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EXCESS-PROFITS TAX AMENDMENTS OF 1941

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Mr. HARRISON, from the Committee on Finance, submitted the following

REPORT

[To accompany H. R. 3531]

The Committee on Finance, to whom was referred the bill (H. R. 3531) to amend certain provisions of the Internal Revenue Code relating to the excess-profits tax, and for other purposes, having had the same under consideration, report favorably thereon with certain amendments and as amended recommend that the bill do pass.

These amendments are as follows:

In lieu of section 13 of the House bill, four new sections are added. Under existing law a corporation entitled to use either the income credit or the invested capital credit is required irrevocably to choose between such credits for each taxable year. The amendments adopted by your committee relieve the taxpayer of the hardship of having to make such an election and provide instead that the credit shall be the one resulting in the lesser tax.

It is provided, however, that if a taxpayer desires to avoid making the necessary computations under both credits, it may disclaim the application of the credit which it does not desire, and thereby relieve itself of the necessity of making the computation under such disclaimed credit.

The amendments made by your committee retain the principle embodied in section 13 of the House bill. Under that principle corporations required under existing law to compute their tax under supplement A may, if they so elect, compute it under such supplement or under part I as do corporations not falling under supplement A.

For convenience, since no other changes were made in the House bill, the report of the Committee on Ways and Means, with certain clerical errors corrected, follows in its entirety. New sections 13, 14, 15, 16, added by your committee are then explained in detail. Section 13 of the House bill, setting out the effective date, becomes section 17.

NEED FOR THE LEGISLATION

The Second Revenue Act of 1940, approved October 8, 1940, taxes at graduated rates reaching a maximum of 50 percent the excess profits of corporations. This act had two major purposes as was stated in the report of your committee. These purposes were, first, to provide additional revenue urgently needed to help meet the costs of the national-defense program, and second, to prevent the rearmament program from furnishing an opportunity for the creation of new war millionaires or the further substantial enrichment of already wealthy persons.

In view of these compelling motives, the provisions of that act lay a tax upon that portion of the earnings of corporations determined to be excess profits. The tax rates provided, or even higher rates, are thoroughly justified if the income subject thereto is clearly of the type intended to be reached. At the same time, equitable considerations demand that every reasonable precaution be taken to prevent unfair application of the tax in abnormal cases. The weight of the burden imposed carries with it a commensurate need for restricting its application to the cases for which it was designed.

Sensible to these considerations, your committee and the Congress, in formulating and enacting that legislation, exercised caution both with respect to the methods provided for measuring the portion of the corporate earnings to be subjected to the tax and in alleviating the specific hardships which were disclosed. At the same time, it was observed that specific treatment designed alone for such unusual cases as could then be foreseen would not prove adequate to meet the equitable demands.

For this reason the committee of conference on the second revenue bill of 1940 adopted a provision hastily designed to take care of unforeseeable situations by providing adjustments for abnormalities of both income and capital. This provision was known to be inadequate at that time but nevertheless was inserted in the law as a token of assurance to taxpayers that further congressional action would be taken in this respect. Thus, in the statement of the managers on the part of the House on the second revenue bill of 1940 (p. 52 of the conference report), the following statement was made with respect to further action toward the relief of abnormalities:

> It is understood that the Treasury and members of the staff of the Joint Committee on Internal Revenue Taxation will give further study to the entire problem covered by this section and will report to the appropriate committees on the subject as soon as possible.

Pursuant to those instructions, the Treasury and the staff of the joint committee made further studies and have reported their findings to your committee which findings furnish the basis for the present legislation.

SUMMARY OF PRINCIPAL FEATURES

Experience with excess-profits taxes, both in the United States and abroad, has demonstrated conclusively that relief in abnormal cases cannot be predicated on specific instances foreseeable at any time. The unusual cases that are certain to arise are so diverse in character and unpredictable that relief provisions couched in other than general and flexible terms are certain to prove inadequate.

For these reasons, the present legislation attempts to provide, both by specific terms and in carefully guarded general terms, a set of flexible rules which should alleviate at least the bulk of the severe hardship cases which may arise. The success or failure of legislation of this type depends, to a considerable degree, upon its intelligent and sympathetic administration. Through its confidence in the experience and ability of the officials of the Treasury Department and the Bureau of Internal Revenue, your committee recommend the present flexible and broad legislation as the most satisfactory method of meeting the contingencies that will arise.

So that the relief afforded by the bill may be available for the entire period covered by the excess-profits tax, the provisions of this legislation are made retroactive to apply to taxable years beginning after December 31, 1939.

The bill affords relief in the following situations:

1. It relieves the hardships which may be caused by the sharply fluctuating earnings of many types of companies, the activities of which are dependent upon business cycles, by allowing unused excess-profits credits to be carried over into the two succeeding taxable years, thereby tending to level off the unusual effects due to rise and fall of income. In addition, the allowance of such an excess-profits credit carry-over will be of substantial benefit to new corporations, and to old corporations undergoing a period of expansion.

2. It adds to the list of adjustments for specific items of abnormal deductions, set out in section 711 (b) of the existing law, a further adjustment for abnormal deductions of any class during the years in the base period.

3. Relief is provided for corporations that experienced rapid growth during the base period. Under existing law, only the average experience during those years can be counted in determining the excess-profits credit based on income. Corporations whose facilities and production capacities were substantially increased during this period would thus be penalized as compared to corporations which had already achieved and maintained a high and constant level of production. The bill will give effect to the ratio of increase during these years. This treatment will afford a substantial advantage to these expanding companies as compared with the use of the level average now required.

4. Existing law provides for adjustments with respect to six specific classes of abnormal income received during the taxable years subject to the excess-profits tax. These specific items were allowed to be spread over the years to which they are actually attributable. Your committee feel that the relief afforded by this provision should not be limited to these specific items but should be available also with respect to any item of abnormal income as such income is defined in the bill.

5. Since the average earnings credit is based upon the amount of the taxpayer's average income during the base period, the happening of some unusual event during this period may create a grave hardship on the taxpayer. For example, the taxpayer's plant may be destroyed by fire or windstorm or its operations for any year greatly impeded by flood, strikes, or other events hampering production and greatly curtailing income for a given period. The bill would attribute to the taxpayer in such an event the earnings which it would normally have experienced had such event not occurred. Likewise, if the taxpayer

can establish that the character of its business as of January 1, 1940, is different from the character of the business engaged in during one or more taxable years of the base period, the taxpayer is permitted to establish what its average base period net income would have been if the character of the business had been the same during each of the taxable years of such base period. The differences which constitute a change in the character of the business are set forth in the bill.

