Excess Profits Taxation: Abnormalities Affecting Income and Capital

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The United States revived the excess profits tax upon corporate income in 1940 with the dual purpose of raising revenue and preventing profiteering on the current rearmament program; and although this form of taxation has in the past raised large sums of revenue, the latter was probably the dominant motive for adopting the present legislation. With that there can be little quarrel so long as only excess profits are subjected to the levy; the difficulty has arisen in determining what tax-free credit should be allowed as the normal profits of industry.

Several methods of computing this credit have been suggested, of which the most commonly applied have been the invested capital basis, under which the taxpayer is allowed a stipulated percentage of the capital employed in his business; and the past earnings basis, under which the allowance is computed from the earnings record of the taxpayer during a period of years selected as "normal." Each of these bases is subject to

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3. Revenue raised by the War and Excess Profits taxes, 1917 to 1921: 1917, $1,638,000,000; 1918, $2,505,000,000; 1919, $1,431,000,000; 1920, $888,000,000; 1921, $335,000,000. Joint Hearings before the Committee on Finance on Excess Profits Taxation, 76th Cong., 3rd Sess. (1940) 155; Buehler, supra note 1, at 293.

These figures are somewhat illusory, however, for large sums have been returned and are being returned for over assessments during these years. See Joint Hearings Report, supra, at 101-103.
4. Joint Hearings Report, supra note 3, at 77. The estimated net revenue for 1940 is but $180,000,000 to $225,000,000. Id. at 103.
5. In addition to the invested capital and base earnings methods of computation, and various modifications, (1) average percentage of profits to invested capital over a period of years (id. at 215); (2) average percentage of profits to sales over a period of years (id. at 253).
6. For the history and general form of excess profits taxes both in the United States and abroad, see Buehler, supra note 1.

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modifications, and neither is entirely unobjectionable; and even a combination of the two, allowing the taxpayer an option as to which he shall adopt, is not a panacea. Abnormalities in the capital or income of corporations are so varied and unforeseeable that no inflexible statutory measure, however wisely framed, can be applied equitably to all corporations throughout the nation.\(^7\)

If the tax is to be applied equitably, therefore, and levied only upon excess profits, some provision must be made for the relief of taxpayers affected by abnormalities. It is the purpose of this paper to consider the provisions of the current act for adjusting such abnormalities, in the light of experience under earlier excess profits legislation, both with regard to the instances in which these problems are likely to arise and the methods whereby they may be alleviated.

Conditions which will effect a prejudicial abnormality necessarily vary with the basis upon which the excess profits credit is normally computed. If prior earnings are the basis, abnormally low income during the base years will prejudice the taxpayer; if invested capital is the basis, abnormality in that regard will be prejudicial; and in any event, unusually high income during the taxable year—the subject of the tax—will affect the amount payable. When the taxpayer is given an election between the capital and income bases, cases which will require special treatment are restricted to those of taxpayers to whom neither basis can be applied fairly; yet instances may arise under all three, which may be generally classified:

I. Abnormalities affecting the basis of computation of the excess profits credit.

A. When invested capital is the basis, and

1. Income-producing property is excluded from invested capital by the terms of the statute.

Comment: If the statute permitted inclusion of all economic elements which contributed to produce the taxpayer's income, no abnormality could arise under this head. The staggering task of computing the "capital" of every taxpayer—difficulties apparent from those encountered by the Interstate Commerce Commission in appraising the relatively few properties of the nation's railroads—has led the redactors of excess profits taxes

7. See Buehler, supra note 1, at 800.
to substitute a similar concept of "invested capital," which is more readily computed but which necessarily excludes some true elements of capital. The number of taxpayers adversely affected, of course, varies inversely with the broadness of the particular "invested capital" concept. For example, the 1918 and 1921 Excess Profits Acts restricted intangibles paid in for stock or shares to twenty-five per cent of the par value of the stock or shares outstanding, and this gave rise to numerous claims for special assessment; no limitation so drastic is made in the 1940 act, so the field of abnormalities is materially reduced.

2. Income is attributable in large part to intangible factors which cannot be capitalized.

Example: T Company is a small "close" corporation, its principal stockholders being four engineers who design labor-saving devices, some of which are installed by T Company. A large part of the corporate income is attributable to the engineers' personal services.

B. When the basis is prior earnings, and

1. The character of the corporation has so materially changed that the past earnings are not fairly representative of present earning power.

Example: W Company, operated two departments during the base years, one of them profitably and one at a loss; the liquidation of the latter department, leaving only the department which had consistently operated at a profit, was completed shortly before the excess profits tax became effective. The base period earnings reflect the net income of the retained department minus the net income for the current taxable year, in the example given, is not affected by an abnormality; the taxpayer has received full credit for its invested capital; but the excess profits credit computed from that invested capital is not high enough to allow the corporation, tax-free, that return which it normally should have. Therefore, under the terminology adopted in this outline, the abnormality instanced affects the excess profits credit computed on the capital basis.
loss of the liquidated department; earnings subject to the tax have not been subjected to this drain.  

2. The corporation experienced abnormally low net earnings during one or more years of the base period.  

Comment: This abnormality may be unique with the particular taxpayer, or it may be common to all taxpayers in that trade or industry. The first is the result, for example, of a strike or fire which caused a temporary cessation of the particular taxpayer's production at some time during the base period. The second is caused by the fact that, although the base period was "normal" for business as a whole, certain trades or industries may nevertheless have experienced depressed conditions. For example, it has been testified that the steamship industry depends upon one or two extremely profitable years in each decade to reimburse it for losses incurred during the interim periods and to yield a reasonable return.  

Abnormally high expenses during one or more of the base period years may also result in abnormally low net income, and consequently an excess profits credit not fairly indicative of the taxpayer's normal earning power.  

3. The taxpayer corporation is materially prejudiced by the time of incorporation.  

Comment: Newly organized corporations are almost invariably adversely affected in the computation of the excess profits credit on income basis, either because of positive discriminations in the statute or because their lack of an earnings record during the base period years compels the adoption of an artificial and arbitrary credit not proportioned to their true earning power.  

Example: X operated his business as an individual proprietorship, earning a large return upon invested capital, until April 1,  

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16. Cf. Grand Rapids Show Case Co., 12 B.T.A. 1024 (1928), affirmed 59 F. (2d) 914 (1932); L.O. 100-A, 2 Cum. Bull. 299 (1920) [Section 327 of the 1918 act applicable to abnormalities during base period ("prewar") years].  
1940; on that date the business was incorporated. Since the corporation was not in existence during any of the base period years (1936-39) it had no earnings record of its own upon which a credit could be determined; and there was no provision in the Excess Profits Act of 1940 as originally passed to permit calculation of the credit on the basis of prior earnings of the proprietorship. The taxpayer was placed at a great disadvantage in comparison with an identical corporation which was organized during even a part of the base period. Under the 1941 amendments, however, the corporation may compute its tax credit from the business' pre-incorporation income of the base period.

The problem of an entirely new enterprise is not so easily solved.

II. Abnormalities affecting the taxpayer's income for the taxable year.

A. When the taxpayer has received "income" during the taxable year which is not properly attributable to its income-producing activities of that year.

Comment: This type of abnormality is due to statutory definitions of income which do not coincide with economic concepts and will usually arise with regard to taxpayers making their returns on the cash basis; the most common example would be a cash basis taxpayer's realization of "profits" during the taxable year which are attributable in whole or in part to activities of another year, as when payment is made in a single lump sum on a contract the performance of which has required, or will require,

22. H.R. Rep. 46, 77th Cong., 1st Sess. (March 7, 1941) 14; Int. Rev. Code § 712; Second Revenue Act of 1941, § 712. Sections 741 and 742 of the Internal Revenue Code originally did not affect corporations which have acquired individual proprietorships and partnerships after the base period, because the definition of an "acquiring corporation" in Section 740 of the code was limited to the acquiring of the assets of other corporations.
23. For computation of excess profits credit on income basis when the corporation has been in existence only a part of the base period, see infra notes 175 and 259.
24. Excess Profits Tax Amendments of 1941, § 8, amending Int. Rev. Code §§ 740, 742, "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." H. R. Rep. 46, 77th Cong., 1st Sess. (1941) 14.
25. See infra, p. 718 et seq.
more than a year.\(^26\) A somewhat different form is presented when the taxpayer realizes taxable "income" due to sale of capital assets in a reorganization maneuver.\(^27\)

B. When the taxpayer's expense deductions have been abnormally low during the taxable year, because sums properly attributable to business expenses of that year have not actually been paid during that period.

Comment: Many small corporations pay inadequate salaries to managers who are also the principal stockholders, and who accept their stock dividends both as interest on their capital and as payment for their personal services. Situations of this kind contributed many special assessment claims under the earlier acts, the retroactivity of the legislation preventing timely adjustment of salaries. The corporation income tax of recent years has probably caused most salaries to be "adjusted" long before the effective date of the 1940 Excess Profits Act, however.\(^28\)

The problem may also arise when, for example, need for facilities during the taxable year causes the taxpayers to delay repairs until the following year.\(^29\)

Conceding that abnormalities should be adjusted, the problem remains of determining how the tax burden may be alleviated in such circumstances without permitting taxpayers not equitably entitled to reduction to evade payment of their full tax, thus defeating the principal purpose of the legislation and depriving the government of revenue. This is, in essence, a dual problem: (1) how, when, and by whom shall relief be granted; and (2) what relief shall be granted.

**HOW, WHEN, AND BY WHOM SHALL RELIEF BE GRANTED?**

The special relief provision may be formulated as a series of specific paragraphs, each applying to a particular type of

\(^26\) Cf. Fort Pitt Bridge Works, 24 B.T.A. 626 (1931).
\(^27\) Cf. Wallis Tractor Co. and J. I. Case Plow Works, 3 B.T.A. 981 (1926).
\(^28\) The situation will persist in the case of growing corporations in need of additional capital, the owner-managers agreeing to draw only enough for living expenses and "plow back" as much as possible into the business. Cf. Sol Frankel, Inc., 3 B.T.A. 494 (1928). See Joint Hearings Report, supra note 3, at 206: "My business is one of those businesses that was an individual proprietorship and was only recently incorporated. The reason it had to be incorporated was that the income tax laws are so severe there would have been no money left with which to expand the business."
abnormality, application of the indicated relief being mandatory whenever the indicated conditions are proved to exist; or the provision's form may be broad and general, with application to specific cases left to the discretion of administrative officials or to an independent board.

The difficulty with the former is that it is inelastic; as the Ways and Means Committee has remarked,

"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."

The very flexibility of a general provision, on the other hand, necessitates a considerable degree of discretion in its application. Senator Smoot said of the discretionary power granted under the 1918 Act, "If exercised wisely it will be a relief to the institutions of the country, and many of them will need it, but if exercised unjustly or unwisely there will be a frightful discrimination between business concerns and industries of the country." If this discretion is granted to the Treasury Department, as it was by the 1918 and 1921 Acts, dissatisfaction is likely to arise from even the fairest administration; for, as was suggested to the Ways and Means Committee twenty years ago, "it is like trying your case before the other fellow's lawyer."

Form and Administration under the 1918 and 1921 Acts

There was no provision for review of special assessment determinations under the 1918 and 1921 statutes, which simply directed

"That in the following cases the tax shall be determined as provided in section 328 ("Computation of Tax in Special Cases"): ....

"(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to

31. 57 Cong. Rec. 506 (1918).
32. Letter from Edgar Rogers, Revenue Revision Hearings before the Committee on Ways and Means, House of Representatives (1921) 266.
abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive."

A form of appeal was allowed within the department, but the popular demand for supervision by an independent board

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33. Revenue Acts of 1918 and 1921, § 327, 40 Stat. 1093 (1919) and 42 Stat. 275 (1923). Subsection (a) permitted special assessment when the commissioner was unable to determine the invested capital under Section 326, the ordinary computation provision (compare Int. Rev. Code § 723; Second Revenue Act of 1940, § 723); subsection (b), in the case of a foreign corporation and (under the 1921 act only) certain corporations with income from sources within possessions of the United States; subsection (c), where a mixed aggregate of tangible and intangible property had been paid in for stock or for stock and bonds and the commissioner was unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively.

The 1917 act [War Revenue Act, tit. II, §§ 200-213, 40 Stat. 302 (1919)] contained no provision for relief of abnormalities [Saner-Ragley Lumber Co., 3 B.T.A. 927 (1926)], although special assessment was permitted when the Secretary of the Treasury was unable to determine invested capital [40 Stat. 307, § 210 (1919)]; the finding could not be made by the commissioner [United States v. Gutzier, 105 F. (2d) 188 (C.C.A. 9th, 1939)]. Although the same circumstances may at the same time give rise to an abnormality and render computation of invested capital impossible, as in Viscose Co., 3 B.T.A. 444 (1926), such an impossibility would be an abnormality of invested capital only if the statute provided that all property the value of which could not be established should be excluded from invested capital.

See, however, Enameled Metals Co., 14 B.T.A. 1392, 1397 (1929): “It is a matter of official record, disclosed in hearings before congressional committees, that in practice the Commissioner did not limit the application of section 210 of the Revenue Act of 1917 to the single situation there set out, but broadened the application to cover such situations as are described in section 327 of the Revenue Act of 1918.” Will this be the tendency under Section 723 of the present act, as to abnormalities for which no relief is provided?

There was also a special provision for foreign corporations in the 1917 act, § 207(b), 40 Stat. 306 (1919).

