excess profits net income increased by the sum of its **Kaylo** losses for those years, was $4,506,065.73. The sum of Kimble's net losses from its **Kaylo** business during the base period was more than 15 percent of its aggregate excess profits net income during the base period.

Television Bulbs.

During the second World War, Owens engaged in the production of handblown, cathode-ray tubes for use in radar equipment. They were forerunners of television bulbs. After the end of the war, Owens experimented with the production of television bulbs and it believed that the production of them would become an expanding and profitable business. A television bulb is the glass portion of the picture tube in a television set. It consists of a glass faceplate, funnel, and neck. Television bulbs and television sets were not generally available to the public at any time before January 1, 1946.

As the television industry grew, it became necessary to produce larger television bulbs, and production by glass blowing was not practical. Owens began to produce, separately, the faceplate, the funnel, and neck. The faceplate and the funnel are produced by glass pressing, and the neck is made from glass tubing. The three component parts are sealed together to make a television bulb.

The production of glass blocks by Kimble, at its Muncie, Indiana, plant, involved the same basic process of glass pressing and sealing as were involved in making a television bulb. For example, the two halves of a glass block are produced by pressing glass and then sealing together two halves to make a glass block. In the glass block business, there was the greatest experience with glass-pressing processes. Because that is true, Owens decided to transfer its television bulb business to Kimble in order to unify the manufacture of two products (television bulbs and glass blocks) which were produced by essentially the same manufacturing processes.

On July 1, 1949, the same day that the **Kaylo** assets were sold by Kimble to Owens, Owens sold its assets used in the production of television bulbs (including the plant at Columbus, Ohio, which had been converted to the production of television bulbs in 1948) to Kimble. Such assets were sold for $2,288,043.22, in cash, which was the book value. No gain or loss was reported by either Owens or Kimble. Thereafter, Kimble produced and sold television bulbs. It is still engaged in that business.

Kimble had no sales of any kind during 1946 and 1947. Its net sales for the period January 1, 1950, through June 30, 1950, after discounts of $133,021.65, amounted to $13,559.275.54. Such amount multiplied by 2 equals $27,118,551.08.

The net sales of Owens for 1946 were $187,040,467.47; and for 1947, they were $227,384,498.35. The average net sales of Owens for 1946 and 1947 amounted to $207,212,482.91.

The net sales of Owens of **Kaylo** products and of glass blocks and insulators for 1946 were $6,041,197.85, and for 1947 were $6,845,225.07. Its average net sales of such products for 1946 and 1947 were $6,443,211.46.

On June 16, 1952, Kimble and Owens entered into an agreement relating to earnings during the years 1946 and 1947 of the glass block and glass insulator business, and the **Kaylo** business, i.e., attributable to the assets transferred by Owens to Kimble at the end of 1947. The net 1946-1947 excess profits net income attributable to such assets was $52,514.16, namely, income of $884,196.89 for 1946, and a loss of $831,782.73 for 1947. These amounts were Glass' 1951 return and within 3 years after the payment by Kimble Glass of $1,060,703.74 of 1951 income tax.

Kimble Glass satisfies the requirements of section 435(e)(1)(B) and is entitled to compute its excess profits credit for the calendar years 1950 and 1951 under section 435(e)(2) of the 1939 Code.

In determining its excess profits net income for 1948 and 1949 for the purpose of determining its excess profits credit, Kimble Glass is entitled to exclude under section 433(b)(18) of the 1939 Code **Kaylo** losses of $2,335,152.17 for 1948 and $1,161,859.66 for 1949.

In determining Kimble Glass' equity capital at the beginning of 1951 under section 437(c) for the purpose of computing its capital addition for the calendar year 1951 under section 435(g), Kimble Glass' liability for excess profits tax under section 430 for the calendar year 1950 was a liability existing at the beginning of 1951 and is to be taken into account in computing such equity capital and such capital addition.

During 1946 and 1947 Owens-Illinois realized losses from **Kaylo** of $472,848.80 and $798,027.37, respectively. Such losses were reflected in the excess profits net income allocated to Kimble Glass pursuant to the agreement executed between Owens-Illinois and Kimble Glass on June 16, 1952.

Owens-Illinois realized profits from television bulbs for 1946 of.$43,949.43, for 1947 of $196,736.78, for 1948 of $203,312.74, and for 1949 of $1,289,022.22.