This general relief provision is felt by your committee to be necessary in order to protect the unanticipated cases not covered by the specific relief provisions of existing law and the other provisions of this bill. To be effective, the provision must be elastic and as flexible as administrative demands will allow.

Proper safeguards, however, are taken to prevent abuse. For example, the burden is upon the taxpayer to establish the abnormality of its experience during the base period. In addition, relief is not granted in situations brought on by (*a*) high prices of material, labor, capital, or any other agent of production, (*b*) low selling price of the product of the taxpayer, or (*c*) low physical volume of sales due to low demand for the taxpayer's product. Furthermore, relief under this provision is denied unless the excess-profits tax otherwise payable exceeds 6 percent of the taxpayer's normal-tax net income for the year and unless the relief afforded by this section would diminish the excess-profits tax otherwise payable by more than 10 percent.

The taxpayer must first compute and pay his tax without regard to this relief provision and then must petition the Commissioner for relief by way of claim for refund.

Your committee feel that so safeguarded and restricted this relief provision, though broad and general in nature, will satisfactorily alleviate hardships due to abnormal conditions in the base period, and at the same time prevent abuses.

6. Under supplement A of existing law, corporations resulting from certain tax-free exchanges or reorganizations during or after the base period are permitted the use of their predecessor's earning experience in the computation of their excess profits credit based on income. The bill extends this privilege to corporations growing out of partnerships or sole proprietorships in tax-free exchanges during this same period. The resulting corporation would thus be allowed to use the earnings history of the predecessor partnership or sole proprietorship, after first converting such earnings to a corporate basis.

7. Under section 10 of the bill, a taxpayer in computing its excess-profits credit may elect within 6 months after the date prescribed by law for filing its first excess-profits return, to charge to capital account, so much of expenditures deducted in the base period for advertising or the promotion of good will, as under rules and regulations prescribed by the Commissioner may be regarded as capital investments. This will benefit the taxpayer, whether it elects the income credit or the invested capital credit in computing its excess-profits tax. Taxpayers using the income credit will have their base-period income increased by the amount of the deduction disallowed. Taxpayers using the invested-capital credit will have their invested capital increased by reason of a restoration of such expenditures to their earnings and profits account. A taxpayer which elects under this section must capitalize all such expenditures not only for the base-period years but also for taxable years subsequent to the base period. Since the deductions

in such cases are retroactively disallowed, the taxpayer is required to pay any additional income tax, plus interest thereon, which is due by reason of the disallowance of the deduction.

Detailed Discussion of the Provisions of the Bill

SECTION 1. TITLE OF THE BILL

This section merely sets out the title of the bill, providing that it may be cited as the "Excess-profits tax amendments of 1941."

SECTION 2. EXCESS-PROFITS CREDIT CARRY-OVER

This amendment removes the restriction of the carry-over privilege to corporations with normal-tax net incomes of not more than $25,000, making it applicable to all corporations, and provides for a 2-year carry-over instead of a 1-year carry-over.

SECTION 3. ABNORMAL DEDUCTIONS IN THE BASE PERIOD

To ascertain the excess-profits credit based on income, it is necessary to determine the excess-profits net income for the taxable years in the base period. For the purposes of computing the excess-profits net income for such years, section 711 (b) (1) of the present law provides for adjustments to the normal-tax or special-class net income, with respect to a number of specific items of both income and deductions. In addition to the adjustments for the deductions specified by the present law, the amendments made by this section provide that any deduction will be disallowed for the base period if it was of a class abnormal for the taxpayer. If such deduction was of a class normal for the taxpayer, then to the extent that it exceeds 125 percent of the average amount of the deductions of such class for the 4 previous taxable years, such excess will be disallowed.

The 125-percent rule, which, in the interests of certainty, is a substitute for the "grossly disproportionate" test in existing law, is also made applicable to subsection (H) (old subsection (G)), adjusting deductions for the payment of claims, awards, judgments, and decrees against the taxpayer, and to subsection (I) (old subsection (H)), adjusting deductions attributable to intangible drilling and development costs with respect to oil and gas wells or mines.

New subsection (K) permits the adjustments provided in new subsections (H), (I), and (J) to be made also where the taxpayer was not in existence for 4 previous taxable years. In such case it will use such previous taxable years during which it was in existence, plus the succeeding taxable years which began before the beginning of its second taxable year subject to the excess-profits tax, but in no case to aggregate more than 4 taxable years. For example, corporation A came into existence on July 1, 1938. For the purpose of measuring abnormalities or excesses of deductions for the taxable year beginning July 1, 1938, it may use the taxable years beginning July 1, 1939, and July 1, 1940. Since the taxable year beginning July 1, 1941, would be the taxpayer's second taxable year subject to the excess-profits tax, that year may not be used. This subsection also restricts the benefits of new subsections (H), (I), and (J) by placing upon the taxpayer the burden of establishing that the abnormalities or excesses in the deductions treated by those subsections are not the consequences of an increased gross income or a decrease in the size of other deductions in the base period or of changes in the type, manner of operation, size, or condition of the business conducted by the taxpayer.

Nor will deductions of any class be disallowed for any taxable year unless they exceed the amount by which the deductions of the same class for such year exceed the deductions of such class for the taxable year for which the excess-profits tax is being computed. For example, for the taxable year in the base period, 1938, a corporation had a deduction of $200,000, although its average deduction of the same class for all of the years in the test period were only $100,000. If in 1940 it had deductions of that class totaling $100,000, for the purpose of determining its average earnings credit to be used in computing its excess-profits tax for 1940, $75,000 of the deduction in 1938 would be disallowed, thereby increasing the excess-profits credit. This would be true since to the extent that the deductions of this class in 1938 exceed 125 percent of the average deductions of the same class during the test period, they are disallowed. If in 1941, however, this taxpayer had deductions of this class totaling $150,000, only $50,000, of the $200,000 for 1938 would be disallowed in determining the average-earnings credit for use against the excess-profits net income for 1941.

New section (G) is old subsection (I) rearranged for convenience.