34. See Williamsport Wire Rope Co. v. United States, 277 U. S. 551, 562n, 48 S.Ct. 587, 590n, 72 L.Ed. 985, 989n (1928).

was not satisfied until the organization of the Board of Tax Appeals in 1924.\textsuperscript{36} Early in its history the board held\textsuperscript{37} that its general jurisdiction extended to supervision of the commissioner's determinations under the special assessment provisions when deficiencies were asserted;\textsuperscript{38} and this was affirmed by the United States Supreme Court in the earliest important case it considered on this subject, \textit{Blair v. Oesterlein Machine Company}.\textsuperscript{39}

\textit{Williamsport Wire Rope Company v. United States},\textsuperscript{40} involving the right to court review of the administrative discretion, had been delayed pending the \textit{Oesterlein} opinion with the expectation that the decision with regard to the board's jurisdiction would also determine the question of judicial review. When the \textit{Williamsport} case appeared, however, the Supreme Court held that the commissioner's determinations under Sections 327 and 328 were not subject to reexamination in the courts:

"To perform that task [of making special assessments], power discretionary in character was necessarily conferred. Whether, as provided in paragraph (d) of § 327, there are 'abnormal conditions'; whether, because of these conditions, computation under § 301 would work 'exceptional hardship'; whether there would be 'gross disproportion' between the tax

\textsuperscript{36} 43 Stat. 336 (1925).

\textsuperscript{37} Oesterlein Machine Co., 1 B.T.A. 159 (1924). The \textit{Oesterlein} case applied, strictly, only to Sections 327 and 328 of the 1918 and 1921 acts; but the same rule was held applicable to Section 210 of the 1917 act in Brownsville & Matamoros Bridge Co., 1 B.T.A. 320 (1925).

"This Board was not created for the purpose of reviewing rulings made by the Commissioner but was created for the purpose of determining the correctness of deficiencies in tax found by the Commissioner. If the deficiency in tax found by him is greater than the true deficiency the Board has authority to decrease it; if it is less than the true deficiency, the Board has authority to increase it [Appeal of the Hotel De France Co., 1 B.T.A. 28 (1924)]."

"If a taxpayer can prove to this Board that he is entitled to a deduction from gross income, the deduction will be allowed even though it has never been claimed by the taxpayer at any hearing had before the Commissioner; otherwise it would be impossible for the Board to determine the correct amount of the deficiency." Gutterman Strauss Co., 1 B.T.A. 243, 245 (1924).

\textsuperscript{38} The board was without jurisdiction as to years with respect to which no deficiencies were asserted. See Pittsburg Supply Co., 14 B.T.A. 620, 621 (1928).

\textsuperscript{39} 275 U.S. 220, 48 S.Ct. 87, 72 L.Ed. 249 (1927).

\textsuperscript{40} 277 U.S. 551, 48 S.Ct. 587, 72 L.Ed. 985 (1928). Sections 327 and 328 of the 1918 act were involved here, but the same rule applied under Section 210 of the 1917 act. Duquesne Steel Foundry Co. v. Burnet, 283 U.S. 799, 51 S.Ct. 481, 75 L.Ed. 1422 (1931), per curiam affirmation of 41 F.(2d) 995 (C.C.A. 3rd, 1930); Central Iron & Steel Co. v. United States, 79 Ct. Cl. 56, 6 F. Supp. 115 (1934), cert. denied 293 U.S. 563, 55 S.Ct. 75, 79 L.Ed. 663 (1934).

The \textit{Williamsport} case cannot be reconciled with the language in \textit{Blair v. Oesterlein Machine Co.}, a fact upon which the court remarked in Ryan Car Co. v. Commissioner, 44 F.(2d) 26, 27 (C.C.A. 9th, 1930).
computed under § 301 and 'that computed by reference to the representative corporations specified in section 328'; what are 'representative corporations engaged in a like or similar trade or business'; which corporations are 'as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances'—these are all questions of administrative discretion."

The circuit court of appeals subsequently held that the Williamsport case did not extend to review of board decisions on this point, jurisdiction of which it considered to have been conferred upon it by statute; but this holding was overruled by two memorandum opinions of the Supreme Court, citing only the Williamsport case. So "The action of the Commissioner or the board, in passing upon the right of a taxpayer to a special assessment, is not subject to review by the courts, unless based upon no evidence, or contrary to law, or so manifestly arbitrary and unreasonable as to amount to an abuse of discretion."

Furthermore, when the taxpayer upon application obtained a determination of his tax under the special assessment provisions, he surrendered the right further to contest in court the correctness of the commissioner's determination with respect to any of the factors necessary to his discretionary finding and the computation of the tax; the taxpayer could seek a judicial rede-

42. Ryan Car Co. v. Commissioner, 44 F.(2d) 26 (C.C.A. 9th, 1930).
45. Peytona Lumber Co. v. Commissioner, 55 F.(2d) 27, 29 (C.C.A. 4th, 1932), cert. denied 287 U.S. 565, 55 S.Ct. 15, 77 L.Ed. 532 (1932). Quaere whether the exceptions are not unjustifiably broad. Compare L. J. Christopher Co. v. Commissioner, 60 App. D. C. 368, 55 F.(2d) 580 (1931), in which the Court of Appeals of the District of Columbia held that it had jurisdiction to review a decision of the Board of Tax Appeals denying the taxpayer special assessment without permitting him to introduce evidence; the decision was reversed and the cause remanded for further proceedings.
46. Central Iron & Steel Co. v. United States, 79 Ct. Cl. 56, 6 F. Supp. 115 (1934), cert. denied 293 U.S. 563, 55 S.Ct. 75, 75 L.Ed. 663 (1934). The reasoning of the court of claims was that, "the system provided by law for a judicial review of the Commissioner's actions in tax cases contemplates that the court shall render final judgment, and, since the court is without jurisdiction to substitute its decision for that of the Commissioner as to the factors to be used in computing the tax, it cannot proceed with a case as though special assessment had not been applied, and the court is likewise without jurisdiction to decide the question presented and remand the case..."
termination of these factors either with respect to the excess profits or the income tax. Beyond this, the lower federal courts have held that the granting of a special assessment did not preclude court action to recover taxes paid thereunder.

(1) when special assessment was made without application by the taxpayer, or upon a qualified application;

(2) when the taxpayer did not acquiesce in the special assessment made after request, and the commissioner did not consider the assessment finally closed;

(3) when the finding of the factors necessary for application of the special assessment provisions was not made by the proper official, or where the finding showed that it did not satisfy the statute;

(4) when the question involved was whether the taxpayer was in an exempt class and that fact could be determined with-

to the Commissioner for further exercise of his discretionary powers to determine whether or not the change in net income results in a greater or less profits tax.” 6 F. Supp. at 115-116.


49. As the recent dates of many of the cases cited reflect, these questions are still live issues, some cases still pending (Joint Hearings Report, supra note 3, at 100); but it has been deemed advisable to adopt the past tense in treating of the 1917, 1918, and 1921 acts.

50. Daily Pantagraph, Inc. v. United States, 68 Ct. Cl. 251, 37 F.(2d) 783 (1939). This point was not before the Supreme Court when it reversed the court of claims decision on another ground in Daily Pantagraph, Inc. v. United States, 282 U.S. 813, 51 S.Ct. 214, 75 L.Ed. 728 (1931). But cf. United States v. Gutzler, 105 F.(2d) 188 (C.C.A. 9th, 1939), in which this factor was present but was not made the basis of the court’s decision.

51. American Chemical Paint Co. v. McCaughn, 19 A.F.T.R. 1311 (E.D. Pa. 1937). The condition was that the application should be disregarded if, under the law, the special assessment would deprive the applicant of his right to court review.

52. McKeever v. Eaton, 6 F. Supp. 697 (D. Conn. 1934). The decision does not purport to go beyond the particular record, under which the court found (1) that the commissioner was adequately apprised, prior to making the special assessment, of the various grounds upon which error was claimed in his computation of the tax; (2) that the taxpayer did not acquiesce in the decision arrived at by the commissioner; (3) that the commissioner never took the position that his special assessment concluded the matter, but continued reexamining the situation upon the merits for several years after the special assessment had been made. See 6 F. Supp. at 702. The latter finding would appear to be irrelevant, since the commissioner can withdraw a special assessment altogether, or substitute another, at any time until the statute of limitations has run, provided that a formal closing agreement has not been entered into. Oak Worsted Mills v. United States, 68 Ct. Cl. 539, 38 F.(2d) 699 (1930); New Jersey Worsted Mills v. Gnichtel, 116 F.(2d) 388 (C.C.A. 3rd, 1940).


54. Garrow, McClain & Garrow v. Bass, 88 F.(2d) 574 (C.C.A. 5th, 1937), cert. denied 302 U.S. 697, 58 S.Ct. 15, 82 L.Ed. 538 (1937). The taxpayer contended that it was a personal service corporation, and in the alternative
out investigation of any of the factors necessary to the commissioner's discretionary findings, and when the taxpayer has not agreed to concede taxable status in order to secure the special assessment.

The enumerated limitations, however, cannot be considered definitively settled; the history of court review after invocation of the special assessment clauses has been one of liberal construction of the taxpayer's right by the lower courts, followed by strict limitation upon presentation of the question to the Supreme Court.

So far as the courts were concerned, the commissioner's only duty under the earlier acts was to consider the taxpayer's claim for special assessment; his discretion could not be fettered, and he could not be compelled to make any particular decision, nor to give his reasons for refusing relief. Even after granting a special assessment, he was not precluded from reconsidering his action and either withdrawing the special assessment altogether or redetermining the tax under the special asked for special assessment under Sections 327 and 328 of the 1918 act.

Held, "If it [the taxpayer] is liable to be taxed as a corporation, the amount of that tax has been finally fixed [by the special assessment] and is in fact not now questioned. But if it is not thus liable, it may have the court so to adjudge." 88 F.(2d) at 576.

55. The taxpayer could not seek court determination that no tax is due because its net income was actually within the non-taxable margin, for that would require judicial consideration of the factors involved in the finding and computation of the tax under Section 328. Central Iron & Steel Co. v. United States, 79 Ct. Cl. 56, 6 F. Supp. 115 (1934), cert. denied 295 U. S. 556, 56 S.Ct. 75, 79 L.Ed. 663 (1934); Michigan Iron & Land Co. v. United States, 6 F. Supp. 563 (Ct. Cl. 1935). These cases may be distinguished from Garrow, McClain & Garrow v. Bass, 88 F.(2d) 574 (C.C.A. 5th, 1937), on the ground that the court there had only to consider the nature of the corporation and its activities, not factors of net income or invested capital.

56. The court intimated, in Garrow, McClain & Garrow v. Bass, 88 F.(2d) 574, 576 (C.C.A. 5th, 1937), cert. denied 302 U.S. 697, 58 S.Ct. 15, 82 L.Ed. 538 (1937), that the commissioner might have required the taxpayer to admit it was a taxable corporation before granting the special assessment, and thus have prevented the taxpayer's subsequently urging its exempt status in court. See Michigan Iron & Land Co. v. United States, 10 F. Supp. 563, 570-571 (Ct. Cl. 1935).


58. 67 App. D. C. at 111, 89 F.(2d) at 855: "We think the petition for mandamus should have been granted, not to require the Commissioner to make any particular decision, nor to limit his discretion by the action of his predecessor for the years 1917-1918 which, so far as we know, may have been altogether wrong, but only to require him to determine and announce his final decision on the merits of the claim."

On the taxpayer's right to introduce evidence in support of his claim, compare L. J. Christopher Co. v. Commissioner, 60 App. D. C. 388, 55 F.(2d) 630 (1931).
provisions, and without apprising the taxpayer of the facts upon which the redetermination was made.

The Board of Tax Appeals, however, in the exercise of its power of review over the commissioner's determinations, held that the granting of special assessment was mandatory when any of the specified conditions were found to exist; and the special assessment device could not be used to raise the tax payable, since these sections were intended as relief provisions.

The board's attitude toward abnormalities was not entirely consistent. In the first volume of its reports, the board said in *Morris & Company, Incorporated*:

"It can not be consistently said that the statute excludes the item from invested capital and at the same time treats such exclusion as so abnormal as to be the ground for relief by special assessment."

Specifically, this statement applied only to those abnormalities classified under I (A) (1), supra; but the "logic" behind it, carried to its conclusion, would have resulted in a denial of relief from any abnormalities caused by the statutory disregard of elements material to computation of the truly excess profits—would have defeated the sole purpose of the special relief pro-

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59. Oak Worsted Mills v. United States, 68 Ct. Cl. 539, 38 F.(2d) 699 (1930); New Jersey Worsted Mills v. Gnichtel, 116 F.(2d) 338 (C.C.A. 3rd, 1940). This was subject to the applicable statute of limitations, of course, and to the formulation of a formal closing agreement. 116 F.(2d) at 342.
62. The four conditions for application of special assessment under the 1918 and 1921 acts are set forth in Section 327 [40 Stat. 1093 (1919), 42 Stat. 275 (1923)]. See pp. 673, 674, and note 33, supra.
64. The *Sumpter Valley* case would seem to render obsolete the earlier decisions (1) that the commissioner could not make a special assessment when the taxpayer could show that the conditions specified in the statute did not exist [Brownsville & Matamoros Bridge Co., 1 B.T.A. 320 (1925)], for the taxpayer would have had no interest in introducing such evidence unless the tax under ordinary statutory assessment had been lower; and (2) that the tax computed under the special assessment could not exceed that determined under Section 302 of the 1918 and 1921 acts [40 Stat. 1089 (1919) and 42 Stat. 272 (1923); Davis & Andrews Co., 2 B.T.A. 338 (1923)], for that section was a limitation upon the ordinary imposition section.
65. Supra p. 668.
visions. This view manifested itself again in *High Shoals Company*, in which water power worth $350,000 was includible in statutory invested capital only in the amount of $50,000, yet special assessment was refused. The vigorous dissent of Trammell, in which Phillips concurred, reviewed the legislative history of the special assessment provisions, and concluded that

"... the question ... presents itself whether, when the taxpayer has in its business assets of a recognized and substantial value which are producing income and which it can not capitalize, due to the limitations of section 326, an abnormality exists which brings it within the provisions of section 327. My view is that it does. That fact, in my opinion, is an abnormality affecting capital, as provided in section 327, provided the amount excluded from invested capital on this account is substantial in amount."