In determining Owens-Illinois' normal-tax net income and surtax net income for 1946, 1947, 1948, and 1949, the respondent did not exclude therefrom the above television bulbs profits and did not reduce such net incomes for 1948 and 1949 by losses realized by Kimble Glass from **Kaylo** during 1948 and the first 6 months of 1949.

Owens-Illinois paid 1951 Federal income tax in the aggregate amount of $30,494,533.75 as follows:

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March 17 $11,000,000.00

June 16 10,346,173.63

September 15 4,574,180.06
December 15 4,574,180.06

On April 6, 1955, Owens-Illinois and the respondent entered into an agreement extending to June 30, 1956, the period of limitations for the assessment of a deficiency in 1951 Federal income tax.

The agreement was entered into within 3 years after the filing of Owens-Illinois' 1951 Federal income tax return and within 3 years after the payment by Owens-Illinois of 1951 Federal income tax of $19,494.533.75.

In computing the average base period net income of Owens-Illinois for the purpose of determining its excess profits credit, the net income realized by Owens-Illinois from television bulbs for the calendar years 1946, 1947, 1948, and the first 6 months of 1949, is includible in the average base period net income of Owens-Illinois.

In computing the average base period net income of Owens-Illinois for the purpose of determining its excess profits credit, losses realized from **Kaylo** by Owens-Illinois for the calendar years 1946 and 1947, and losses realized by Kimble Glass from **Kaylo** for the calendar year 1948 and the first 6 months of 1949 are not includible therein.

In determining Owens-Illinois' equity capital at the beginning of 1951 under section 437(c) of the 1939 Code, for the purpose of computing its capital addition for the calendar year 1951 under section 435(g) of the 1939 Code, Owens-Illinois' liability for excess profits tax under section 430 of the Code for the calendar year 1950 was a liability existing at the beginning of 1951, and is to be taken in account in determining the equity capital and capital additon.

Depletion Issue.

During 1951 Owens-Illinois operated two glass bottle manufacturing plants in California, one at Los Angeles, and the other at Oakland, California.

The two principal ingredients used in this production of glass are feldspar and silica. Throughout its other glass-manufacturing operations in other parts of the country, Owens-Illinois purchased the necessary feldspar and silica in 1948 and 1949 from its **Kaylo** business, under section 433(b)(18), in determining its excess profits net income for 1948 and 1949 for the purpose of determining its average base period net income.

Owens-Illinois contends that in determining its average base period net income there should be included in its average base period net income the profits which it realized from its television bulb business, and there should be excluded the losses of the **Kaylo** business which were realized by Kimble Glass, or which are allocated to Kimble Glass under section 462(e)(6).

The petitioners contend further that the amounts of the excess profits tax for 1950 of Kimble Glass and Owens-Illinois, imposed retroactively by the 1950 Excess Profits Tax Act, should be disregarded in determining under section 437(c) the equity capital of each petitioner, respectively.

In its 1951 income tax return, Kimble Glass reported income tax net income of $2,102,418.47, and excess profits net income of $2,099,354.04, and tax in the amount of $1,060,703.74, which it paid. Kimble Glass claimed an excess profits credit for 1951 in the amount of $6,608,022.29, which amount exceeded its excess profits net income for 1951 by $4,508,668.25. Kimble Glass claimed the foregoing amount as an excess profits credit carryback to 1950 and received a refund of $210,845.11 for 1950. For 1950, Kimble Glass reported income tax net income in the amount of $13,149,220.78, excess profits net income of $13,146,608.90, and a tax of $6,845,373.53, which was paid. The above refund of $210,845.11 resulted from the carryback from 1951.

In the notice of deficiency the respondent, making two minor adjustments, determined that for 1951 Kimble Glass' income tax net income was $2,098,624.27, that its excess profits net income was $2,095,559.84, and that the excess profits credit was $1,609,527.92. This resulted in a deficiency of $143,884.02 for 1951 and the disallowance of the tentative refund of $210,845.11 made to Kimble Glass for 1950. For the year 1950 respondent made two small adjustments, resulting in a reduction of total income tax liability as assessed by petitioner on its original return of $1,850.90, which, when combined with the disallowance of the $210,845.11 tentative refund for 1950, resulted in a deficiency of $209,024.25.