SECTION 4. COMPUTATION OF AVERAGE BASE-PERIOD NET INCOME

The amendments made by this section are designed for the relief of corporations that experienced rapid growth during the base period. In determining the excess-profits credit based on income the present law requires the use of the average earning experience of the corporation during the years in the base period. Trends of growth during this period are given no weight. Thus, corporations which have materially expanded in the base period and have for the last year in such period a business capacity and an income much larger than that for the first year, are restricted under existing law to the use of a level average of such years. The inequities of this treatment may be illustrated by a comparison of two corporations, both of which have average base-period earnings of $250,000 and, under the present law, the same credit based on income. One of these corporations has shown substantial growth during these base-period years while the other has maintained a constant level.

Tax year	Excess profits net income	
	Corporation A	Corporation B
1936	$250,000	$100,000
1937	250,000	200,000
1938	250,000	300,000
1939	250,000	400,000
Total	1,000,000	1,000,000
Average	250,000	250,000

To give these two corporations the same excess-profits credit based on income as does the existing law, operates inequitably in the case of corporation B, whose earnings have steadily increased during the base period. A credit of $250,000 does not properly reflect its earning power as of the time the excess-profits tax became applicable.

Section 4 of the bill provides an optional method whereby the factor of growth will be taken into account in ascertaining the base-period average.

The method provided for by this section is operative only where the earnings for the second half of the base period are in excess of the earnings for the first half of such period. For this purpose, the base period is divided into halves, each of an equal number of months. The aggregate of the excess-profits net income for each half is first determined. The excess of the aggregate for the second half over the aggregate for the first half is then ascertained and divided by two. The amount so found is then added to the excess-profits net income for the second half and the sum resulting from such addition is divided by the number of months in the second half and multiplied by 12. The resulting figure will be the average base period net income (95 percent of which is to be used in ascertaining the credit), except that the average base period net income so computed cannot exceed the highest excess-profits net income for any taxable year in the base period.

An example of the operation of this section is as follows: Suppose a taxpayer reporting on the calendar-year basis has the following amounts of excess-profits net income for the base period years: 1936, $100,000; 1937, $200,000; 1938, $300,000; and 1939, $400,000. Under the present provisions its average base period net income would be $250,000. Under the proposed amendment its average base period income would be computed as follows:

Sum of excess-profits net income for second half of base period	$700, 000
Sum of excess-profits net income for first half	300, 000
Difference	400, 000
Difference divided by 2	200, 000
Second half excess-profits net income	700, 000
Total of last 2 amounts	900, 000
Total placed upon an annual basis (divided by number of months in second half of base period, 24, and multiplied by 12)	450, 000
Highest excess-profits net income for any taxable year	400, 000
Average base period net income	400, 000

This method in the case of growing corporations will thus provide a credit which is closely related to the earnings of the second half of the base period, so that the factor of growth is thus taken into account in the computation of the credit.

The 1st of June 1940 marks generally the beginning of the industrial expansion under the national defense program. It was because of this that the amortization allowance in the Second Revenue Act of 1940 was confined to construction and acquisition after June 10, 1940. Corporations whose last taxable years in the base period extend beyond May 31, 1940, may have greatly expanded their facilities of production and, consequently, their income after that date. In giving effect to the factor of growth during the base period, equitable demands do not indicate that growth after May 31, 1940, should be taken into account.

For this reason, section 713 (f) (7), as set out in section 4 of the bill, limits the benefits to be accorded to the growth factor to increases occurring prior to June 1, 1940. In order to achieve this result in the determination of the growth factor, the excess-profits net income for any taxable year in the base period ending after May 31, 1940, is reduced by the ratio which the number of months in such year after May 31, 1940, bears to the entire number of months in such year. To such income so reduced is then added an amount which bears the same ratio to the excess-profits net income of the preceding year as the number of months after May 31, 1940, bears to the number of months in such preceding taxable year.

For example, a corporation accounts on the basis of fiscal years beginning October 1 and ending September 30. It had an excess-profits net income of $400,000 for the year ending September 30, 1939, and $600,000 for the year ending September 30, 1940. Both of these taxable years are in the base period but 4 months of the fiscal year 1940 are after May 31, 1940. As applied to this corporation, this provision would operate as follows:

Taxable Year	Period		Number of months	Excess-profits net income
	Beginning—	Ending—		
1939	Oct. 1, 1938	Sept. 30, 1939	12	$400,000
1940	Oct. 1, 1939 June 1, 1940	May 31, 1940 Sept. 30, 1940	8 4	600,000
Under subpar. (A) of sec. 713 (f) (7) the excess profits net income for 1940 is reduced by 4/12 or 1/3 of $600,000, equals				200,000
Total				400,000
Under subpar. (B) this sum is increased by 4/12 of the excess profits net income for 1939 or 1/3 of $400,000, equals				133,333
Total				533,000

Thus, for the purposes of this method of computing the excess-profits credit, $533,333 would become the excess profits net income for 1940 in lieu of $600,000, the actual figure for that year.

If, in the above example, the number of months in the preceding taxable year had been less than the number of months in the fiscal year 1940 after May 31, 1940, then recourse must be had to the second preceding taxable year to find the income to be attributed to the excess of such months. For example, a corporation has for its last three taxable years in the base period the following taxable periods and excess profits net incomes:

Taxable years		Number of months	Excess-profits net income
Beginning—	Ending—		
July 1, 1938	June 30, 1939	12	$400,000
July 1, 1939	Sept. 30, 1939	3	75,000
Oct. 1, 1939	Sept. 30, 1940	12	600,000

Instead of the treatment set out in the previous example, subparagraphs (B) and (C) prescribe the following:

Taxable years	Period: Beginning—	Period: Ending—	Number of months	Excess profits net income
1939, first	July 1, 1938	June 30, 1939	12	$400,000
1939, second	July 1, 1939	Sept. 30, 1939	3	75,000
1940	Oct. 1, 1939 June 1, 1940	May 31, 1940 Sept. 30, 1940	8 4	600,000
As in the previous example, subparagraph (A) would reduce the excess profits net income for 1940 by 4/12 or 1/3 of $600,000 equals				200,000
Total				400,000
Under subparagraph (B) there would be added to the sum so obtained the entire excess profits net income for the 3 months constituting the second 1939 fiscal year				75,000
For the 1 month still not taken into account, subparagraph (C) has recourse to the first 1939 fiscal year and attributes to such month 1/12 of $400,000 equals				33,333
Total				508,333

Thus, for the purpose of the computation under subsection (f), the corporation would have an excess-profits net income for its fiscal year 1940, the last year in its base period, of $508,333 instead of the actual amount of $600,000.