The same year Trammell reiterated his view in the majority opinion of the board in *G. M. Standifer Construction Corporation*, stating that, "This section of the statute [327] is admittedly relief legislation and should be liberally construed in accordance with the well-accepted rule of statutory construction with respect to such legislation."

Ultimately Trammell's view prevailed, and in subsequent board decisions the distinction was commonly drawn,

"We have held that a taxpayer does not fall within the provisions of sections 327 and 328 merely because assets are used in the business which may not be included in invested capital. *Morris & Co.*, 1 B.T.A. 704. The exclusion must be such as to create an abnormal condition." (Italics supplied.)


"Congress expressly excluded 'borrowed money' from invested capital; yet we know from the legislative history that it is intended to give relief in cases where borrowed money constitutes an abnormal condition. The Board itself seems to have recognized borrowed money as an abnormality in the Saner-Ragley Lumber Company appeal, 3 B.T.A. 927 (1926)."

67. 3 B.T.A. 305 (1926).

68. Because Section 326(a)(2) of the 1918 act [40 Stat. 1092 (1921), Cf. 42 Stat. 274 (1923)] provided that tangible property paid in for shares of capital stock was to be included in invested capital only to the extent of the value at the time of such payment, without regard to subsequent enhancement. See *High Shoals Co.*, 3 B.T.A. 305, 307-308 (1926).

69. 3 B.T.A. at 308.

70. 4 B.T.A. 525 (1926).

71. Id. at 541.

72. Clarence Whitman & Sons, Inc., 11 B.T.A. 1192, 1198-1199 (1928). See
Detailed consideration of the situations which the board considered "abnormal" within the meaning of the statute would not be particularly profitable; abnormalities were determined on the facts of each case, and the many diverse factors involved in most were not always differentiated in the final determination. In general, however, the board required proof that the alleged abnormality was substantial and that it was unusual in the taxpayer's trade or business. If the abnormality was an exclusion of capital, the taxpayer was required to show that the property excluded (from statutory invested capital) was actually used in the operation of the business or that it contributed to the production of taxable income.

The substantiability requirement was simply common sense; as the board itself expressed it,
"In many businesses there will be some good will, or some appreciation in the value of assets, or some other factor which can not enter into the computation of invested capital. The exclusion must be such as to cause exceptional hardship.

" . . . no two businesses can be alike in all their factors. Each is bound to have certain favorable or unfavorable conditions as compared with others. It was not to such things as these that Congress had reference in the use of the word abnormalities in section 327, but rather to those situations where by reason of some peculiarity in the corporate structure, invested capital was unusually small as compared with the total capital employed in the business or income was affected by some unusual circumstance." 

The requirement that the circumstance complained of be unusual in the taxpayer's trade or business was the necessary result of the statutory phrase, "exceptional hardship as evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328", but it was unfortunate in that it denied relief for abnormalities which might affect an entire industry.

The requirement that the abnormality result in "exceptional hardship" led to denials of special assessment when the taxpayer had "considerable admitted invested capital," and when the taxpayer was already in the lowest tax bracket.

In accordance with the specific direction of Section 327(d)—absolutely necessary, indeed, if the statute was to impose a tax at all—special assessment was denied when the taxpayer's income resulted merely from a high return on normal invested capital.

77. Enamed Metals Co., 14 B.T.A. 1392, 1398 (1929). Compare Raymond Syndicate, Inc., 21 B.T.A. 600, 605 (1930): "A condition that is common to many corporations does not create such an abnormality in invested capital as warrants the application of special assessment."

78. Section 327(d) of the 1918 and 1921 acts, 40 Stat. 1093 (1919) and 42 Stat. 275 (1921). See pp. 673-674, supra.

79. Quaere as to the extent to which the board disregarded the rule in such situations. See note 75, supra. See L.O. 1000-A, 2 Cum. Bull. 299, 300 (1920): "[Section 311, 40 Stat. 1090 (1919)] gives relief to industries which passed through a period of depression in the prewar years." This, however, related only to the war profits tax credit.

80. Powell Coal Co., 12 B.T.A. 492 (1928). But cf. Marc Eidlitz & Son, Inc., 18 B.T.A. 187 (1929), in which special assessment was granted when "[the taxpayer's] invested capital, although substantial, was only remotely responsible for its earnings."

capital;\textsuperscript{82} as a consequence of this, "efficient management" was never regarded as an abnormality,\textsuperscript{83} and large income alone was not proof of abnormality, even though the net return for the year exceeded invested capital.\textsuperscript{84} The second proviso of Section 327 (d) —that special assessment should not be accorded a taxpayer fifty per cent or more of whose gross income was derived on a cost-plus basis from a government contract or contracts made during the war period—was also enforced by the board by requiring the taxpayer to negative the existence of such a condition.\textsuperscript{85}

The burden was properly placed upon the taxpayer to prove that it came within the provisions of Section 327.\textsuperscript{86} Data on representative taxpayers was not available to the taxpayer;\textsuperscript{87} however; accordingly the board considered that the taxpayer had made a prima facie showing of the applicability of Section 327 (d) upon its proving that abnormal conditions affected its capital or income, although the "gross disproportion" of the tax and resultant "exceptional hardship"—as evidenced by comparisons—were not indicated.\textsuperscript{88}

Even with this concession, it was failure to sustain the burden of proof rather than the invalidity of the abnormalites urged which accounted for a majority of the rejected claims for special assessment.\textsuperscript{89} This was unfortunate, but inevitable; a lesser burden of proof would have permitted evasions by the very taxpayers upon whom the levy was intended to rest.

\textsuperscript{84} Goldie Oil & Gas Co., 18 B.T.A. 443 (1929), and cases cited therein. But cf. Woodbury Shoe Co., 19 B.T.A. 433 (1930).
\textsuperscript{85} Logan-Gregg Hardware Co., 2 B.T.A. 647 (1925).
\textsuperscript{86} Huff, Anrews & Thomas, 1 B.T.A. 542 (1925); Richards and Brennan Co., 1 B.T.A. 972 (1925). Cf. Gaukler & Stewart, 1 B.T.A. 578 (1925); Gottlieb Bros., 1 B.T.A. 684 (1925).
\textsuperscript{87} Barton, supra note 75, at 335. The so-called "secrecy provisions" contained in Section 3167 of the Revised Statutes, as reenacted by Section 1018 of the Revenue Act of 1924 [43 Stat. 344 (1925)] were relied upon by the commissioner even to the extent of resisting subpoena by the Board of Tax Appeals. See Oesterlein Machine Co., 1 B.T.A. 159, 163-167 (1924); Friedman, supra note 66, at 349. The commissioner refused to comply with subpoenas requiring information from returns of other taxpayers relevant to the inquiry (ibid.) until the Supreme Court upheld the board's power [Blair v. Oesterlein Machine Co., 275 U.S. 220, 48 S.Ct. 87, 72 L.Ed. 249 (1927)].
\textsuperscript{89} Cases cited 3 Prentice-Hall 1941 Fed. Tax Serv. ¶¶ 53484, 53524. See Friedman, supra note 66, at 308-309.
There were decisions denying abnormalities which might validly be criticized; there was discontent aroused in some circles by the administration of the relief provisions; but, on the whole, the results attained were satisfactory. Certainly the applications by the board were more equitable than the results which could have been secured under a relief provision as inflexible as the taxing measure itself.

The greatest objection to Sections 327 and 328, perhaps, is the tremendous amount of litigation which they provoked—literally thousands of cases, some of which were still pending when the 1940 Excess Profits Act was imposed. 90

Form and Administration under the 1940 Act

The Second Revenue Act of 1940 as originally proposed 91 made no provision for relief of abnormalities; 92 the treasury considered that the improvements in the new act's basic structure—particularly the treatment of intangible property on the same basis as any other, 93 and the inclusion of a portion of the taxpayer's borrowed capital in statutory invested capital 94—rendered such relief unnecessary. 95 There is no doubt that this liberalization of the concept of invested capital, and the provision of an alternative basis for computation of the excess profits credit (computed from the tax-payer's earnings during the years 1936 to 1939, inclusive 96) will alleviate many situations which would have

90. See Statement of Colin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation, Joint Hearings Report, supra note 3, at 97, 100:
"MR. McCORMACK. Mr. Stam, under your plan, the question of invested capital is based on the general theory of looking at the earnings in terms of dollars made during the base period, instead of in terms of percentages. So that a corporation, having a 4-year base-period experience, will not have the complicated questions of invested capital arise. That was a very difficult question in the 1918 act, was it not?"
"MR. STAM. That is true.
"MR. McCORMACK. Out of which arose many thousands of court cases.
"MR. STAM. That is true. Over 10,000 cases were litigated, some of which have not yet been disposed of."
91. H. R. 10413.
96. Int. Rev. Code § 713(b); Second Revenue Act of 1940, § 713(b), as amended (in matters not relevant to the present citation) by Excess Profits Tax Amendments of 1941, § 4.
required special assessment under the earlier acts, but testimony at the joint hearing soon revealed many situations of potential inequity. The demand for a flexible relief provision resulted in amendment by the Senate, adding two new sections which were subsequently accepted by the conference committee and designated Sections 721 and 722.

The first of these sections listed six specific situations in which income for the taxable year should be considered abnormal; the second was an abnormalities section as brief and broad as any that can be conceived, simply declaring:

“For the purposes of this subchapter, the Commissioner shall also have authority to make such adjustments as may be necessary to adjust abnormalities affecting income or capital, and his decision shall be subject to review by the United States Board of Tax Appeals.”

Apparently this would include not only abnormalities affecting income or capital in the computation of the excess profits credit, but also abnormalities in the income for the taxable year, and to that extent it offered a duplicate or alternative remedy to the one supplied by Section 721. In all probability, the jurisprudence with regard to court review developed under Section 327(d) of the 1918 and 1921 Acts would have been applied here; and the former Board of Tax Appeals authorities would have been revived for the determination of abnormalities, except insofar as the absence of the specific limitations of the earlier statute might be construed to have liberalized the relief

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97. See pp. 668-669, supra.
100. Id. at 162, 246, 262.
102. Int. Rev. Code § 721; Second Revenue Act of 1940, § 721. These situations are considered infra p. 687.
104. See supra pp. 674-678.
105. The abolition of comparatives as the basis for determining an abnormality and computing the tax under special assessment removes the basis upon which the Supreme Court distinguished review of special assessment determinations from other discretionary tax problems (see Williamsport Wire Rope Co. v. United States, 277 U.S. 551, 559, 48 S.Ct. 587, 589, 72 L.Ed. 985, 987 (1928)); but this is a slight hurdle for a court which could reconcile the Williamsport decision with the language it used as the basis for its decision in Blair v. Oesterlein Machine Co., 275 U.S. 220, 48 S.Ct. 87, 72 L.Ed. 249 (1927). See note 40, supra.
106. See pp. 678-684, supra.
107. The requirements (1) that the abnormality result in “exceptional
provision. The last clause, "and [the commissioner's] decision shall be subject to review by the United States Board of Tax Appeals," resolved the question which led to the protracted litigation of the Oesterlein case, but it posed the new question, whether it extended the board's jurisdiction to cases in which no deficiency is alleged.

But all this is now of academic interest. Section 722 was enacted with the understanding "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." On March 7, 1941, Sections 721 and 722 were repealed retroactively.

The substituted provisions took the form of a seventeen-section act radically revising the excess profits tax statute of the preceding year. Changes in the basic structure of the tax may be expected to narrow the field of "hardship cases" materially; three sections deal respectively with abnormalities in deductions during the base period, abnormalities in income of the taxable year, and abnormalities of income during the base period. The result is a mixture of specific provisions and specific limitations and broad administrative discretion in a complexity that is marvellous to behold but exasperating to construe.

This can be accepted, if the provisions accomplish their intended task: to relieve taxpayers affected by abnormalities, yet to safeguard the remedy from abuse. But will they adequately discharge this function?

Section 721 is devoted to abnormalities in the income for the taxable year caused by inclusion of items which are attributable hardship" as evidenced by "gross disproportion" of the claimant's tax as compared with representative corporations; (2) that less than 50% of the claimant's gross income have been derived on a cost-plus basis from government contracts made during the war period.