Kimble Glass in its petition asserts that it is entitled to compute its average base period net income, for purposes of the excess profits credit, under section 435(e)(2), and further, that in arriving at such base period net income it may exclude certain losses during 1948 and 1949 from its **Kaylo** business within the provisions of section 433(b) (18). Under this theory Kimble Glass claims a refund, based on a claimed excess profits credit of $6,287,016.68, of $837,634.01 for 1950, in addition to the $210,847.11 tentative refund previously received. For 1951, Kimble Glass claims a refund of $1,925.56 which results from the downward adjustment in its income tax net income made by respondent coupled with its prior and present assertion that its excess profits credit exceeds its excess profits net income.

In computing its excess profits credit for the year 1951, Owens-Illinois eliminated from its base period losses sustained in the operation of the **Kaylo** business under the provisions of part II of the Excess Profits Act of 1950, and included in its base period the profits realized from its television bulb operations.

The respondent, in his notice of deficiency, determined that the provisions of part II are not applicable to the losses arising from the operation of the **Kaylo** business, and that such losses must be restored to the base period income of Owens-Illinois. Furthermore, the respondent determined that the provisions of part II are applicable to the television bulb operations and, therefore, the base period profits of the television bulb business are to be eliminated from Owens-Illinois' base period net income.

These two changes in the computation of Owens-Illinois' excess profits credit, along with several minor adjustments, including the allowance of an increased depletion deduction of $38,591.64, resulted in the determination of a deficiency of $330,462.50 for 1951.

In its petitioner, Owens-Illinois maintained its position as to the proper computation in determining its excess profits credit. Furthermore, it claimed an additional depletion deduction of $160,275.10 over the amount claimed on its original return. The claim for an additional depletion deduction resulted in a claim for an overpayment of tax of $179,417.51.

Both petitioners for the year 1951, in computing their net capital additions, one of the elements affecting their excess profits credit, failed to reduce their equity capital for January 1, 1951, by the amount of excess profits taxes for the year 1950, which taxes were imposed retroactively by the Excess Profits Tax Act of 1950, which became effective on January 3, 1951.

Owens-Illinois has been, and is, a leading manufacturer of glass bottles and other glass containers. However, with the increased competition in the container business Owens-Illinois began, as long ago as the 1930's to broaden its line of manufacture into other types of glass products. In 1940 Owens-Illinois began developing a structural product known as **Kaylo** Roof Tile, composed of lime, silica sand, and asbestos. Subsequent to this Owens-Illinois acquired plants at Berlin and Sayreville, New Jersey, where the manufacture of this **Kaylo** product was started.

During the 1940's Owens-Illinois was also engaged in the production of glass blocks and, to a minor extent, glass insulators at plants in Muncie, Indiana, and Columbus, Ohio.

Because these three products, **Kaylo,** glass blocks, and glass insulators, were or were expected to be marketed in the construction and building business and also because the manufacture and marketing of these products differed substantially from its glass container operations, Owens-Illinois decided to set up a subsidiary corporation and transfer to it the assets necessary to manufacture these three products.

This transaction was carried out in late December 1947, by the creation of Kimble Glass and the transfer to it of the plants located at Columbus, Ohio, Sayreville and Berlin, New Jersey, and Muncie, Indiana, including machinery, equipment, furniture and fixtures, inventories, and other assets relating to the properties above described. In return Owens-Illinois acquired 10,000 common shares of Kimble Glass, its entire authorized capital stock, and Kimble Glass became a subsidiary.

Following the transfer of the **Kaylo** and the glass block and insulator businesses to Kimble Glass, it engaged in (1) the production of **Kaylo** at the Sayreville and Berlin, New Jersey, plants and (2) the production of glass blocks and insulators at the Muncie, Indiana, and Columbus, Ohio, plants. Shortly thereafter, the relatively small production of glass blocks and insulators at the Ohio plant was discontinued. On June 15, 1948, Kimble Glass sold the Columbus, Ohio, plant to Owens-Illinois for $1,736,458.19, paid in cash. The production of glass blocks and insulators at the Muncie, Indiana, plant continued and Kimble Glass is still engaged in that activity.

Kimble Glass was unable to manufacture **Kaylo** at a cost which would enable it to be sold profitably. More efficient manufacturing processes were essential.