Provision is made in the amendment for the manner of computation where the taxpayer, because of changes in its accounting period or for other reasons, has more or less than 4 taxable years, and where part of 1 taxable year is in the first half of the base period and the other part is in the second half. To illustrate this division of a taxable year lying partly in the first half and partly in the second, the following example is given:

Years in the base period: Beginning—	Years in the base period: Ending—	Number of months	Excess profits, net income
Sept. 1, 1936	Aug. 31, 1937	12	$30,000
Sept. 1, 1937	Dec. 31, 1937	4	20,000
Jan. 1, 1938	Dec. 31, 1938	12	60,000
Jan. 1, 1939	Dec. 31, 1939	12	100,000
Total		40	210,000
FIRST HALF			
The taxable year beginning Sept. 1, 1936, and ending Aug. 31, 1937		12	30,000
The taxable year beginning Sept. 1, 1937, and ending Dec. 31, 1937		4	20,000
One-third of the taxable year beginning Jan. 1, 1938, and ending Dec. 31, 1938		4	20,000
Total		20	70,000
SECOND HALF			
Two-thirds of the taxable year beginning Jan. 1, 1938, and ending Dec. 31, 1938		8	40,000
The taxable year beginning Jan. 1, 1939, and ending Dec. 31, 1939		12	100,000
Total		20	140,000

In making the computations under this alternative a deficit in excess-profits net income (or in the case of more than one deficit, the greatest deficit) is not counted as zero as in the case of the computation on the straight average basis.

SECTION 5. ABNORMALITIES IN INCOME IN TAXABLE PERIOD

Section 721 of the present law provides relief with respect to certain abnormalities in income in the taxable period. These abnormalities, six in number, are specifically described. If abnormal income falling within any one of these six described classes is received by the taxpayer it is provided that such income should be allocated to the taxable years to which it is attributable and the tax for the current year may not exceed the tax for that year without the inclusion of the portions of the item attributable to prior years plus the increases in tax that would have resulted in such prior years from the addition to gross income of the portions of the item attributable to those years. It is believed advisable to extend the principle of this section to any abnormal item of income. As the types of abnormal income that may occur cannot be predicted in advance, adequate relief can only be granted by thus extending the scope of this section.

The test of whether an item is abnormal is clarified to provide expressly that if the item includible in the gross income of the taxable year is in excess of 125 percent of the average amount of the gross income of the same class for the 4 previous years it shall be considered abnormal. If the taxpayer was not in existence for the 4 previous taxable years, the test period is the period during which it was in existence. An item will also be considered abnormal if it is of a class which the taxpayer normally does not receive. The mere fact that an item includible in the gross income of the taxpayer is abnormal, or is in excess of 125 percent of the average amount of the gross income of the same class for the test period, does not result in the exclusion of such item from excess-profits net income. It is necessary that the item be found attributable to other taxable years. Consequently, if an increase in business renders an item of income in excess of 125 percent of the income for the test period, the increase in business will not result in such increased income being excluded from excess-profits net income.

It is provided further that if an item of gross income is found to be abnormal such item shall be reduced by 125 percent of the average amount of the gross income of the same class for the four or less previous taxable years constituting the test period.

Such abnormal item is further reduced by a proportionate part of the direct costs or expenses attributable thereto. The item so reduced is then allocated to the previous or future taxable years to which it is attributable. The computation of the tax follows the method presently provided for in section 721, except that a limitation is provided on the amount of tax that may be incurred where the item is attributable in whole or in part to future years. Under this limitation the tax on income attributable to future years in no case can exceed the tax that would be payable if the entire income were subject to tax in the year of receipt.

SECTION 6. ADJUSTMENT OF ABNORMAL BASE PERIOD NET INCOME

Section 722 of the bill is designed to afford relief in the case of certain situations not covered by other sections of the bill. The relief is confined to the adjustment of the abnormal base period net income of a taxpayer electing the average earnings credit, and applies only in the case of a taxpayer whose first excess-profits tax taxable year begins in 1940.

In order to obtain any benefit under this section, the taxpayer must meet one of the following tests:

(1) The character of its business as of January 1, 1940, must have been different from the character of the business engaged in during one or more of the taxable years in its base period, or

(2) Normal production, output, or operation in one or more of the taxable years in the base period must have been interrupted or diminished because of events abnormal in the case of the taxpayer.

CHANGE IN CHARACTER OF BUSINESS

The character of the business engaged in by the taxpayer as of January 1, 1940, is considered different from the character of the business engaged in during one or more of the taxable years in its base period only if:

(1) There is a difference in the products or services furnished. For example, if a corporation in one year of the base period was engaged in both the radio broadcasting and department store business and on January 1, 1940, was engaged only in the radio-broadcasting business, the department-store business having been discontinued, the corporation is deemed to have changed the character of its business. The same is true where a corporation was engaged in one of the base-period years in both the wholesale and retail dry-goods business and on January 1, 1940, was engaged only in the retail dry-goods business.

(2) There is a difference in the capacity for production or operation. An illustration of such a difference would be where the corporation has enlarged its plant or increased its capital.

(3) There is a difference in the ratio of nonborrowed capital to total capital. A corporation which during the base period was operating largely on borrowed capital but as of January 1, 1940, was operating largely on equity capital is deemed to have such a difference.

(4) The taxpayer was in existence during only part of the base period. An example is where a corporation in 1938 reorganized into two or more corporations. The new corporations would have been in existence for only a part of the base period.

(5) The taxpayer acquired before January 1, 1940, all or a part of the assets of a competitor with the result that the competition of such competitor was eliminated or diminished. Assume that two newspapers were operating at a loss or with very little income during all or part of the base period. Prior to January 1, 1940, the first newspaper purchased the franchises or other assets of the second newspaper and as a result of this transaction the condition of the surviving paper was much more promising. A difference in the character of the business of the taxpayer has occurred.

Having established that the character of its business as of January 1, 1940, is different from the character of the business engaged in during one or more of the taxable years in its base period, the taxpayer is permitted to establish what its average base period net income would have been if the character of its business had been the same during each of the taxable years of such base period. In constructing its average base period net income, high prices of materials, labor, capital, or any other agent of production, low selling price of the product, a low physical volume of sales owing to low demand for such product, or for the output of the taxpayer during the base period would not be considered as making the net income abnormal.