108. See p. 683 and note 87, supra.
112. Excess Profits Tax Amendments of 1941.
113. See H.R. Rep. 146, 77th Cong., 1st Sess. (1941). These matters are beyond the scope of this article.
table, in whole or in part, to other years. The six specific classes of
such income enumerated in Section 721 of the 1940 statute are
carried over to the amended Section 721 (a) (2):

"(A) Income arising out of a claim, award, judgment, or
decree, or interest on any of the foregoing;\(^{115}\) or

"(B) Income constituting an amount payable under a con-
tract the performance of which required more than 12
months;\(^{116}\) or

"(C) Income resulting from exploration, discovery, pros-
pecting, research, or development of tangible property, pat-
ents, formulae, or processes, or any combination of the
foregoing, extending over a period of more than 12 months;\(^{117}\) or

"(D) Income includible in gross income for the taxable
year rather than for a different taxable year by reason of a
change in the taxpayer's accounting period or method of ac-
counting;\(^{118}\) or

"(E) In the case of a lessor of real property, income
included in gross income for the taxable year by reason of
the termination of the lease;\(^{119}\) or

"(F) Income consisting of dividends on stock of foreign
corporations, except foreign personal holding companies."\(^{120}\)

These specific provisions were made to provide for those ab-
normalties which Congress could foresee, and at the same time
to avoid the necessity of administrative selection—which had
provoked so much criticism under the earlier acts—in a majority
of the cases which might arise. Yet Congress sensibly admitted
that "the types of abnormal income that may occur cannot be

\(^{115}\) Compare Trojan Oil Co., 26 B.T.A. 659 (1932). Cf. Welch v. Obispo
Oil Co., 301 U.S. 190, 57 S.Ct. 684, 81 L.Ed. 1033 (1937). Contrast Fort Pitt

Reg. 109, §30.721-3.

117. Possible source: Joint Hearings Report, supra note 3, at 115 et seq.


D. 4980, 1940-28, Int. Rev. Bull. 2, after the decision of Helvering v. Bruun,
309 U.S. 461, 60 S.Ct. 651, 84 L.Ed. 864 (1940).

predicted in advance,"\textsuperscript{121} and so provided further that "the classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.\textsuperscript{122} Power was delegated to the commissioner, that is, to add further subdivisions to Section 721 (a) (2) as the need might arise; but the action will be quasi legislative in effect, and the ruling once established will be available to other taxpayers, rather than quasi judicial (as under the earlier acts) with the possibility of diverse results on the same set of essential facts.\textsuperscript{123} This may be expected to preclude some of the suggestions of favoritism and discrimination which were heard under the former arrangement. Unfortunately, this necessarily prevents the application of special relief in those cases in which the abnormality is a combination of factors no one of which alone would suffice.\textsuperscript{124}

Relief is not applied, of course, merely upon a showing that the claimant has income of the indicated classes; it must appear that it is abnormal for the taxpayer to receive income of this class or in this amount,\textsuperscript{125} and that it is attributable to other years.\textsuperscript{126} The latter is, as applied to abnormalities of gross income for the taxable year, an elementary requirement of necessity; for abnormally large income attributable to the taxable year is the very incidence of the tax. This limitation is merely the application to one type of abnormality of the rule under the 1918 and 1921 Acts that special relief should not be granted "in any case in which the tax ... is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital."\textsuperscript{127}

It may theoretically be an abnormal condition for a taxpayer to receive regularly income of the same class attributable to years other than that in which it is credited; but if the sums are substantially the same from year to year, correction would be a useless effort: Deduction of sums includible in gross income of

\textsuperscript{121} H.R. Rep. 146, 77th Cong., 1st Sess. (1941) 9.
\textsuperscript{122} Int. Rev. Code § 721(a)(2).
\textsuperscript{124} Cf. E. B. Ficklen Tobacco Co., 10 B.T.A. 51 (1928).
\textsuperscript{126} Int. Rev. Code § 721(c); H. R. Rep. 146, 77th Cong., 1st Sess. (1941) 10.
\textsuperscript{127} Revenue Acts of 1918 and 1921, §327(d), 40 Stat. 1093 (1919) and 42 Stat. 275 (1923). For the Board of Tax Appeals' application of this limitation, see supra p. 682.
the taxable year but attributable to other years would be offset by addition of sums includible in other years but actually earned in the taxable year. Such a taxpayer suffers little if the income received during each year is taxed arbitrarily as if it were attributable to activities of that year. But if it is unusual, or abnormal, for the taxpayer to receive income of this class, it should be taxed only upon the portion of the income which is properly attributable to the taxable year. The same is true of the excess portion when the taxpayer regularly receives such income, but during the taxable year has received it in an abnormally large amount.

This problem was disposed of under the 1918 and 1921 Acts by the vague standard that the abnormality must cause "exceptional hardship" as evidenced by "gross disproportion" between the tax owned by the claimant under the ordinary scale and that paid by representative corporations as nearly as may be, similarly circumstanced." In the 1941 statute Congress has sought to avoid the uncertainty of the former criterion by providing, very specifically, that income of a class which the taxpayer normally receives shall not be considered abnormal in amount unless it exceeds 125 per cent of the average amount of the gross income of the same class received during the four previous taxable years, or such portion of that time as the taxpayer was in existence. Here Congress has chosen definiteness at the sacrifice of flexibility, making possible the obvious disparity in the following hypothetical case:

X Corporation and Y Corporation are identical in structure and services rendered; each regularly receives $100,000 per year from judgments entirely attributable to previous years, and $100,000 per year from long-term contracts performed in previous years. Both make their returns on the cash basis. During 1940 each experiences a twenty per cent increase of gross receipts from these two sources; but X Corporation's increase is uniform,

129. Id. at § 328(a), 40 Stat. 1093 (1919) and 42 Stat. 275 (1923). For application of this limitation under the 1918 and 1921 acts, see supra p. 682.
131. Int. Rev. Code § 721(a)(1). Note that the test here is the average for the four previous taxable years, not the base period of four fixed years (1936-1939) used for determination of the excess profits credit on income basis. Id. at § 713(b)(1)(A); Excess Profits Tax Amendments of 1941, §4. Compare Section 713(b)(1)(B), making a similar provision for computation of the excess profits credit on income basis for a corporation in existence during only part of the forty-eight months preceding the beginning of its first taxable year; but see note 175, infra.

A corporation organized after December 31, 1939, and receiving during its
whereas Y Corporation's increase is concentrated in the "judgments" class.

<table>
<thead>
<tr>
<th></th>
<th>X Corp.</th>
<th>Y Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average income from judgments during four previous taxable years</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Average income from long-term contracts during four previous taxable years</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Income from judgments during 1940</td>
<td>120,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Income from long-term contracts during 1940</td>
<td>120,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Total income for 1940</td>
<td>$240,000</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

On this highly-idealized record, it is apparent that each had $40,000 of abnormal income during 1940. Y Corporation can, in fact, secure reduction of its 1940 income from judgments by the difference between $140,000 and $125,000 (125% of $100,000, the average of four previous years), but X Corporation's income in both brackets is below 125 per cent of its average income from the same sources, and therefore is not "abnormal" within the statutory test. Assuming that the excess profits credit for each is $195,000, and disregarding deductions, the result is:

<table>
<thead>
<tr>
<th></th>
<th>X Corp.</th>
<th>Y Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income for 1940</td>
<td>$240,000</td>
<td>$240,000</td>
</tr>
<tr>
<td>Minus net abnormal income attributable to other years</td>
<td>0</td>
<td>15,000</td>
</tr>
<tr>
<td>Minus excess profits credit and exemption</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Adjusted excess profits net income subject to tax for 1940</td>
<td>$40,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

first year of existence income of one of the indicated classes, includible in gross income for 1940 but attributable in whole or in part to future years, would have no "previous taxable years" upon which to determine an average for the purposes of the 125 per cent rule. Would it be considered "abnormal for the taxpayer to derive income of such class," in which event the 125 per cent limitation would be inapplicable? If so, the result may be entirely unrealistic; for example, the corporation may be a new construction company which has received advance payment for performance of a construction contract during 1940 and 1941, and which is intended to execute long-term contracts, the income to be reported on the completed contract basis in accordance with U.S. Treas. Reg. 103, §19.42-4(b). If not, Section 721 will offer no relief to corporations formed after December 31, 1939, during the first year of corporate existence.

132. This hypothesis is worked out in extremely simplified and skeletal form; computation of relief is considered in greater detail infra, p. 705.
133. See Int. Rev. Code § 721(c). If the previous year were subsequent to December 31, 1939, there would be an additional tax under Section 721(c)(2). See infra, pp. 703-704.
134. See Int. Rev. Code § 710(b); Second Revenue Act of 1940, § 710(b).
But criticism is easy; any figure which Congress could fix would be susceptible to similar treatment, and the discrimination is no more serious than that between employers of eight or more persons, who are subject to the Federal Unemployment Tax, and those who employ fewer and are exempt. A more serious question is whether the 125 per cent figure is too high to permit alleviation of many real abnormalities, or so low that the Bureau of Internal Revenue will be deluged with applications; and that is essentially a matter of personal opinion, upon which only future events can cast light. Congress must accept the evils of inflexibility to avoid the evils of flexibility.

Congress found it inadvisable, however, to devise a mechanical means of determining to what previous or future year income of this kind should be attributed, and in what amount; this it left to future regulations of the commissioner with the approval of the secretary. The hypothetical case suggested was simplified by the assumption that all income in question was attributable to previous years not subject to excess profits taxation, but in the normal case there will be the compound problem of determining (a) the amount of such income attributable to the taxable year (which will, of course, be included in the excess profits net income subject to tax); (b) the amount to be attributed to previous years and its allocation among those years, some of which will ordinarily be subject to the excess profits tax; and (c) the amount to be attributed to future years, and to which years.

One further point remains: The statute provides that, "All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects." This rigorous rule of pleading was probably intended to prevent amendments by taxpayers seeking to evade the 125 per cent limitation; but many meritorious claims

138. Also by eliminating from consideration expenses entailed in the earning of such income, and by treating gross income and net income as identical. See infra, p. 705 et seq., for detailed consideration of these factors.
139. See Int. Rev. Code § 721(c)(2).
140. See id. at § 721(d).
141. For relief to be granted under this and other sections, see infra, p. 705 et seq.
may be forfeited for failure to select the proper name by which
the rose should be called. This does not necessarily imply neg-
ligence; neither courts nor boards are noted for their invariable
acceptance of the construction which seemed reasonable before
the measure reached their hands.

With this exception, however, Congress may be said to have
performed a creditable job in its handling of abnormalities affect-
ing gross income of the taxable year. The rest will depend upon
sympathetic administration.

But it should be noted that the six classes of income design-
nated, and those which the commissioner is empowered to pre-
scribe by regulation, refer exclusively to abnormal gross income
received. There is no provision for the correlative factor—ab-
normally low expenditures which result in high net income.
Assume that the T Company is a small corporation organized
since December 31, 1939, and that it is not a reorganization of a
partnership or proprietorship. In order to build up the capital
of the corporation, the managers (who are the sole stockholders)
agree to accept salaries far below their true worth. The result,
of course, is an abnormally large net return if the corporation earns
even normal gross income. Since there is no provision for the
adjustment of such an abnormality, T Company must pay an
excess profits tax although it actually has only normal profits,
and although an identical corporation forced to hire outside

143. See id. at § 721(a)(1). Cf. II(A) of the outline of abnormalities, supra
p. 671.
144. See II(B) of the outline of abnormalities, supra p. 671.
145. This is assumed to avoid possible application of Int. Rev. Code § 722,
as amended by Excess Profits Tax Amendments of 1941, § 6, although that
section is confined to adjustment of the excess profits credit on income basis
See infra note 146.
146. This is assumed to avoid Int. Rev. Code § 742, as construed by refer-
ence to Section 740, as both are amended by Excess Profits Tax Amendments
of 1941, § 8.

If the corporation could secure the benefit of an excess profits credit
computed on income basis (either under these sections or because it had an
actual earnings record during the base years), and if comparably low sal-
aries were also paid during the whole of the base period, the resulting
abnormally high excess profits credit would cancel the abnormally high
income for the taxable year, and no prejudice would result. This problem
arises either when the corporation is forced to adopt the capital basis excess
profits credit (as under the facts given), or when the determination to build
up capital by this device is made late in or after the base period.
147. Int. Rev. Code § 721 does not apply because (a) it is not "income
of any class includible in the gross income of the taxpayer" under Section
721(a)(1), and (b) it is not attributable to any other year.
managers of similar ability, and at their "market value," would have no tax to pay.\textsuperscript{148}

The statute also lacks any provision for relief of abnormalities affecting the excess profits credit computed on the capital basis, such as has been a feature of every excess profits act since February, 1919. If the concept of invested capital has been perfected to the point that no abnormalities can arise, this omission was proper; but the committee itself points out in its report on the 1941 amendments that abnormalities are diverse and unpredictable.\textsuperscript{149} Relief of capital abnormalities is unnecessary, also, if adequate provision has been made for adjustment of the excess profits credit based on prior income to the situation of every taxpayer in every conceivable case; in fact, the capital basis of computation would then become useless except as a means whereby overcapitalized corporations can avoid the purpose of the statute. But has this ideal been attained under the 1941 amendments?

"Section 722 of the bill," said the report of the Committee on Ways and Means, "is designed to afford relief in the case of certain situations not covered by other sections of the bill."\textsuperscript{150} From this it would be expected that the provision would be quite broad, covering all those points of the outline of abnormalities above\textsuperscript{151} except II(A). But "The relief is confined to the adjust-

\textsuperscript{148} This type of abnormality was quite common under the 1918 and 1921 acts, which required all corporations to compute the excess profits credit on an invested capital basis. A few of the cases in which the Board of Tax Appeals granted special assessment because of inadequate salaries paid in a close-held corporation were Yale-Brevda Paper Box Manufacturing Co., 2 B.T.A. 900 (1923); Sol Frankel, Inc., 3 B.T.A. 494 (1926); Saner-Ragley Lumber Co., 3 B.T.A. 927 (1926); Selwyn Operating Co., 5 B.T.A. 723 (1926); G. Angelo Co., 12 B.T.A. 480 (1926). For the requisites of establishing inadequacy of salaries, consult Crowley Bros., Inc., 2 B.T.A. 477 (1925); Warren County Fertilizer Co., 17 B.T.A. 113 (1929); Green, Matthews, Taylor Co., 19 B.T.A. 359 (1930).