Moreover, contrary to the original expectation, it was not possible to market **Kaylo** through existing glass block distribution channels. The management concluded that the problem of producing **Kaylo** profitably could best be solved by teaming the more experienced research personnel of Owens-Illinois, who had participated in the initial development of **Kaylo,** with production personnel who could devote undivided attention to the problems involved, and that in the meantime there should be curtailment of efforts to market **Kaylo** products. It was decided that the **Kaylo** business should be transferred from Kimble Glass to Owens-Illinois.

On July 1, 1949, Kimble Glass sold to Owens-Illinois the assets used in the **Kaylo** business, including the Sayreville and Berlin, New Jersey, plants for $11,631,741.46, paid partly in cash and partly by cancellation of amounts owed by Kimble Glass to Owens-Illinois. The sale of these assets was at their book value. No gain or loss was recognized by either party.

Following the above sale, Owens-Illinois conducted the **Kaylo** business and was still doing so at the time of the trial.

On the same day, July 1, 1949, that Kimble Glass sold the **Kaylo** assets to Owens-Illinois, Owens-Illinois sold to Kimble Glass its assets used in the production of television bulbs, including the plant at Columbus, Ohio, which had been converted to the production of television bulbs in 1948. Such assets were sold at their book value for cash in the amount of $2,288,043.22. No recognized gain or loss to either party resulted from this sale.

Kimble Glass, it has not been shown that it had such an increase; but, rather, that Kimble Glass merely substituted a profitable product, television bulb assets, for an unprofitable product, the **Kaylo** assets.

In the Lucky Lager case, we recognized that the general approach of section 435(e)(1)(A) was to measure increase in physical volume, and that one of the tests there used for this purpose was that gross receipts for the last half of the base period should be 150 percent or more of gross receipts for the first half of the base period. However, we observed that the gross receipts test is not a direct measure of physical volume of production because an increase in gross receipts could result solely from an increase in the price of the commodity sold without any attendant increase in the physical volume of production. We stated that this possibility was in the legislative mind, but that the percentage used in the gross receipts test was deemed by Congress to be sufficiently large so that only those taxpayers will be able to qualify whose business has grown substantially more rapidly than the average.

Section 435(e)(1)(B) was introduced as a floor amendment in the Senate (96 Cong. Rec. 16803) and, therefore, the House and Senate committee reports do not discuss this subsection. It may be presumed, however, that subsection (B) also attempts to measure increase in physical volume of production, using sales as the yardstick. However, what we said about subsection (A) must also apply to subsection (B), namely that Congress, though earnings experience. He cites Industrial Loan Society, Inc., 14 T.C. 487.

There is no merit in this contention. The statute requires that part of the net sales in 1946-1947 by Owens-Illinois shall be allocated to Kimble Glass for the purpose of determining whether Kimble Glass is qualified under the television growth formula; i.e., whether Kimble Glass' own 1949 and 1950 sales exceeded the 1946 and 1947 sales allocated to it by the required percentages. In determining its own base period net income under section 435(e)(2), Kimble Glass has to use only its own base period experience for 1949 and 1950. On the other hand in determining its average base period net income, Owens-Illinois has to use its own base period income reduced by the 1946-1947 excess profits net income allocated to Kimble Glass under section 462(i)(6), which Kimble Glass cannot use in computing its average base period net income under section 435(e)(2). We agree with the petitioners that the respondent's concern about a duplication of earnings experience is unfounded because there is no duplication of earnings experience.

It is concluded that Kimble Glass has satisfied each of the requirements of section 435(e)(1)(B) and, therefore, is entitled to the benefits of its provisions, and may compute its average base period net income under section 435(e)(2).

The next question is whether in determining its excess profits net income for 1948 and 1949, Kimble Glass is entitled to exclude losses from its **Kaylo** business and differed substantially from the taxpayer's other business unless it is of a type classifiable by the Standard Industrial Classification Manual in a different major industry group or in a different subgroup of the taxpayer's major industry group than that in which its other business is so classifiable: Provided, however, That this paragraph shall not apply unless the sum of the net losses of such branch during the base period exceeded 15 per centum of the aggregate excess profits net income of the taxpayer during the base period. For the purposes of this paragraph, the aggregate excess profits net income of the taxpayer during the base period shall be the sum of its excess profits net income for all years in the base period, increased by the sum of the net losses of such branch during the base period.