Moreover, the taxpayer in constructing its average base period net income would be required to eliminate that part of the items of gross income which were abnormally large or the deductions which were abnormally small. This net income would also have to be constructed as if the base period normal production, output, or operation had not been interrupted or diminished because of the occurrence of events abnormal in the case of such taxpayer. Such abnormal events might include a flood, a strike, or other events hampering production, output, or operation.

The amount of the average base period net income so established, if it is greater than its actual average base period net income, will be considered its average base period net income for the purposes of its excess-profits credit. In no case, may the taxpayer's average base period net income, as established exceed the excess-profits net income established for the last taxable year in such period.

Assume for example, that a newspaper corporation, which had a fiscal year ending March 31, 1940, had acquired the franchises of a rival newspaper in December 1939. Prior to that time, both papers had operated at a loss or a small profit. After such acquisition, the surviving newspaper showed a much larger profit for the remainder of its fiscal year ending March 31, 1940. Under this section, such a newspaper, by establishing what it would have earned in the base period if the character of its business had been the same throughout its base period, will be able to secure substantial relief. This relief will, however, be limited to the amount of its excess-profits net income established for the last year of its base period. Thus, if the corporation was able to establish that if the rival newspaper had been acquired as of April 1, 1939, it would have earned for the full fiscal year 1940 an amount which would make its excess-profits net income for that year $300,000, this would be the highest amount it could substitute for its average base period net income.

Interruption or diminution of normal production or operation in the base period.

A taxpayer may secure relief under this section if its normal production, output, or operation was interrupted or diminished because of events abnormal in the case of the taxpayer. As in the case of taxpayers under the first category, high prices of materials, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for such product or for the output of the taxpayer are not considered as abnormal. A common example of such an abnormality is where the business of the taxpayer has been interrupted or diminished due to a fire, flood, or strike. For example, if fire in 1935 had destroyed a taxpayer's plant so that the taxpayer's normal production in 1936 was diminished, the taxpayer would be permitted to establish what its normal income would have been if normal production had existed in 1936.

CHANGE OF CHARACTER OF BUSINESS AND INTERRUPTION OF NORMAL PRODUCTION

A taxpayer with both a change in the character of business and an occurrence of an abnormal event interrupting its normal production, output, or operation in the base period is subject to the limitation that its average base period net income under this section cannot exceed the excess-profits net income established for the last taxable year of such base period.

Limitation of amount of relief.

In order to make this provision administratively workable, it is provided that it shall not be operative unless the excess-profits tax computed without reference to this section is at least 6 percent of the taxpayer's normal-tax net income for such year, and unless the application of this relief provision would reduce the excess-profits tax by at least 10 percent thereof. As a necessary complement to these limitations, it is also provided that any relief obtained under this section shall not reduce the excess-profits tax below 6 percent of the taxpayer's normal-tax net income for the taxable year, and that the tax computed after the application of this relief provision shall be increased by an amount equal to 10 percent of the tax that would have been payable without the benefit of this section. Your committee feels that these limitations are necessary to a proper administration of this relief provision. The generality of the relief provided requires that the Bureau of Internal Revenue should not be loaded with so many petitions for relief as to make it impossible for it to examine and pass upon such requests with the requisite expedition and care. If experience should demonstrate that these limitations are too high, consideration will be given to their reduction.

Administrative procedure.

It is deemed advisable in the interests of good administration, in view of the nature of the problem presented by section 722, that the taxpayer should not be permitted to apply the section in the computation of the excess-profits tax liability shown upon its return and that the taxpayer should be required to conform to reasonable restrictions with respect to the time within which it may make application for the benefits of the section. Accordingly, under the provisions of subsection (e) a taxpayer is not permitted to claim the benefits of section 722 in computing its tax upon the return. A taxpayer, in order to obtain the benefits of section 722, must make an application to the Commissioner of Internal Revenue under regulations to be prescribed by the Commissioner with the approval of the Secretary of the Treasury. Generally, this application must be made within 6 months from the date prescribed by law for the filing of the return. The time prescribed by law for filing the return includes the period of any extension of time for filing the return granted by the Commissioner. If the application is not made within such period, further opportunities in the following situations are afforded the taxpayer to secure the benefits of section 722. These situations are as follows:

(1) Under established practice and with a view to disposition of tax cases without litigation, the Commissioner ordinarily issues what is termed a preliminary notice of tax liability so as to afford the taxpayer

an opportunity of a hearing before the formal notice of deficiency is mailed under section 272 (a) (1) from which appeal lies only to the Board. Where such preliminary notice is issued to the taxpayer, the latter is given a period of 90 days from the date of such notice in which to make application to the Commissioner for the benefits of section 722. If in such case a formal notice of deficiency is not issued until after the expiration of such 90-day period and the taxpayer does not avail itself of the opportunity to make such application within such period, the taxpayer cannot thereafter claim the benefits of the section.

(2) Owing to the running of the statute of limitations against the making of assessments, the Commissioner may find it necessary (*a*) to mail a formal notice of deficiency without having issued a preliminary notice of the tax or (*b*) having issued a preliminary notice, to mail a formal notice of deficiency prior to the termination of 90 days. In either (*a*) or (*b*) the taxpayer may claim the benefits of section 722 in its petition to the Board or by means of an amended petition conformable to the rules of the Board.

In cases under (1) or (2), the benefits of the section shall not reduce the tax under chapter 2E by an amount in excess of the deficiency determined under that subchapter without the application of section 722.

If for any taxable year the average base period net income has been determined under section 722, the Commissioner is authorized by regulations approved by the Secretary to prescribe the extent to which the requirement of subsection (e), with respect to filing application for the benefits of section 722, may be waived for a subsequent taxable year.

SECTION 7. CONSOLIDATED RETURNS OF INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL

Section 730 of the present law dealing with consolidated returns under the excess-profits tax does not permit an insurance company to join in a consolidated return with a noninsurance company. This restriction was inserted because of the special manner in which the income of insurance companies is computed under the income-tax laws. It is believed, however, that the differences of computation in the case of an insurance company other than life or mutual are not so significant as to prevent such a company from filing a consolidated return with an ordinary corporation with which it is affiliated. Consequently, this section amends section 730 to permit such insurance companies, i. e., those subject to taxation under section 204, to join in consolidated returns with ordinary corporations.