Low expenses during the taxable year were relieved as the result of abnormalities when the corporation had leases at low rental from an affiliated corporation [San Francisco Hotel Co., 22 B.T.A. 740 (1931)], a parent corporation [California Coast Oil Co., 25 B.T.A. 902 (1932)], or a sole stockholder [Bates-Bowman Corp., 20 B.T.A. 460 (1930)]. Apparently contra: Kimball Tyler Co. of Maryland, 18 B.T.A. 729 (1930). Cf. Standard Slag Co., 20 B.T.A. 503 (1930). Ordinarily, however, special assessment was not granted because of advantageous relationships enabling the taxpayer to obtain the benefit of reduced costs [Continental Products Co., 24 B.T.A. 119 (1931)], and advantageous contracts for the purchase of raw materials were not considered abnormal [Everett Logging Co., 19 B.T.A. 1098 (1930)]. But cf. A.R.R. 518, 4 Cum. Bull. 401 (1921).


\textsuperscript{150} Id. at 10.

\textsuperscript{151} Supra pp. 668-671. Int. Rev. Code § 711(b)(1)(H), (I), (J), and (K) supplement Section 722. See infra p. 695 et seq.
ment of the abnormal base period net income of a taxpayer electing the average earnings credit," and within that category it applies only to the situations specifically designated.

As was shown in the outline of abnormalities, the excess profits credit based on prior earnings may be abnormal when

1. the character of the corporation has so materially changed that the past earnings are not fairly representative of present earning power;

2. the corporation experienced abnormally low net earnings during one or more years of the base period; or

3. the taxpayer corporation is materially prejudiced by the time of incorporation.

Section 722 (a) (1) provides relief in the first of these instances, but it is applicable only if

"(A) there is a difference in the products or services furnished; or

(B) there is a difference in the capacity for production or operation; or

(C) there is a difference in the ratio of non-borrowed capital to total capital; or

(E) the taxpayer acquired, before January 1, 1940, all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished." These clauses seem sufficiently broad to cover all cases of changes in the character of any business; but prescience is particularly difficult in this field. The restrictive "only" was no doubt another line in the bureau's defenses against too numerous applications, at the cost of possible individual injustices.

Relief for abnormalities of the second class is supplied by Section 722 (a) (2), when the taxpayer "establishes ... that in one or more of the taxable years in [the] base period normal production, output, or operation was interrupted or diminished because of the occurrence of events abnormal in the case of such taxpayer." This clause, fortunately, is left more general than the preceding one; the committee has indicated that it is intended to apply when the taxpayer has experienced a fire, flood, or
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strike\textsuperscript{155} interrupting or diminishing operations during the base period,\textsuperscript{156} but application in other instances is wisely left open.

The effectiveness of Section 722(a) (2) in correcting abnormalities resulting in low income during the base period will depend in large measure upon the strictness or liberality with which the interruption-of-operation clause is construed. Suppose that the Z Company publishes a daily newspaper, suspension of which was threatened by a flood which disabled its plant during a base period year. It was able to secure the use of another press and continued uninterruptedly to produce and sell the same number of newspapers; but the small capacity of the emergency press compelled omission of the advertising which is Z Company's chief source of revenue. Would this be an interruption or diminution of "normal production, output, or operation"? Clearly it must be, if the purpose of the section is to be effectuated.

If the taxpayer brings itself within the terms of Section 722(a) (1) or (2), it has established that it is affected by abnormal conditions; but that alone does not entitle it to relief. It must show that the excess profits credit computed under this section is greater than that ascertained under the ordinary provisions of the statute;\textsuperscript{157} and to establish this the taxpayer must prove "the amount that would have been its average base period net income" if the character of its business had been the same during the base period, and if none of the abnormal events had occurred.\textsuperscript{158} A more difficult burden of proof can scarcely be imagined; it is like answering the old nonsense, "If you don't have a brother, would he like chocolate ice cream if you did?" The taxpayer must prove that abnormal conditions existed which diminished its base-period earnings, and then it must establish what those earnings would have been if the conditions had not existed—which can rarely be more than an informed guess. This will be considered at greater length in the discussion of the relief to be granted, in connection with which the problem also arises.\textsuperscript{159}

\textsuperscript{155} Compare Grand Rapids Show Case Co., 12 B.T.A. 1024 (1928), affirmed 59 F.(2d) 914 (1932).


\textsuperscript{157} Int. Rev. Code § 722(a)(4). Compare the rule established by the Board of Tax Appeals under the earlier acts that special assessment may not be applied unless the resulting tax is lower than that determined under the ordinary provisions.

\textsuperscript{158} And "if in each of such taxable years none of the items of gross income had been abnormally large, and none of the items of deductions had been abnormally small . . . ." [Int. Rev. Code § 721(a)(3)].

\textsuperscript{159} See infra, p. 710 et seq.
A further limitation upon the application of Section 722 is that the "high prices of materials, labor, capital, or any other agent or 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, shall not be considered as abnormal." These are the "normal" variants of the capitalist economy—supply and demand; but the limitation seems unduly broad. Any of these factors may be abnormal when caused by abnormal conditions; yet relief under Section 722 apparently is precluded in such circumstances as these:

1. The newspaper publisher instanced above was able to secure a press adequate to continue normal operations during the flood, but was compelled to pay a high rental for the use of the emergency equipment.

2. A taxpayer manufacturing semi-finished goods experienced "low physical volume of sales owing to low demand for such product" during the base period because of strikes which closed many of the finishing plants which constitute its restricted market.

3. The taxpayer purchased its raw materials during the base period years under a disadvantageous contract stipulating a price in excess of market value. The contract has expired, and it is able to purchase on the open market, and thus has a greater net income although its production and the sale price of its product remain the same.

4. The taxpayer introduced a new product in 1936, which it sold at a loss during the base period year to introduce the commodity to the public. Having built up a market, the taxpayer has now raised the price and is earning a substantial profit on the same volume of sales and with the same costs.

In any event, it may be doubted that in examples (1), (3), and (4) "normal production, output, or operation was interrupted or diminished because of the occurrence of events abnormal in the case of such taxpayer" under Section 722(a)(2); and certainly in none of these situations is there a change in the character of the business sufficient to bring it within Section 722(a)(1).

161. But cf. A.R.R. 388, 3 Cum. Bull. 363 (1920), denying special assessment sought because of inefficient management during the prewar period. If this was alleged as an abnormality affecting the war profits tax credit [see Excess Profits Tax of 1918, § 311, 40 Stat. 1090 (1919); L. O. 1900-A, 2 Cum. Bull. 299 (1920)], it would indicate a refusal of relief under the facts of the hypothesis; but the exact basis of A.R.R. 388 is not clearly shown.
The taxpayer in the fourth hypothesis, however, could obtain some measure of relief under Section 733; and relief should be granted the taxpayer in both the latter two examples, as having sustained abnormal deductions during the base period, under Section 711. But there is no such recourse for the taxpayer in the second example.

Adjustment under Section 722 is also denied unless the tax computed under the ordinary provisions exceeds six per cent of the taxpayer's normal-tax net income for the year, and unless the application of the section would diminish the tax otherwise payable by at least ten per cent. These limitations were included to limit the number of cases for administrative consideration, with the understanding that they might be reduced if experience proved them too high.

By analogy to the 1918 and 1921 Acts, the burden of proof will probably be placed upon the taxpayer to allege and prove that the effect of the relief will be greater than the percentages indicated, and to negative Section 722 (b) (1).

The discussion so far has been of diminution of the base

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162. The Board of Tax Appeals frequently granted special assessment when valuable good will was excluded from statutory invested capital under the 1918 and 1921 acts. Clarence Whitman & Sons, Inc., 11 B.T.A. 1192 (1928); Farnsworth, Hoyt Co., 16 B.T.A. 309 (1929); Thomas B. Moreland Co., 16 B.T.A. 858 (1929). But cf. Raymond Syndicate, Inc., 21 B.T.A. 600 (1930) (special assessment not to be granted when the good will was developed only incidentally by advertising intended primarily to sell the taxpayer's goods). Int. Rev. Code § 733, Excess Profits Tax Amendments of 1941, § 10, now permits taxpayers to capitalize past expenditures for the promotion of good will, thus fictitiously reducing the deductions and increasing the net income of the years in question; the taxpayer is then required to pay the additional income tax which would have been due had these sums been charged to the capital account instead of deducted as business expenses in the years they were expended. Int. Rev. Code § 734, Excess Profits Tax Amendments of 1941, § 11. It was probably lack of such a provision which led to administrative nonacquiescence in such cases as Marc Eidlitz & Son, Inc., 18 B.T.A. 187 (1929). See IX-2 Cum. Bull. 72 (1930).

The method of "ascertainment of Amount of Adjustment" prescribed by Section 734(d) would not appear, however, to avoid a companion difficulty which resulted in special assessments under the earlier acts: impossibility of determining the amount of such expenditures which should be capitalized. Northwestern Yeast Co., 5 B.T.A. 223 (1926); Conrad & Co., 13 B.T.A. 1322 (1928); George W. Caswell Co., 14 B.T.A. 15 (1928). The taxpayer was required to show, however, that its capital was not small simply because it had not taken the trouble to establish a larger amount. Union Drawn Steel Co., 15 B.T.A. 761 (1929). Cf. Enameled Metals Co., 14 B.T.A. 1392 (1929), a rule which may be applied under Section 733. Cf. Int. Rev. Code § 723; Second Revenue Act of 1940, § 723.

163. See infra p. 698 et seq.

164. Int. Rev. Code § 722(c). Compare the rule under the earlier acts that the effect of the abnormality must be substantial.


166. See supra p. 682.
period net income by abnormalities reducing the gross receipts during that period. The net income may similarly be affected by abnormally high expenses. Nothing in the "General Rule" of Section 722(a) (2) would appear to prevent its application when interruption or diminution of normal operations lowered net income during the base period because of increased expenses, but this type of abnormality ordinarily is not so caused; and, as was shown in the three hypotheses last given, the limitations of Section 722 make its application impossible in many instances of abnormal deductions. Section 711(b) (1) (H), (I), (J) and (K), however, permits adjustment of abnormal deductions during the base period, when it is abnormal for the taxpayer to have income of this class, or if the income of that class exceeded 125 per cent of the average amount of such deductions in the four previous taxable years. Two classes of abnormal deductions—payment of judgments, claims, awards, or decrees, and intangible drilling and development costs—are specified in the statute, and other classifications may be made by regulations prescribed by the commissioner with approval of the secretary. Deductions will not be adjusted "unless the taxpayer establishes that the abnormality or excess is not a consequence of an increase of the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer."

These provisions are the correlative of Section 722(a) (2), but in form they are closely analogous to Section 721. The discussion of the latter section is applicable here, except that there is no requirement of "irrevocable election" nor that the expenditures deducted be attributable to another year, and the provision for taxpayers which have not been in existence during four previous taxable years is somewhat different.

167. Added by Excess Profits Tax Amendments of 1941, § 3.
169. Id. at § 711(b)(1)(H). Compare Section 721(a)(2)(A).
170. Id. at § 711(b)(1)(I). Compare Section 721(a)(2)(C).
171. Id. at § 711(b)(1)(J). Compare last sentence of Section 721(a)(2).
172. Id. at § 711(b)(1)(K)(II).
173. See supra notes 168, 169, 170, and 171.
174. If the taxpayer was not in existence for four previous taxable years, Section 711(b)(1)(K)(I) provides for the addition, to those previous taxable years during which the taxpayer was in existence, of succeeding taxable years which begin before the beginning of the taxpayer's second taxable
Despite the criticisms which have been offered, Section 722 [as complemented by Section 711 (b) (H), (I), (J), and (K)] with sympathetic administration, will probably offer adequate relief in the great majority of instances in which the excess profits credit determined under the normal base-period computation is inapplicable because of changes in the character of the enterprise, or because of occurrences abnormally diminishing the base period net income.

But what of corporations prejudiced by the time of incorporation? Section 722 (b) (2) (D) directs that existence during only part of the base period shall be considered a change in the character of the business, so corporations organized in the several years before January 1, 1940, are entitled to the benefits of that year under the subchapter, until a maximum of four is attained. A corporation organized on January 2, 1935, and filing its returns on the calendar year basis, in complaining of an abnormal deduction in 1938 would compute its averages from the years 1935, 1936, 1937, and 1939; the same corporation, if organized on January 2, 1937, could use only 1937, 1939, and 1940 (the last succeeding taxable year which begins before the beginning of its second taxable year under the statute).

Section 721 is devoted to abnormalities affecting income of the current taxable year and, since conditions in "succeeding taxable years" cannot be known at the time the return is filed, no corresponding provision can be applied. Section 721(a) (1) stipulates that "if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence" shall determine the average.

175. Int. Rev. Code § 713(b)(1); Excess Profits Tax Amendments of 1941, § 4:

"(b) Base Period.—"

"(1) Definition.—As used in this section the term 'base period'—"

"(A) If the corporation was in existence during the whole of the forty-eight months preceding the beginning of its first taxable year under this subchapter, means the period commencing with the beginning of its first taxable year beginning after December 31, 1935, and ending with the close of its last taxable year beginning before January 1, 1940; and

"(B) In the case of a corporation which was in existence during only part of the forty-eight months preceding the beginning of its first taxable year under this subchapter, means the forty-eight months preceding the beginning of its first taxable year under this subchapter."