Kimble Glass acquired the **Kaylo** and the glass block and insulator businesses from Owens-Illinois at the end of 1947. Kimble Glass produced and sold **Kaylo** in 1948 and 1949. It realized a loss from its **Kaylo** business for 1948 of $2,335,152.17. During 1949 it realized a further loss from that business of $1,161,859.66. The question is whether such **Kaylo** losses are excludible in computing Kimble Glass' excess profits net income for 1948 and 1949 under section 433(b)(18).

The first requirement under section 433(b)(18) is that the branch must have been operated at a loss during 2 or more taxable years in the base period. Kimble Glass operated the **Kaylo** business during the taxable years 1948 and 1949 and realized losses therefrom during each of such 2 years.

The second requirement is that the **Kaylo** business must have been a branch of Kimble Glass' business. That term is defined in section 433(b)(18) to mean a 'unit or subdivision of the taxpayer's business which was operated in a separate place from its other business and differed substantially from its other business with respect to character of products or services.' **Kaylo** was produced by Kimble Glass at separate plants at Sayreville and Berlin, New Jersey, and was marketed through a separate sales organization. During the same period, Kimble Glass was producing glass blocks and insulators at Muncie, Indiana, and at Columbus, Ohio. Kimble Glass has shown that **Kaylo** differed substantially from the other base period products of Kimble Glass which consisted of glass blocks and insulators and, after June 30, 1949, television bulbs. Glass blocks and insulators and television bulbs were all glass products. **Kaylo** was not a glass product. **Kaylo** was a chemical compound of lime, asbestos, and sand and was useful as an insulating material, as well as for roof deck slabs, wall panels, and fire doors. If **Kaylo** had not differed substantially from the other base period products, it would not have been possible for Kimble Glass to have sold the **Kaylo** business to Owens-Illinois on June 30, 1949, and to have retained the glass block and insulator business and acquired the television bulb business. **Kaylo** is still being produced by Ownes-Illinois, and Kimble Glass is producing glass blocks, glass insulators, and television bulbs.

Respondent argues that **Kaylo** was similar to glass blocks and insulators because all were used in the building and construction industry, and, therefore, that the **Kaylo** business did not differ substantially from the glass block and insulator business. This contention is clearly without merit. For example: Many products other than glass are used in the building and construction industry, such as steel and wood. It cannot be said that the steel business and the lumber business do not differ substantially from the glass block business. As a matter of fact, the glass insulators produced by Kimble Glass were used primarily by the communication industry. Furthermore, **Kaylo** products were not restricted to the building and construction industry because **Kaylo** had important uses as an insulating product, and it was in the high-temperature insulation field that **Kaylo** ultimately was found to have its best application.

Another requirement of section 433(b)(18) is that the branch business must have been classified by the Standard Industrial Classification Manual in a different major industry group or in a different subgroup of such major industry group than that in which the taxpayer's other businesses were classified. It has been stipulated that Kimble Glass satisfies this requirement; that is to say, that the production of **Kaylo** was classified in a different major industry subgroup than the production by Kimble Glass of its other base period products, consisting of glass blocks and insulators and television bulbs.

The final requirement is that the sum of the branch net losses during the base period must have exceeded 15 percent of the taxpayer's aggregate excess profits net income during the base period which, for this purpose, is increased by the sum of the net losses from the branch in question. Kimble Glass easily satisfies this requirement. Its excess profits net income during 1948 and 1949, when increased by the **Kaylo** losses, aggregated $4,506,065.73.

It is concluded that Kimble Glass is entitled to exclude its **Kaylo** losses for 1948 and 1949 in the computation of its average base period net income. Since Kimble Glass did not realize any **Kaylo** losses for the years 1950 and 1951 here involved, the adjustment under section 433(b)(18) is the full amount of its 1948 and 1949 net **Kaylo** losses.