SECTION 8. INCORPORATION OF PARTNERSHIP OR SOLE PROPRIETORSHIP

Under present provisions a corporation formed as a result of the incorporation of a partnership or sole proprietorship may not use the earnings experienced by the latter in determining its excess-profits credit based upon income. It is believed that this restriction operates inequitably with respect to such corporations. Accordingly, this section amends the present provisions of the excess-profits tax to permit the earnings of the predecessor partnership or proprietorship to be reflected in the base-period credit of the resulting corporation in those instances in which the assets of the partnership or proprietorship are transferred to the corporation in a tax-free exchange. The amendments in question are made to supplement A of the excess-profits tax provisions, which deals with a comparable situation where the component taxpayer was a corporation. In these situations the computations required by supplement A with respect to the income of the partnership or the proprietorship shall be made as if such partnership or proprietorship were a corporation; viz, the deduction on account of income taxes shall be computed in accordance with the income taxes applicable to corporations, a deduction for salaries shall be allowed, etc.

SECTION 9. REVIEW OF ABNORMALTIES BY BOARD OF TAX APPEALS

Section 9 of the bill (adding sec. 732 to the Excess Profits Tax Act of 1940) extends to the Board exclusive jurisdiction to review the Commissioner's decision upon any question the determination of which is necessary solely by reason of section 711 (b) (1) (H), (I), (J), or (K), section 721 or 722. For example, an item of income of $100,000, the amount of which is not in dispute, is includible in gross income for 1940 and involves a question concededly arising under section 721 (a) (2) (A). The Commissioner determines that the item is attributable to 1939 and 1940 in the respective sums of $25,000 and $75,000. Such determination is made upon an issue arising solely under section 721 and, if the taxpayer contests such allocation, the determination of the Commissioner in such case is reviewable only by the Board. If, however, the Commissioner determines, for example, the amount of income derived by a taxpayer from a transaction falling within section 721 (a) (2) (E), relating to amounts included in gross income for the taxable year by reason of the termination of a lease of real property, and the amount so determined is contested by the taxpayer, the question as to amount of such income is not one arising solely by reason of the abnormality provisions but independently of them and hence review of the determination as to the amount in such a case is not confined to the Board.

Likewise, review is not confined to the Board if, for example, the Commissioner determines that the taxpayer realized in 1940 income of a character which, if realized in that year, would fall within section 721 (a) (2) (A) but which the taxpayer contends was realized in 1939. In such case the question whether income was so realized in 1940 may be reviewed by the courts upon appeal from the decision of the Board. Assuming in such case that it is ultimately held that the income was realized in 1940, a dispute as to the resulting question of allocation as between years of such item may not be carried beyond the Board.

Under existing law, unless a deficiency has been determined by the Commissioner, a taxpayer has no right of appeal to the Board (sec. 272 (a) (1), I. R. C.). Thus, for example, if a refund claim were filed by a taxpayer and the Commissioner disallowed the claim in whole or in part but did not determine deficiency, no right of review of the Commissioner's action by the Board would be present. Inasmuch as the taxpayer's right to relief under certain of the relief provisions provided in this bill may only be raised by a claim for refund, it is necessary that a procedure be provided whereby the Board may obtain jurisdiction to review a decision by the Commissioner disallowing such claims. Accordingly, section 732 (added to the Excess Profits Tax Act of 1940 by sec. 9 of the bill) provides that the taxpayer may file a petition with the Board of Tax Appeals within 90 days after notice of such disallowance is mailed for redetermination of the excess-profits tax. If such petition is filed such notice of disallowance is deemed to constitute a notice of deficiency for the purposes of assessment and collection of any deficiencies and the credit or refund of overpayments (including the suspension of the statute of limitations with respect thereto). If such appeal is taken, then all pertienent issues bearing upon the tax liability under chapter 2E may be raised by the taxpayer and reviewed by the Board. If the Board does not find an overassessment but finds a deficiency in such cases, such deficiency may be assessed and collected, regardless of any statute of limitations otherwise applicable. If a claim for refund involving an issue of abnormality is disallowed in whole or in part, and the taxpayer does not wish to appeal to the Board, it still has the right to sue in the courts upon any issue raised in such claim except the issue with respect to abnormalities.

SECTION 10. CAPITALIZATION OF CERTAIN EXPENDITURES

This section permits a taxpayer, under certain limitations, to capitalize expenditures for advertising and goodwill promotion made in the base period, which the taxpayer had previously deducted as an expense. Such a provision will prevent hardship to taxpayers who deducted such items at a time when the effect of such deduction on their excess-profits credit could not be foreseen.

Only expenditures which, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, may be determined to be in the nature of a capital investment are allowed to be capitalized. It is expected that such regulations will provide a method by which to differentiate normal advertising and goodwill expenditures which may properly be classified only as current expenses from those expenditures which may be considered to build up permanent business values, such as those embodied in trade-marks or trade names, and which are in effect a further investment in and a permanent asset of the taxpayer's business.

If a taxpayer makes an election under this section, its normal-tax or special-class net income for each base period taxable year in which advertising and goodwill expenditures were deducted shall be recomputed as if that portion of such expenditures which is permitted to be capitalized had been capitalized in such taxable year. Hence, the net income for each such year will be increased by the amount of the deduction disallowed, and in the case of a corporation electing the invested capital credit, the increase in net income will effect an increase in earnings and profits.

Since the revenue laws applicable to each taxable year are retroactively amended by this section in order to make the election here provided govern the deductibility of advertising and goodwill expenditures in such prior taxable years, the deductions taken are deemed to have been disallowed, and the taxpayer must pay the additional income tax which would have been due if the treatment in the prior income tax taxable year had been in accordance with the election provided for in this section, plus interest thereon. This prevents a taxpayer from obtaining the benefits of both a deduction and a capitalization with respect to the same item.

If no provision or rule of law prevents correction of the effect of disallowing such deductions, any additional income tax which would have been due if such deductions had been capitalized, will be collected as a deficiency for the particular base period taxable year. If, however, correction of the effect of such treatment is barred, correction will be made by means of the adjustment provided under section 734.

A taxpayer electing under this section must capitalize all such expenditures deducted for base period taxable years which may be regarded as a capital investment. It is further provided that amounts allowed as a deduction on account of such expenditures in taxable years prior to the base period may not, under any circumstances, be capitalized.