If a corporation is organized and begins operations after December 31, 1939, however, its "first taxable year under this subchapter" begins immediately. Even if it intends regularly to file returns on the basis of a fiscal year beginning a fractional year after the date of organization, it must file a return for that fractional period (cf. U. S. Treas. Reg. 109, § 19.52-1) and this period apparently would be considered a "taxable year" [cf. Int. Rev. Code § 48(a), 53 Stat. 26 (1939)]; it is necessarily a "taxable year beginning after December 31, 1939," and therefore subject to the excess profits tax under Section 710, and consequently is the "first taxable year under this subchapter" [Int. Rev. Code § 713(b)(1)(B)]. A corporation organized after December 31, 1939, therefore, could not have been in existence during any "part of the forty-eight months preceding the beginning of its first taxable year under this subchapter," and Section 713(b)(1)(B) apparently would be inapplicable; and the same would be true of Section 722 (b)(2)(D). This con-
section. Neither Section 722 nor Section 711 can apply, however, to corporations organized after December 31, 1939, unless they are "acquiring corporations" under Section 740; such enterprises are forced to rely upon the capital basis computation of the excess profits credit. Since there is no provision for adjustment of the excess profits credit so determined, these corporations may suffer a very real prejudice at a critical stage of development.

The most obvious example is an enterprise of such high risk that a return in excess of eight per cent is necessary. Corporations organized to discover and develop new mineral deposits

clusion is in accord with the specific provision of Section 712(a), that all domestic corporations other than those in existence before January 1, 1940, must compute their excess profits credits under Section 714 (capital basis). The limitation is even more stringent with regard to foreign corporations. See note 177, infra.

Accepting this, what was the purpose of rephrasing Section 713(b), paragraph (1) of the Second Revenue Act of 1940, which applied the base period of the present Section 713(b) (1)(A), into the apparently dichotomous subparagraphs, Section 713(b) (1)(A) and (B), of Section 4 of the 1941 amendments (quoted above)? (1) If the corporation was not in existence before January 1, 1940, it cannot avail itself of Section 713; and this is true even if it is an "acquiring corporation" (Int. Rev. Code § 741). (2) If the corporation was in existence before January 1, 1941, the "forty-eight months preceding the beginning of its first taxable year" under the excess profits tax will necessarily coincide with the period indicated in Section 713(b)(1)(A) as the base for corporations in existence during the whole forty-eight months.

But even if Section 713(b)(1)(B) does apply to corporations organized after December 31, 1939, such a corporation has no actual earnings record during any part of the indicated forty-eight months, and must compile its "income basis" excess profits credit entirely under the assumptions of Section 713(d)(2)—which is substantially the same as the capital basis excess profits credit.

A corporation which is an "acquiring corporation" under the definition of Section 740 may determine its average base period net income under § 742 (as both sections are amended by Excess Profits Tax Amendments of 1941, § 8) but may not elect computation under Section 713 unless it was itself in existence prior to January 1, 1940 (Int. Rev. Code § 741; U. S. Treas. Reg. 109, § 30.741-1).

176. The exact language of Section 722(a) merely restricts the relief to taxpayers "whose first taxable year under this subchapter begins in 1940," which would apply to all corporations subject to the tax which began operations before January 1, 1941. However, Section 722 is of benefit only to corporations computing the excess profits credit on the income basis, and domestic corporations organized after December 31, 1939, must adopt the capital basis computation (Int. Rev. Code § 712) unless they are "acquiring corporations" within the meaning of Section 740, as amended by Section 8 of the 1941 amendments. The same thing is true of Section 711(b)(1)(H), (I), (J), and (K).

177. Section 721(a), as amended by Excess Profits Tax Amendments of 1941, § 13. This is with regard to domestic corporations; a foreign corporation is required to adopt the capital basis unless it was in existence and doing business or maintaining an office in the United States for the full forty-eight months prior to the beginning of its first taxable year under the statute. Section 712(b).

usually fail; accordingly those which succeed must pay for those which fail, in addition to yielding a fair return, else the hazard would be so "loaded" that intelligent investors, however speculatively inclined, could not be attracted. If the successful enterprises of this kind are to be heavily taxed upon their income above eight per cent, new ventures will be greatly discouraged. Congress was sufficiently impressed by this argument\(^\text{179}\) to grant special exemption to corporations engaged in the mining of minerals considered necessary for strategic purposes;\(^\text{180}\) but only seven minerals are listed.\(^\text{181}\)

The risk ratio varies, however, with every type of enterprise;\(^\text{182}\) and although it might theoretically be desirable to adjust the excess profits credit computed on the capital basis to the true economic normal return of each taxpayer, the vagueness and variability of such factors ordinarily renders their consideration impractical for taxation purposes.\(^\text{183}\) Corporations which must adopt the capital basis and which are subject to a high degree of risk will be taxed on earnings which are not excess profits, but this seems to be an unavoidable evil of this form of taxation.

Many other abnormalities affecting the capital basis excess profits credit could be alleviated, however, as they were under the 1918 and 1921 Acts. Perhaps the most common was a high

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\(^{179}\) Joint Hearings Report, supra note 3, at 224-227.

\(^{180}\) Int. Rev. Code § 731.

\(^{181}\) Only gold mining was so favored under the 1918 and 1921 acts [Revenue Acts of 1918 and 1921, § 304(c), 40 Stat. 1090 (1919) and 42 Stat. 273 (1923)], and gold is not included in the list of prosaic metals production of which is encouraged by the present statute. The old order changeth, yielding place to Fort Knox.

Section 721(a)(2)(C) should not be considered as offering adequate relief in the problem suggested. For that provision to apply, (1) the development must be related to the particular property out of which the income arises; and (2) the development must have been by the taxpayer corporation itself, not by a predecessor (U.S. Treas. Reg. 109, § 30.721-4); and (3) even if the first two conditions are met, the relief is restricted to deduction of the abnormal income attributable to other years [Int. Rev. Code § 721(c)(1)], and economically the return attributable to the taxable year must exceed 8%.

\(^{182}\) Dewing, op. cit. supra note 17, at 144-151, 175-177.

\(^{183}\) In extreme cases, the Board of Tax Appeals under the earlier acts granted special assessment when the corporation's capital was relatively small and the income was attributed in large part to the personal skill of the managers. Guarantee Construction Co., 2 B.T.A. 1145 (1925); E.B. Ficken Tobacco Co., 10 B.T.A. 51 (1928). These are the dominant factors which, according to Dewing, necessitate a higher rate of return on the investment (Dewing, op. cit. supra note 17, at 145-146). If relief is to be granted in such cases, however, the administering authority must have broad discretion to consider the individual case on its facts, a power which Congress was reluctant to grant in 1941.
percentage of borrowed capital, which was not includible in invested capital under those statutes.\textsuperscript{184} The Treasury prided itself upon the improvement in that regard of the capital concept of the present act,\textsuperscript{185} yet but one-half of the taxpayer's borrowed capital is includible today.\textsuperscript{186} This merely reduced the degree of discrimination, rather than removing it; a corporation which has financed itself by bonds and stock in equal portions will still have but three-fourths the capital basis excess profits credit of an otherwise identical corporation which has issued stock alone.\textsuperscript{187}

Another type of abnormality which was relieved under the earlier acts \textsuperscript{188} but which apparently is not provided for today may be illustrated by a corporation organized after December 31, 1939, as an advertising agency. The principal stockholders are the active managers of the corporation and most of the income is attributable to their personal efforts, but they own less

\textsuperscript{184.} Section 326 (b), Revenue Acts of 1918 and 1921, 40 Stat. 1082 (1919) and 42 Stat. 275 (1923); U. S. Treas. Reg. 45 and 62, Art. 831.

"Section 327 of the respective Revenue Acts does not specifically provide that the use of borrowed money in carrying on business creates an abnormality of capital or affects income abnormally. Whether it does or not is a question of fact to be determined in each case. It is not necessarily true that such a situation creates an abnormality. We think, however, that where capital is a material income-producing factor, but where, because of the fact that the capital employed is in large part borrowed, there is no invested capital or the invested capital is materially disproportionate to the net income as compared with representative corporations engaged in a like or similar trade or business, an abnormality of invested capital is produced which is clearly contemplated by section 327." G. M. Standifer Construction Corp., 4 B.T.A. 525, 561 (1926). See also L. O. 1109, I-2 Cum. Bull. 253 (1922).

"An inordinately large amount of borrowed funds" was repeatedly applied as at least one factor indicating the taxpayer was entitled to special assessment [e.g., Saner-Ragley Lumber Co., 3 B.T.A. 297 (1926); Pierce Oil Corp., 32 B.T.A. 408 (1935)] if the taxpayer showed that its proportion of borrowed capital was abnormally large for its business or industry [Higginbotham-Bailey-Logan Co., 8 B.T.A. 568 (1927)], although it was indicated that this factor alone would not justify relief [Ferdinand Buedingen Co., Inc., 13 B.T.A. 1065 (1928)] and the taxpayer was not permitted special assessment if it operated on borrowed funds while it permitted its surplus to lie idle [see Warren County Fertilizer Co., 17 B.T.A. 113 (1929)] or to be lent to its officers and principal stockholders [Spiesberger & Son Co., 2 B.T.A. 492 (1925)].

185. Treasury Memorandum, Joint Hearings Report, supra note 3, at 94-95.


187. It is difficult to understand the objections to inclusion of all borrowed capital, with disallowance of the deduction of all interest payments [cf. Int. Rev. Code § 711(a)(2)(B)] which would place corporations employing borrowed capital on the same basis as others. Int. Rev. Code § 722(b)(2)(C) would then be unnecessary.

188. See supra note 183. As was indicated there, this type of abnormality is really an extreme case of high risk necessitating a return in excess of 8\%.
than seventy per cent of the stock. Because of the date of incorporation the taxpayer must adopt the capital basis; the stock ownership removes it from the very restricted statutory definition of a personal service corporation; it can secure no relief under Section 721, for none of its income is attributable to other than the taxable year. The corporation must therefore submit to taxation of all earnings above eight per cent on the meager capital employed in such enterprises. The situation could be remedied by raising the salaries of the managers, but capital for such enterprises is difficult to obtain, and the outside stockholders will not easily consent to this device even if the corporation has secured legal advice in time to effect the change for the first taxable year under a retroactive statute.

Examples could be multiplied, but with little profit. The only essentials are (1) that the taxpayer be affected by an abnormality in its capital basis excess profits credit; (2) that there be no specific exemption applicable; and (3) that the taxpayer be organized after December 31, 1939. The corporate structure of the nation cannot be solidified as it existed on that date.

The Review of Abnormalities Determinations

Section 732, added by the 1941 amendments, specifies that the Board of Tax Appeals shall have jurisdiction to review determinations under these special assessment provisions. It is broader than the doctrine of review developed under the earlier acts, for refund claims are added to the jurisdictional grant by the device of considering the commissioner's notice of disallowance of the claim as a deficiency notice for the purpose of assessment and collection of any deficiencies and the credit or refund of overpayments, if a petition is timely filed with the board. This extension was necessary if the taxpayer was to be granted review of determinations under Section 722, for the tax return must be computed and filed without benefit of the section before an application for relief will be entertained.

191. Or, if a foreign corporation doing business or having an office within the United States, less than 48 months before the beginning of the corporation's first taxable year under the statute. See supra note 177.
193. See supra p. 686.
The authorities under the earlier acts denying court review of abnormalities determinations\(^{196}\) met qualified congressional approval, for the statute now specifically provides that "If . . . the determination of any question is necessary solely by reason of section 711(b) (1) (H), (I), (J), or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Board."\(^{197}\) The comment of the committee report\(^{198}\) indicates that the adverb "solely" is intended seriously. Under the earlier legislation it was held that the granting of special relief precluded subsequent judicial review or redetermination of any of the factors entering into the determination, such as the taxpayer's net income for either excess profits or income tax purposes.\(^ {199}\) In the report on Section 732 of the current act it was said:

"If . . . 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."\(^{200}\)

The "amount of such income" is still a necessary element in determining whether special relief is due, under the 125 per cent provision; but the broad administrative discretion which was the basis for such decisions under the former acts\(^ {201}\) has been replaced by more rigid tests, under which the taxpayer is entitled to relief if it demonstrates that its circumstances meet the statutory conditions. This is no less true of those fields in which power has been delegated to the commissioner, for such power is to be exercised by quasi legislative regulation rather than by quasi judicial consideration of the peculiar condition affecting

\(^{196}\) See supra p. 674 et seq.
the individual taxpayer, of which the net income ascertained might be the deciding factor.

Unless the courts are swayed by analogies which are more apparent than real, court review and redetermination of collateral matters and in collateral actions will be much less restricted under the new statute than under the old one.

WHAT RELIEF SHOULD BE GRANTED?

If the ideal is to be attained, and only truly excess profits are to be subjected to the levy, a taxpayer affected by abnormalities should have its tax reduced to that which would have been due had conditions been normal. If the abnormality affects the excess profits credit, an artificial credit should be constructed which avoids the results of the abnormal conditions; if it affects the net income for the taxable year, that sum should be reduced to the amount which normally would have been realized in the absence of the abnormality. The latter is comparatively easy; if a specific item can be pointed out as abnormal, the value of that item can usually be assessed with fair accuracy, and determination of the amount equitably subject to tax is a matter of simple subtraction. The construction of an accurate artificial excess profits credit, however—whether done directly, or by correction of the invested capital or base period net earnings, as the case may be—may call for only vaguely scientific guesswork.