Respondent argues that if Kimble Glass' contentions are sustained, the result will be that neither the average base period net income of Owens-Illinois nor of Kimble Glass will reflect the **Kaylo** losses of Kimble Glass. That is true, but we believe it is immaterial. As far as Owens-Illinois is concerned, the **Kaylo** losses of Kimble Glass were not realized by Owens-Illinois, and such losses should not be reflected in the average base period net income of Owens-Illinois. The inevitable effect of section 433(b)(18) in any case to which it is applicable is that the losses excluded thereunder are not reflected in the average base period net income of the taxpayer which realized them and are not reflected in the average base period net income of any other taxpayer. The respondent erred in failing to allow Kimble Glass the benefit of section 433(b)(18).

Computation of Average Base Period Net Income of Owens-Illinois.

This issue involved the determination of the average base period net income of Owens-Illinois, for the purpose of computing its excess profits credit, with respect to which the respondent has mad adjustments for which, the petitioners contend, there is no supporting authority. The respondent made his determination under a view about certain transactions of Owens-Illinois and Kimble Glass, involving both **Kaylo** and television bulb products and assets, with which petitioners vigorously disagree. Furthermore, respondent's adjustments were made under a theory which the petitioners claim is without foundation.

The respondent excluded from the average base period net income of Owens-Illinois, the television bulb profits realized by it when Owens-Illinois operated the television bulb business during the period January 1, 1946, to June 30, 1949. That determination of the respondent was made in computing the excess profits credit of Owens-Illinois. Respondent made that determination upon his theory and conclusion that the television bulb business, in 1949, was transferred to Kimble Glass in a part II transaction (secs. 461-464, 1939 Code), which the petitioners deny. They say that there was a sale for cash.

The transfer of assets to Kimble Glass was made on July 1, 1949. Respondent refers to that transfer as Transaction 2 (under his theory), as distinguished from the transfer of the **Kaylo,** Insulux, and other assets by Owens-Illinois to Kimble Glass on January 2, 1948, which he refers to as Transaction 1 (under his theory). Reference is made hereinafter to these transactions. Petitioners object to respondent's premise that what respondent calls Transaction 2 was a finalization' of Transaction 1.

Petitioners maintain that when the **Kaylo** assets were transferred to Kimble Glass (then A.S.P.) at the end of 1947, or the beginning of 1948, there was then no predetermined plan contemplating any subsequent transfers of properties such as were made on July 1, 1949.

Since the very statement of the problem involves referring to the operation of the **Kaylo** products business by one or the other of the petitioners, and, also, the operation of the television tube business by one or the other of the petitioners, it may be convenient, to say the least, to restate the background facts before turning to the questions to be decided.

Kimble Glass was incorporated on December 23, 1947, under the name of American Structural Products Company.

Owens-Illinois developed prior to 1947 a chemical-compound product made of lime, silica, asbestos, and sand to which it gave the trade name **'Kaylo.'** Owens-Illinois operated the **Kaylo** business during 1946 and 1947, prior to transferring it to Kimble Glass. It began production of **Kaylo** in 1941.

As of January 2, 1948, or at the end of 1947, Owens-Illinois transferred several assets and production divisions, including the Insulux Division (which made glass blocks and insulators) and the **Kaylo** Division to Kimble Glass (A.S.P.) in return for all of its authorized capital stock, consisting of 10,000 shares of the common stock and it became a wholly owned subsidiary of Owens-Illinois.

The respondent points out that this transaction was a part II transaction of the type described in section 461(a)(1)(E), part II, subchapter D, and that Kimble Glass became an acquiring corporation, and Owens-Illinois became a component corporation within the definitions contained in section 461 (a) and (b). The petitioner does not deny this. Under respondent's theory, this is the start of the problem here.

Kimble Glass carried on the **Kaylo** production business from the beginning of 1948 until July 1, 1949. It sustained losses. They amounted to $2,335,152.17 in 1948, and $1,161,859.66 in the first 6 months of 1949.

On July 1, 1949, Kimble Glass sold the **Kaylo** business and assets, including two plants in New Jersey to Owens-Illinois for cash in the sum of $11,631,741.46. Thereafter, Kimble did not carry on any **Kaylo** business. The assets were sold at book value. Accordingly, Kimble carried on the **Kaylo** business only from January 1, 1948, through June 30, 1949.

After June 30, 1949, Owens carried on the **Kaylo** business from July 1, 1949, on, and it still operates that business. Owens sustained losses, as stated in the facts in each of the years 1949, 1950, and 1951. Subsequently that business showed a profit.