In order to secure a treatment of expenditures for advertising and goodwill promotion in taxable years beginning after December 31, 1939, uniform with the treatment accorded similar expenditures in base-period years, subsection (b) provides that a taxpayer which has elected to capitalize expenditures which it has shown to be properly considered capital investments, must capitalize for income and excess-profits tax purposes any similar capital expenditures in subsequent taxable years.

SECTION 11. ADJUSTMENT IN CASE OF INCONSISTENT POSITION

Section 11 of the bill amends the Internal Revenue Code by the addition of a new section designated section 734. Section 734 provides for an equitable adjustment when a determination of the tax liability under chapter 2E treats an item or transaction affecting such tax liability in a manner inconsistent with the treatment accorded such item or transaction in the determination of the income tax liability of the taxpayer, or a predecessor for a taxable year or years beginning prior to January 1, 1940. Adjustment is authorized only if (1) upon the date of the determination under chapter 2E correction of the effect of the inconsistent treatment of the item or transaction is prevented (except for the provisions of sec. 3801) in some one or more of such prior taxable years by the operation of a provision of law (other than the provisions of sec. 3761 relating to compromises) or a rule of law, e. g., statute of limitations, closing agreement, Board decision, or rule of res judicata, etc., and (2) the inconsistent position adopted in the determination is asserted and maintained by the party (either the Commissioner or the taxpayer) who would be adversely affected by an adjustment under this section.

A final determination is not a prerequisite to the application of the section. Whenever the tax liability is determined under chapter 2E and the conditions prescribed in subsection (b) are satisfied, the adjustment is made as an essential part of the determination of such tax liability. If there are further proceedings in the case and the determination is overruled, the adjustment falls with the determination. If the determination becomes final, the adjustment likewise becomes final.

No adjustment under the section is authorized for any taxable year unless correction under the ordinary procedure applicable to the assessment and collection of deficiencies or the refund or credit of overpayments, as the case may be, for such taxable year is prevented. If, however, the item or transaction, in respect of which the inconsistent position is adopted in the determination, affected the determination of the tax liability in several of the prior taxable years, the ascertainment of the amount of the adjustment will require a recomputation with respect to each such year as to which correction of the effect of the inconsistent treatment is prevented.

Example.—In December 1934 corporation X transferred depreciable property to corporation Y in exchange for stock of Y having a fair market value of $100,000. At the time of the transfer the property had an adjusted basis in the hands of X corporation of $80,000 and an estimated remaining life of 20 years. The exchange was treated as nontaxable and the gain of $20,000 realized by the X corporation was not recognized. For each of the years 1935 to 1939, inclusive, corporation Y was allowed deductions for depreciation in the amount of $4,000, computed on a basis of $80,000, the same basis the property had in the hands of the X corporation. In its excess-profits tax return for the taxable year 1940, corporation Y claimed that the property should have a basis of $100,000 for invested capital purposes, and also claimed a deduction of $5,000 for depreciation for such year. This position was based upon the contention that the 1934 exchange was taxable and the gain of $20,000 should have been recognized and added to the basis of the property in the hands of the Y corporation. Timely claims for refund based upon the allowance of additional deductions for depreciation for the taxable years 1938 and 1939 were filed. The statute of limitations prevents any adjustment either by way of refund of overpayments or assessment of deficiencies for the taxable years 1934 to 1937, inclusive. The Commissioner's determination of the excess-profits-tax liability for the taxable year 1940 adopted the inconsistent position asserted by corporation Y and, accordingly, if the computation under section 734 (d) discloses a net increase in the taxes previously determined for the taxable years for which correction is prevented an adjustment is authorized under the provisions of section 734. The ascertainment of the amount of the adjustment under subsection (d) requires a revision of the tax of X corporation previously determined for the year 1934 to reflect the recognition of gain in the amount of $20,000, and a revision of the tax of Y corporation previously determined for the years 1935, 1936, and 1937 to reflect the allowance of an additional $1,000 depreciation deduction for each of those years. If, in any of the prior taxable years, the X or Y corporations had been liable to the tax imposed on personal holding companies by title IA of the Revenue Acts of 1934, 1936, or 1938, it would be necessary to determine the increase or decrease in such tax for each such year plus the interest attributable to each.

Any such increases would be aggregated with the increases in the title I taxes for the prior taxable years and the decreases likewise would be aggregated with the decreases in the title I taxes. The difference between the aggregate of the increases and the aggregate of the decreases would then be ascertained and the net increase so determined would be the amount of the adjustment under the terms of the above example. If the difference between the aggregate of the increases and the aggregate of the decreases so ascertained were a net decrease, then no adjustment under this section would be authorized, since by the terms of the example the taxpayer had maintained the inconsistent position, and the section does not permit either the taxpayer or the Commissioner to obtain a tax benefit by his own inconsistency.

The method of adjustment is prescribed in subsections (c) and (d). If the adjustment represents an increase in tax, it is added to the tax imposed by chapter 2E; if the adjustment represents a decrease in tax, it is subtracted from the tax imposed by that chapter.

The recomputation prescribed in subsection (d) is merely the ascertainment of the amount of the increase or decrease in each income tax previously determined in each of the prior taxable years if the item or transaction in question had been treated consistently with the treatment accorded such item or transaction in the taxable year for which the determination under chapter 2E is made. The recomputation does not admit of revision of any other items except to the extent that the treatment of items taken into account in ascertaining the tax previously determined is affected by the change in the gross or net income. If any such items are affected, as, for instance, deductions for contributions, foreign-tax credit, etc., revision should be made in conformity with such change. If only one taxable year is involved, the increase or decrease in each of the income taxes previously determined plus interest thereon, computed as if each such increase or decrease were a deficiency or an overpayment, as the case may be, for such taxable year, shall be ascertained. The net increase or net decrease in respect of such taxes and interest for such taxable year is the amount of the adjustment. If the inconsistent treatment of the item or transaction affected more than one of the prior taxable years, it is necessary to determine the increases or decreases in each of the taxes previously determined for each such year in which correction under the ordinary procedure is prevented. To the increases or decreases so ascertained in each such tax for each such year there shall be added interest thereon computed as if each increase or decrease constituted a deficiency or an overpayment, as the case may be, for such year. The difference between the sum of the increases, including the interest computed on such increases, and the sum of the decreases, including the interest computed on such decreases, shall be ascertained and the net increase or net decrease so determined is the amount of the adjustment under this section.