If another taxpayer could be found which is identical except that the conditions affecting it are entirely normal, the knot could be cut by simply applying its tax to the applicant. Unfortunately, "identical" corporations exist only in theory and hypotheses; but the 1918 and 1921 Acts attempted to apply the principle by directing that the successful applicant's tax be "the amount which bears the same ratio to the net income of the taxpayer . . . as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income . . . for such year."\(^2\)\(^2\) Factors to be considered in selecting these comparable corporations were "character of business, size and condition of plant, gross income, net income, profit per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances."\(^2\)\(^0\)

\(^{202}\) Int. Rev. Code § 328(a), 40 Stat. 1093 (1919) and 42 Stat. 275 (1923). The clauses omitted directed that the $3,000 exemption be deducted from both net incomes for the purposes of the comparison.

This was probably the most severely criticized feature of the 1918 and 1921 Acts. The taxpayer did not know what corporations were selected to be compared with his, and those chosen frequently bore little resemblance to the claimant’s. Moreover, the comparatives procedure would not alleviate abnormalities which affected an entire industry and the leading concerns in each industry (which usually were selected as the comparatives by which other taxpayers were measured) had no remedy.

No clear measure of relief was indicated in the hastily drawn general section of the 1940 Act but the 1941 amendments produced a variety of elaborate and varied provisions expressed specifically in terms of percentages of past averages, of the normal tax net income, and of the excess profits tax under the ordinary computation; and one exceedingly intangible measure which will probably cause more trouble than all the others combined. In general, the relief to be granted under the present statute is that which would reduce the taxpayer’s abnormality to the maximum discrimination which is denied relief under the limitations of the sections applicable. This cognate relationship which the measure of relief bears to the limitations upon the granting of relief permits summary consideration of most of these stipulations at this point, for the same policies motivated adoption and the same criticisms are applicable.

The computation of the tax due from a taxpayer who is affected by abnormalities affecting gross income of the taxable year, relievable under Section 721, is less formidable as a problem of mathematics than the involved approach of the statute would indicate. In essence, it considers as “normal” 125 per cent of the average gross income of that class which the taxpayer has received during four previous taxable years, and allocates to the years to which it is properly attributable the excess minus a pro rata share of the expenses involved in earning the abnormal income; but no provision is made for raising the excess profits credit if a portion of the abnormal income is attributable to the

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205. Barton, loc. cit. supra note 204; Cogger, loc. cit. supra note 204.
206. See supra, p. 682.
207. Joint Hearings Report, supra note 3, at 162.
208. Int. Rev. Code § 722; Second Revenue Act of 1940, § 722. The relief provision of Section 721 was the skeleton of that employed under the 1941 amendment of that section, which will be discussed in the text.
base period years. To follow the statute, the "net abnormal income" must first be computed: the amount of the abnormal income complained of minus (1) 125 per cent of the average amount of gross income of the same class during four previous taxable years, and (2) the pro rata share, allocable to the difference of those two items, of the direct costs or expenses through the expenditure of which this abnormal income was in whole or in part derived, which are deductible in determining the normal-tax net income of the taxable year. The portion of this net abnormal income which is attributable to other than the taxable year is then determined under regulations prescribed by the commissioner, and that amount is deducted from the gross income for the current taxable year; a partial excess profits tax is then computed on this basis.

Thus the T Company, which files its returns upon the calendar year basis, began performance of a construction contract on January 2, 1939; the contract was completed on June 1, 1941, on which date the full consideration, $250,000, was paid to the Company. T Company regularly receives income of this class, the average amount for four previous taxable years being $100,000, and it reports such income upon the completed contract basis in accordance with Section 19.42-4(b), Regulations 103. Costs and expenses in performance of the contract totaled $200,000, $80,000 having been expended in 1939 and the same sum in 1940, and $40,000 in 1941. The T Company's excess profits credit computed on the income basis is $15,000, and in addition to the $250,000 from this contract it received only $10,000 of includible income in 1941, in the earning of which no expenses were entailed.

Since the T Company's income from long-term contracts during 1941 exceeds 125 per cent of its average income of that class in four previous taxable years, it is entitled to the benefits of Section 721.

211. Id. at § 721(a)(3)(B).
212. Id. at § 721(b). See U.S. Treas. Reg. 109, § 30.721 (promulgated before the amendment of the 1941 amendments, but probably still valid).
214. Id. at § 721(a)(2)(B).
Applying the statute to determine relief:

Gross income 1941 $260,000

Gross income from long-term contracts $250,000

125% of average income of this class $125,000

Pro rata share of expenses

\[
\frac{x \times (250,000 - 125,000)}{200,000} = \frac{100,000}{250,000}
\]

Sum of last two items 225,000

Net abnormal income 215

Net abnormal income attributable to years other than 1941 (4/5 of last item) 216 20,000

Gross income for purposes of § 721(c) (1) $240,000

Deductions 1941 217 200,000

Normal-tax net income as reduced by § 721(c) (1) $40,000

Income tax 1941 218 12,540

Excess profits net income 1941 219 $27,460

Excess profits credit $15,000

Exemption 220 5,000

Sum of last two items 20,000

Adjusted excess profits net income 221 $7,460

Excess profits tax under Section 721(c) (1)

(25% of last item) 222 $1,865

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215. Id. at § 721 (a)(3).

216. Computed in accordance with U.S. Treas. Reg. 109, § 30.721-3, promulgated before the 1941 amendments but probably still applicable.


218. Under Int. Rev. Code § 711(a)(1)(A), "The deduction for taxes shall be increased by an amount equal to the income [tax] . . . for such taxable year," for the purpose of computing the excess profits net income. This adjustment is treated as a separate item to render it more apparent in the example.

Since Section 721(c) relates only to the excess profits tax, the income tax is computed upon the normal-tax net income [Int. Rev. Code § 13(a) (2)] without subtraction of amounts of abnormal income attributable to other years. The tax in the example is computed at the rate fixed by Second Revenue Act of 1940, § 101, amending Int. Rev. Code §§ 13(b)(1) and 15. 53 Stat. 863 (1939), or 24% of $60,000; the corporation income tax rates for 1941 will probably be raised by the revenue act now under consideration by Congress, with the effect of reducing the adjusted excess profits net income subject to the excess profits tax.

219. The excess profits net income is the normal-tax net income, as defined in Int. Rev. Code § 13(a)(2), with the adjustments directed in Section 711(a), of which the only adjustment relevant to the example is the additional deduction for income taxes (see note 218, supra).


221. Id. at § 710(b).

222. Id. at § 710(a)(1), as applied under the direction of Section 721(c) (1).
EXCESS PROFITS TAXATION

But $10,000 of this abnormal income is attributable to 1940, which was also subject to the excess profits tax; if this sum had actually been received and returned in that year, as the attribution fictitiously considers that it was, the tax for that year would have been increased. So there is added, to the tax which is payable for 1941, the additional sum which the T Company would have had to pay in 1940 if this $10,000 had been returned in that year. Assuming that T Company paid a 1940 excess profits tax of $4,000 upon a gross income of $100,000 and an adjusted excess profits net income of $16,000, the computation would be:

Partial tax computed under Section 721(c) (1) (see above) $1,865

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income 1940</td>
<td>$100,000</td>
</tr>
<tr>
<td>Income added for purposes of § 721(c) (2)</td>
<td>10,000</td>
</tr>
<tr>
<td>Total of last two items</td>
<td>$110,000</td>
</tr>
<tr>
<td>Deductions and income tax for 1940 (assumed)</td>
<td>64,000</td>
</tr>
<tr>
<td>Fictitious excess profits net income</td>
<td>$46,000</td>
</tr>
<tr>
<td>Excess profits credit 1940</td>
<td>$15,000</td>
</tr>
<tr>
<td>Exemption 1940</td>
<td>5,000</td>
</tr>
<tr>
<td>Total credit and exemption</td>
<td>20,000</td>
</tr>
<tr>
<td>Adjusted excess profits net income (fictitious)</td>
<td>$26,000</td>
</tr>
<tr>
<td>Tax due on last item</td>
<td></td>
</tr>
<tr>
<td>First $20,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>30% on remaining $6,000</td>
<td>1,800</td>
</tr>
<tr>
<td>Total tax</td>
<td>$6,800</td>
</tr>
<tr>
<td>Minus tax paid for 1940</td>
<td>4,000</td>
</tr>
<tr>
<td>Amount to be added, under § 721(c) (2), to tax payable for 1941</td>
<td>2,800</td>
</tr>
<tr>
<td>Total tax payable for 1941</td>
<td>$4,665</td>
</tr>
</tbody>
</table>

There still remains the $10,000 attributable to the base period year 1939, which—if the fiction of restoration to proper years is to be carried through logically—should be added to the gross and net incomes for that year, with a consequent increase of the

223. Section 721(c) (2). It was probably the lack of a provision of this kind which led to administrative nonacquiescence in such cases as Pittsburgh Supply Co., 14 B.T.A. 520 (1928) [See VIII-2 Cum. Bull. 69 (1929)] and Red Salmon Canning Co., 15 B.T.A. 790 (1929). [See VIII-2 Cum. Bull. 70 (1929)].
225. Id. at § 721(c).
excess profits credit. This would diminish the adjusted excess profits net income subject to tax not only for the year 1941, but also for 1940 and for all future years. But the relief stops there: That amount of abnormal income attributable to years previous to 1940 is entirely disregarded. This is illogical, but any other solution would necessitate revision of excess profits tax payments for all past years each time a sum of abnormal income partially attributable to a base period year might appear. This would be an impossible burden upon the Bureau of Internal Revenue.

If a portion of the abnormal income is attributable to a future year, that sum is simply added to the gross income for that year when the time for filing returns arrives, and the excess profits tax is computed upon the whole. The taxpayer is protected from the possibility of its being in a higher bracket in the subsequent year, or the rates of the tax being increased, by the limitation that the additional tax because of attributable income actually received in a previous taxable year may not exceed the amount saved the taxpayer in that year by the use of this remedy, there being considered the amounts paid in intervening years to which a portion of the amount received may be attributable and upon which additional tax is paid. The government is protected against avoidance of the tax in the future year by the taxpayer's liquidation or transfer of substantially all its assets. This protection is offered by the provision of Section 721(b) that in either of those events all amounts attributable to a future year shall be attributed to the first taxable year in which such transfer or distribution occurs; or to the year in which the abnormal income would be includible but for the relief measure, if that year is subsequent to that in which the first transfer or distribution occurs. Thus if the T Company received an abnormal sum includible in gross income of 1940 for the performance of a contract in 1941 and 1942, it could not secure the benefits of Section 721 if it began distribution of assets in 1940 or any previous year; if it begins such distribution in 1941, the portion of the abnormal income attributable to 1942, and upon which the tax would otherwise be due at that time, is automatically added to that attributable to 1941.

Insofar as adjustment of abnormal current income is concerned, the 125 per cent rule is the only factor which prevents the taxpayer's securing complete relief under Section 721; and

226. Id. at § 721(d).
that stipulation was necessary as the concomitant of the prohibition against the granting of relief unless the gross abnormal income exceeds 125 per cent of the past average of that class.\textsuperscript{227} Otherwise a taxpayer with a 126 per cent abnormal income could secure reduction up to 100 per cent if all of the item were attributable to past or future years, while a taxpayer with a 125 per cent abnormal income could secure no relief at all. If it is abnormal for the taxpayer to receive income of that class, the 125 per cent limitation is inapplicable\textsuperscript{228} and apparently complete relief may be secured.\textsuperscript{229}

This result is clearly specified in Section 711,\textsuperscript{230} providing for the disallowance of abnormal deductions during the base period, under which section the 125 per cent rule is equally applicable when the taxpayer regularly has deductions of the same class.\textsuperscript{231} No attempt is made to allocate deductions abnormal in amount in the year taken but attributable to other years, so most of the problems of relief under Section 721 do not arise. There is a limitation upon relief under Section 711, however, that the abnormal deductions during the base period year may not be reduced below the amount of the deduction in the same class for the taxable year under consideration.\textsuperscript{232}

The greatest problem of measure of relief, from the taxpayer's viewpoint, is presented by Section 722. Assuming that the taxpayer has shown that it is affected by a change in the character of its business or an interruption or diminution of its operations during the base period which entitles it to computation of its excess profits credit under that section, the taxpayer still must establish "the amount that \textit{would have been} its average base period net income" if none of the abnormal events had occurred.

\textsuperscript{227} Id. at § 721(a)(1).
\textsuperscript{228} Ibid.
\textsuperscript{229} Id. at § 721(c), as construed by reference to Section 721(a)(3), does not specify this result, but if the "average amount of the gross income of the same class determined under paragraph (1)" is zero, this is the necessary consequence of multiplying 0 by 1.25. But may it not be abnormal for the taxpayer to receive income of a certain class, although it has received an item of income of that class during one of the previous four years? If so, the strict application of the terms of Section 721(a)(3) in computing relief under Section 721(c) might result in the taxpayer's being entitled to relief under the section, but the measure of relief being an increase in the tax payable. The spirit if not the letter of the provision could be preserved by applying Int. Rev. Code § 711(b)(1)(J)(i) by analogy.
\textsuperscript{230} Ibid.
\textsuperscript{231} Id. at § 711(b)(1)(J)(ii).
\textsuperscript{232} Id. at § 711(b)(1)(J)(iii).
or if the character of the business during the base period had been the same as on January 1, 1940.233

In at least one situation which Section 722 was doubtless designed to relieve, this burden of proof will be very simple. A representative of Marshall Field & Company testified at the Joint Hearing234 that his corporation had, prior to 1940, operated both retail and wholesale departments; and that the losses of the latter department in large degree absorbed the profits of the former. Liquidation of the wholesale department was completed in 1939, and the character of the business thereafter was exclusively retail. It is obvious from the testimony235 that separate books were kept on the two departments, and Marshall Field will easily be able to establish, to an odd cent, what its average base period net income would have been had the wholesale department been liquidated four years earlier.