It is at this point that respondent's views under this issue turn to an allegation about what he regards as a tendency of Owens to transfer assets back and forth rather freely, for on July 1, 1949, Owens sold assets to kimble, namely, its television bulb production assets, including a plant in Columbus, Ohio, where TV bulbs were made. Owens sold the assets for cash, at book value, for the sum of $2,288,043.22, and no gain or loss was realized. Thereafter Kimble produced TV bulbs and still does so.

Owens owned and operated the TV bulb business from January 1, 1946, to June 30, 1949. From that business, Owens realized net profits as follows:.

$43,949.43 for 1946; $196,736.78 for 1947; $203,312.74 for 1948; and $1,289,022.22 for 1949.

The respondent takes the following position: Transaction 1, at the end of 1947, the exchange of Kimble's stock for the **Kaylo** assets, was a part II transaction. Transaction 2, on July 1, 1949, involved two transactions, the sale of **Kaylo** assets by Kimble to Owens, and the sale of TB bulb assets by Owens to Kimble. The respondent argues that these two sales of assets were mere form, and that in substance there was only an exchange of assets by Owens and Kimble and a 'finalization' of the 1947 transfer of the **Kaylo** business to Kimble, whereby those assets went back to Owens-Illinois. As such, respondent argues that Transaction 2 was a part II transaction, also, and that Kimble is still, in this transaction, the acquiring corporation, as described in section 461(a)(1)(E), and Owens is still its component.

It is the respondent's primary contention that the losses sustained from the carrying on of the **Kaylo** productions business must be included in Owens-Illinois' 'base period experience in order that its excess profits credit and excess profits net income be computed on a consistent basis.' He argues that since Owens operated the **Kaylo** business during the base period years of 1946 and 1947 and the last 6 months of 1949 and all of the excess profits tax years, it is only proper that all of the Kayl0 losses incurred during the base period years should be included by Owens in the computation of its excess profits credit. He applies the same reasoning to the profits realized from the conduct of the TV bulb business, namely, that since Owens did not have the TV bulb business during its excess profits years, it would be improper to include the TV bulb profits in Owens' base period experience. Therefore, the respondent contends that he properly excluded the profits realized from the TV bulb business in computing Owens' excess profits credit. Cf. Wood-Mosaic Company v. United States, 160 F.Supp. 636,affd. 272 F.2d 944, involving a part II transaction, which held that a component corporation is not entitled to use its pre-1947 base period earnings experience where it transferred assets to an acquiring corporation in 1947 in a transaction described in section 461.

The question is, therefore, whether the transactions on July 1, 1949, constituted a part II transaction, so that in computing the excess profits credit of Owens-Illinois, the losses sustained in the years 1946-1949, inclusive, from the operation of the **Kaylo** business must be included in the base period experience of Owens, and the profits earned during the years 1946 to 1949, inclusive, in operating the television bulb business must be excluded from the base period experience of Owens.

The position of Owens-Illinois is that there were bona fide, arm's-length sales of properties on July 1, 1949, and that the evidence does not provide any support for respondent's claim that the transfers of properties by Kimble Glass to itself, or the transfers by itself to Kimble constituted a part II transaction, in which Owens-Illinois was a component corporation.

The crux of the issue is whether the July 1, 1949, transaction was a part II transaction. The respondent argues for the application of the substance-over-form rule in these cases, and he urges the invocation of that rule here to avert distortion of the purpose of the statute. We are of the opinion, however, that the record does not support a finding that the transactions of both corporations with each other involved mere paper transfers of property between affiliated corporations. For example, on the record here, a holding that the 1949 transfers of properties were not sales for cash would be unwarranted. Nor are we able to conclude that Kimble's sale in 1949 of the **Kaylo** business properties to Owens-Illinois was the last step in a series of several planned steps. Distributors Finance Corporation, 20 T.C. 768; Charles R. Mathis, Jr., 19 T.C. 1123.

It is concluded that the 1949 transaction was not a part II transaction.