In computing the tax previously determined for any prior taxable year there shall be taken into account any adjustment previously made under the provisions of section 3801.

While the amount of the adjustment under this section is to be computed by determining the difference which would have resulted in the tax previously determined in the prior taxable years in which the inconsistent treatment took place, such prior taxable years are brought into the picture only for the purpose of measuring the amount of the adjustment. The amount of the adjustment so ascertained is to be added to or subtracted from, as the case may be, the excess-profits tax for the taxable year of the determination under chapter 2E.

In any case where a determination of the tax liability under chapter 2E results in the adoption of inconsistent positions with respect to several items, whether such inconsistent positions were maintained by the taxpayer or the Commissioner, or both, an independent determination under the provisions of this section shall be made in respect of each such item both for the purpose of determining the amount of the adjustment and whether such adjustment is authorized. The several adjustments authorized shall be aggregated for the purpose of determining the net addition to, or the net reduction in, the tax imposed by chapter 2E. If the adjustments result in an aggregate net increase, the tax imposed by chapter 2E shall in no case be less than the amount of such aggregate net increase.

If a determination under the provisions of chapter 2E adopts an inconsistent position with respect to an item and results in an adjustment under this section, similar treatment of the same item for subsequent taxable years under chapter 2E is not an inconsistency authorizing further adjustment under this section.

Inconsistent treatment within the meaning of the section may relate to the principle or rule of law applied in determining the taxable status of an item or transaction or it may relate only to the amount of the item which is to be taken into account for tax purposes. The inconsistency is to be ascertained by reference to the actual treatment of the item in the earlier year rather than to what the taxpayer or the Commissioner may have urged at that time. Moreover, the fact that the inconsistent position in the later year is based upon an authoritative judicial interpretation of the revenue law which differs from the accepted interpretation of such law in the earlier year does not remove a case from the scope of the section.

Adjustments to income specifically authorized under the provisions of chapter 2E in computing the excess-profits net income do not occasion an adjustment under this section, as the section permits adjustment only where the treatment in the prior taxable year was not correct under the law applicable to such year. This exception does not, however, extend to the disallowance of deductions for taxable years in the base period pursuant to an election under section 733 to capitalize expenditures made for advertising or the promotion of goodwill which were previously allowed as deductions. Section 733 specifically provides for an adjustment under this section if correction of the tax liability for the taxable year in which the deduction was previously allowed is otherwise prevented.

The term "predecessor" as used in this section means any taxpayer, other than a taxpayer subject to an adjustment under this section, whose tax liability in a prior taxable year in respect of a particular item affects the liability of a taxpayer under chapter 2E with respect to such item, and whose tax liability in such prior taxable year in respect of such item would have been different if there had been no inconsistency between the determination of the liability of the taxpayer under chapter 2E and the determination of its own liability for such prior taxable year. The term includes, among others, a member of an affiliated group as defined in section 730 or a component corporation within the meaning of section 740 (b) (or, if such component corporation is a partnership, the members of such partnership).

SECTION 12. ADMISSIBLE ASSETS OF DEALERS IN SECURITIES

For corporations using the invested capital credit dividends, except dividends (actual or constructive) on the stock of foreign personal holding companies, are excluded from the excess profits net income. Likewise, stock in corporations, except stock in a foreign personal holding company, is made an inadmissible asset by section 720 (a) (1) of the present law. Corporate stocks held by dealers, not as investments for themselves but for sale to their customers, are, in reality, no different from any other article held for sale by a dealer.

Section 12 of the bill amends section 720 (a) (1) of the present law so as to allow corporate stocks held by a dealer for sale to customers to be treated as admissible assets. However, dividends on stocks so treated are subjected to the excess-profits tax to the extent that they exceed the credit for dividends received provided in section 26 (b) of the Internal Revenue Code. Such stocks held by dealers for investment would continue to be treated as inadmissible assets.

SECTIONS 13, 14, 15, AND 16. ALLOWANCE OF CREDIT

Under existing law a domestic corporation which was in existence before January 1, 1940, is required to elect in its return between the credit based upon invested capital and the credit based upon base-period income. The committee bill relieves the taxpayer of the necessity of making such an election and instead provides that the credit shall be an amount computed under either section 713 (the credit based upon base-period income) or section 714 (the credit based upon invested capital), whichever amount results in the lesser tax for the taxable year for which the tax is being computed. As a consequence of the elimination of the election requirement, the bill also eliminates as unnecessary the provision that if no return is filed, only the invested capital method may be used. A similar change is made with respect to foreign corporations. Section 741 of supplement A is likewise amended to eliminate the requirement of an election.

These sections require, in the case of a taxpayer which under section 712 or section 741 is entitled to have the excess profits credit computed under section 713 or section 714, whichever results in the lesser tax under this subchapter, that the return shall contain computations of two tentative taxes, one with the credit computed under section 713 and one with the credit computed under section 714. The return shall also contain all information which under regulations is prescribed as necessary for the computations under each credit. A return which contains only computations under one of the credits shall (except in the event of a disclaimer as hereinafter described) be regarded as no return.

It is provided, however, that a taxpayer who does not desire to make the necessary computations in its return under both credits may state in its return that it disclaims the use of whichever credit it does not desire. In that event the computation and information based on the credit so disclaimed may be omitted from the return. If such disclaimer is made, the credit so disclaimed shall not, for the purposes of the internal-revenue laws (e. g., the computation of earnings and profits, the computation of the excess profits credit carry-over, etc.) be applicable to the computation of the tax for such taxable year with respect to which the disclaimer is made.

Section 15 of the committee bill retains the principle of section 13 of the House bill with respect to supplement A corporations. Supplement A of the existing provisions of the excess-profits tax provides for a method of computation of the base period net income in the case of corporations which have experienced mergers, consolidations or liquidations. Such method under the present law is mandatory for such corporations. The bill amends section 742 of existing law to make such method elective in the case of corporations actually in existence prior to January 1, 1940. Such corporations may compute their average base period net income under either section 713 or supplement A. The election must be made in the taxpayer's return.

SECTION 17. EFFECTIVE DATE

This section provides that the amendments made by this act shall be effective as of the date of enactment of the Excess Profits Tax Act of 1940, which applies to taxable years beginning after December 31, 1939.

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