The television bulb profits were realized by Owens-Illinois during the period when it owned and operated the television bulb business. Section 433(b) provides that a corporation's excess profits net income for taxable years in the base period shall be 'the normal-tax net income, as defined in section 13(a)(2)' adjusted as provided in paragraphs (1) through (18). Respondent does not contend that the television bulb profits realized by Owens-Illinois were not includible in its 'normal-tax net income' for the years involved. In fact, he treated them as being the income of Owens-Illinois rather than of Kimble-Glass for purpose of determining the income tax liability of Owens-Illinois and Kimble Glass for the years 1946-1949. Nor does respondent contend that any of the adjustments specified in paragraphs (1) through (18) of section 433(b) are applicable. Since the television bulb assets were not transferred to Kimble Glass in a part II transaction, we are unable to find a legal basis for respondent's action in excluding those profits from the average base period net income of Owens-Illinois.[FN3]

The situation is the same with respect to the **Kaylo** losses. Kimble Glass owned and operated the **Kaylo** business during 1948 and the first 6 months of 1949. The losses for those periods were realized by Kimble Glass. In determining the income tax liability of Owens-Illinois and of Kimble Glass for 1948 and 1949, the respondent did not attempt either to allow to Owens-Illinois or to disallow to Kimble Glass the losses realized by Kimble Glass for those years. Respondent does not contend that any of the adjustments prescribed in section 433(b) justify the allocation of the **Kaylo** losses of Kimble Glass to Owens-Illinois.

With respect to the 1946 and 1947 **Kaylo** losses realized by Owens-Illinois but allocated to Kimble Glass under section 462(2)(6), we understand that respondent's attempt to reallocate those losses is based on the same theory as his proposal to allocate to Owens-Illinois the 1948 and 1949 losses of Kimble Glass. It is our view that the 1946 and 1947 **Kaylo** losses were, however, properly allocated to Kimble Glass under section 462(i) (6), we understand that respondent's attempt to reallocate those losses is based on the same theory as his proposal to allocate to Owens-Illinois the 1948 and 1949 losses of Kimble Glass. It is our view that the 1946 and 1947 **Kaylo** losses were, however,

properly allocated to Kimble Glass under section 462(i)(6), together with the glass block and insulator profits of Owens-Illinois for 1946 and 1947, and, therefore, that such **Kaylo** losses should be excluded from the average base period net income of Owens-Illinois.

We conclude that the base period transactions between Kimble Glass and Ownes-Illinois were undertaken for sound business purposes and were bona fide. Originally **Kaylo** was transferred to Kimble Glass, along with the glass block and insulator business, because it was thought that both operations were foreign to the basic glass container business of Owens-Illinois that both products could be marketed in the building and construction industry, and that a strong company in that industry could be established. The evidence shows that it soon became apparent that considerable additional work had to be done in order to produce **Kaylo** profitably. It was decided that the **Kaylo** business should be transferred to Owens-Illinois to take advantage of its more experienced research personnel. In the meantime, it was decided that there should be a curtailment of efforts to market **Kaylo.** Technological problems in connection with the production of television bulbs led the management of Owens-Illinois to conclude that that operation should be transferred to Kimble Glass since Kimble Glass was producing glass blocks and insulators by the same glass pressing and sealing techniques which were required in the manufacture of television bulbs. Both moves turned out advantageously. Television bulbs were produced profitably by Kimble Glass, and Owens-Illinois ultimately solve the problems involved in producing **Kaylo** which is now being produced at a profit. The business soundness of the 1949 transactions is evidenced today by the fact that Kimble Glass is still producing television bulbs, glass blocks, and insulators, and Owens-Illinois is still producing **Kaylo.** There is nothing in the record to support respondent's contention that the transactions were not bona fide. The fact that the television bulb properties and the **Kaylo** properties were sold at book value is not evidence of lack of bona fides or proof that the transaction was not an arm's length transaction.

We hold that the respondent erred in excluding from the average base period net income of Owens-Illinois, the profits which it realized from the production of television bulbs; and that the respondent also erred in including in the average base period net income of Owens-Illinois, the **Kaylo** losses realized by, or allocated under part II to, Kimble Glass.

Liability for 1950 Excess Profits Tax.

The issue is whether the liability for 1950 excess profits tax of each petitioner, imposed under section 430, was a liability to be taken into account at the beginning of 1951 in computing each petitioner's equity capital for the purpose of determining net capital addition for 1951 under section 435(g).

Each petitioner contends that its excess profits tax liability for 1950 did not constitute a liability at the beginning of 1951 which is to be taken into account.