Somewhat more difficult will be the problem of filling in the profits gap of a taxpayer who has suffered a fire, flood, or strike during the base period. It can be no more than informed guess, determined by reference to past and subsequent earnings; but—unless the taxpayer's income fluctuates widely and unpredictably—it will be no more difficult than the computation of damages in many breach of contract suits.

But what of the corporation which has expanded its plant?236 If it was operating at less than full capacity before expansion, the indication is that the enlargement of facilities was dictated by increased demand due directly or indirectly to the defense program—and that the increased profits are those which it is the purpose of the act to tax. Under those circumstances the taxpayer might well be left to computation of its excess profits credit under the ordinary provisions of the statute.237 If there is no such indication, however, how is it to be determined what portion of the taxpayer's present production capacity could have been absorbed by the market demand which existed several years before?

What, too, of a taxpayer in existence during only part of the base period238—how can it be intelligently guessed, much less

233. Id. at § 722(a).
235. Id. at 261.
237. With the benefit, of course, of Section 713(a)(1)(B) if the income basis is adopted.
238. Id. at § 722(b)(2)(D).
proved, what would have been earned during years in which the
corporation was not in existence? And what of a corporation
which acquired the assets of a competitor in the last months of
1939?239

It was failure to sustain the burden of proof which led to
most of the rejections of special assessment claims under the 1918
and 1921 Acts,240 and it may be feared that Section 722 will offer
even greater obstacles to relief.

This criticism is consciously without constructive suggestion.
The burden of proof must necessarily be placed upon the tax-
payer to prevent abuse of the relief provisions; and speculation
over the "might have been" is always an inexact and usually
futile pursuit, in which imaginative historians have excelled ac-
countants and lawyers.

In the case of expanded capacity the administrative official
might ease the burden by assuming that the taxpayer could have
earned during the base period years that income per unit on its
present plant which was averaged in that industry during the
same period; but this is merely an application of the compara-
tives principle which provoked so much criticism under the
earlier acts, and moreover the computation is based upon factors
which may not be readily available. And even this would offer
little assistance when the taxpayer has acquired its chief com-

petitor;241 this raises problems of control of supply which
economists frequently consider but rarely attempt to evaluate.

The figures so determined, by whatever means, are im-
portant not only in the computation of average base period net in-
come, and consequently of the excess profits credit on income
basis,242 but may also determine one of the limitations upon the
relief which may be granted under Section 722. The average base
period net income indicated by these assumptions may not ex-
ceed the excess profits net income for the last taxable year in
the base period—which may be determined in exactly the same
way.243 If the character of the business actually was the same
during this last taxable year of the base period, as on January 1,

239. Id. at § 722(b)(2)(E). See Illustration, H. R. Rep. 146, 77th Cong.,
1st Sess. (1941) 12.
240. See supra p. 684.
241. Int. Rev. Code § 742, as amended by Excess Profits Tax Amend-
ments of 1941, § 8, does not offer an adequate solution, for the competition
may have reduced both corporations to inadequate earnings or even losses.
1940, and if no abnormal events occurred in that year, the limita-
tion will be a more definite figure.

Further limitations upon the relief to be granted are that
the tax may not be reduced below six per cent of the taxpayer's
normal-tax net income for the taxable year, and that the tax
computed under Section 722 (a) shall be increased by ten per cent
of the tax computed without reference to the section. Like the
125 per cent limitation in Sections 721 and 711, discussed above,
these limitations were necessary to keep the relief in harmony
with the conditions required for admittance to the benefits of the
section.

As has already been stated, these specific limitations were
included so that the Bureau of Internal Revenue would not "be
loaded down with so many petitions for relief as to make it impos-
sible for it to examine and pass upon such requests with requisite
expedition and care." This, no doubt, was the utilization of a
lesson learned from the volume of litigation under the earlier
acts. "If experience should demonstrate that these limitations
are too high, consideration will be given to their reduction."

244. Int. Rev. Code § 722(d). Thus if the taxpayer's normal-tax net
income is $100,000, its excess profits tax without benefit of Section 722 is
$11,000, and its tax computed under Section 722(a) is $5,000, the tax may
not be reduced below $6,100 ($5,000 tax computed under Section 722(a) plus
$1,100 or 10% of the tax computed without reference to Section 722), since
this is also in excess of 6% of the normal-tax net income ($6,000). But if the
tax without reference to Section 722 were $9,000, the 10% clause would fix
a limitation of only $5,900, and the 6% limitation ($6,000) would be the
effective one.

If the taxpayer were entitled to the benefits of both Section 722 and
Section 721, presumably the tax under Section 721(c) would be computed
first, and the 10% limitation of Section 722(d) would refer to 10% of that
sum ("the tax computed without reference to [Section 722]"). But does
the "6 per centum of the taxpayer's normal-tax net income" limitation
[Section 722(d)] refer to the strict definition of Section 13(a)(2), or to the
reduced normal-tax net income which is determined for the purposes of
Section 721 by reducing the taxpayer's gross income [Section 721(c)(1)]
with consequent similar effect upon its net income [cf. Section 21], adjusted
net income [cf. Section 13(a)(1)], and normal-tax net income [Section 13(a)
(2)], although nothing is said in Section 721(c) of the latter three items?
Applied to the example given supra p. 707 et seq., the limitation under the
former interpretation would be $3,600 (6% of $60,000), under the latter
$2,400 (6% of $40,000). The latter seem the preferable construction; for the
purposes of the excess profits tax the effect of Section 721(c) is to consider
sums of abnormal income attributable to other years as not includible in
gross income for the current taxable year, and consequently all concepts
derived from gross income should reflect this adjustment.

245. See supra p. 711 et seq.
248. See supra p. 884.
CONCLUSION

The following passage is an excerpt from the report submitted by the Committee on Ways and Means on the Excess-Profits Tax Amendments of 1941:

"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."\(^{250}\)

This expression of legislative intention and grasp of the problems presented is realistic and entirely laudable. But has the performance of Congress matched its intentions? Certainly there is no general measure for the relief of abnormalities affecting capital and income comparable to Sections 327 and 328 of the 1918 and 1921 Acts,\(^{251}\) or Section 722 of the 1940 Act as originally passed.\(^{252}\) Congress has chosen to treat the various types of abnormalities separately—which may be equally effective and perhaps preferable, if the entire field is covered.

Under this statute the abnormalities which may arise and require relief may affect either the income for the current year, the excess profits credit computed from prior earnings, or that computed upon the capital basis. As has been shown, not all of these possible situations have been provided for.

Section 721 provides fairly adequately for abnormalities in

\(^{250}\) Id. at 2.
\(^{251}\) Supra, p. 673 et seq.
\(^{252}\) Supra, p. 684 et seq.
the gross income of the current taxable year;\textsuperscript{258} but the net income may be abnormal because of low deductions, while the gross income remains unaffected.\textsuperscript{254}

Section 722 is somewhat less complete in its scope, which purportedly extends to abnormalities affecting the base period income and therefore the excess profits credit computed thereon.\textsuperscript{255} In this it is supplemented by Section 711 (b) (1) (H), (I), (J), and (K), providing relief—to what extent is not entirely apparent—for abnormal deductions in the base period years.\textsuperscript{256}

So there are situations not covered by the relief sections which affect income and the income excess profits credit. The most serious fault in the statute, however, is the omission of any provision, narrow or broad, for the correction of abnormalities affecting the excess profits credit determined on the capital basis. This may result in a very real prejudice against corporations which must adopt the capital basis computation—and, as has been shown, these include all corporations organized since December 31, 1939, unless they are entitled to the benefits of Section 742.\textsuperscript{257}

If the alternative excess profits credit computed on capital basis is to be retained at all—for that is a confession that not all taxpayers can secure equitable treatment under the prior income computation—there should be a general provision for relief of abnormalities affecting that basis. This provision might well take the form adopted for Section 721, providing specifically for all those circumstances which Congress can foresee, and thus avoiding the need for administrative discretion in its application; but there must be a general clause permitting the commissioner or the Board of Tax Appeals to make adjustments in cases not foreseeable, and in cases in which the abnormality is not a single, selectable factor, but a combination of relatively intangible factors.

If Congress is unwilling to grant such wide discretion to the commissioner, fearing public misinterpretation and criticism of his decisions and the possibility of his being faced with so many applications that none could be handled adequately, it should at least provide relief for new corporations. Under the statute as it stands a corporation organized during the base period years (1936 to 1939, inclusive\textsuperscript{258}) has three alternative bases upon which

\begin{itemize}
  \item\textsuperscript{253} Supra, p. 686 et seq.
  \item\textsuperscript{254} Supra, p 692 et seq.
  \item\textsuperscript{255} Supra, p 693 et seq.
  \item\textsuperscript{256} Supra, p. 697 et seq.
  \item\textsuperscript{257} Supra, p. 698, and note 177.
  \item\textsuperscript{258} See note 176 supra.
\end{itemize}
to compute its excess profits credit;\textsuperscript{259} an enterprise begun two
days later, or at any time thereafter, \textit{must} adopt the capital
basis.\textsuperscript{260} This is a very real discrimination against a class of tax-
payers especially susceptible to abnormal conditions and particularly
in need of fair treatment.

Discouragement of new business enterprises is always unde-
sirable, as a matter of policy; but the application of an income-
basis excess profits tax to entirely new corporations is a difficult
problem at best. Since they were not in existence during the base
period years selected as "normal," the statutory test can offer no
indication of their normal earning power. Yet in many instances
the abnormal conditions which may be expected to arise were
relieved under the 1918 and 1921 Acts.\textsuperscript{261}

The simplest solution would be to re-phrase Section 722(b)
(2) (D) so as to read

\"(D) the taxpayer was not in existence during the whole
of its base period.\"\textsuperscript{262}

There would still remain the taxpayer's burden of proving "the
amount that would have been its average base period net income"
if it had been in existence during the base period,\textsuperscript{263} which may
be almost insurmountable if the letter of the statute is applied.

Adequate relief can be granted only by an officer or board
with quasi judicial power to consider the peculiar conditions
affecting the individual applicant. The relief preferably should be
elastic, and therefore necessarily should rest in the discretion of
the authority upon whom the power of determination is conferred;
but if a criterion must be indicated, the "representative corpora-
tions" principle of the earlier acts is probably least objectionable.
Rather than being applied to determine the rate of tax payable,
however, these comparatives wherever possible should be used to

\begin{itemize}
\item \textsuperscript{259} (1) Capital basis (Section 714); (2) Income basis (see note 175 supra);
(3) It may avail itself of special relief under Section 722(b)(2)(D), if it
feels that it can establish what its earnings would have been if it had been
in existence during the base period (see supra, p. 711 et seq.) and that the credit
so established will be greater than that obtainable under either of the first
two options.
\item \textsuperscript{260} See note 177 supra. Superficially, Section 713(b)(1)(B) is incon-
sistent with this; but note 175 supra. Even Section 721 may be inapplicable
during the first year of corporate existence. See note 131 supra.
\item \textsuperscript{261} See supra pp. 691-692, and note 148; p. 701 and notes 183, 184.
\item \textsuperscript{262} The present phrasing is "(D) the taxpayer was in existence during
only part of its base period." Section 712 and 741, of course, would require
amendment to accord with the suggested provision.
\item \textsuperscript{263} See supra p. 711 et seq.
\end{itemize}
determine the corrective of the particular abnormal condition involved: If officers' salaries are abnormally low, the taxpayer should be permitted as an additional deduction the difference between the sums paid and the average salary deductions of comparable taxpayers; if the business is one in which income is largely attributable to personal effort of the managers, the taxpayer's excess profits credit should be raised to that percentage of its invested capital which is the average rate of return of other enterprises in the same trade or business during the "normal" base period years.

The administration of such a provision would require much care and time. No doubt it would provoke criticism and suspicion, but certainly it would be preferable to the denial of relief, however meritorious the case, which must result in many instances under the present statute.

Congress has striven valiantly to steer a course between the Scylla of inflexibility and the Charybdis of possible administrative abuse; and it has succeeded, at least, to the satisfaction of a press\textsuperscript{264} which has found events abroad more newsworthy than those in the halls of Washington. It may be hoped that Congress, by its compromise, has not adopted the evils attendant upon both alternatives.

APPENDIX

CLASSIFICATION OF ABNORMALITIES

I. Abnormalities affecting the basis of computation of the excess profits credit.

A. When invested capital is the basis, and

1. Income-producing property is excluded from invested capital by the terms of the statute.

2. Income is attributable in large part to intangible factors which cannot be capitalized.

B. When the basis is prior earnings, and

1. The character of the corporation

\textsuperscript{264} Time, March 10, 1941, p. 77: "Last week businessmen had the satisfaction of seeing almost every one of their suggestions adopted at last. If Congress had bungled in haste, it had done a good job of repenting at leisure."
EXCESS PROFITS TAXATION

has so materially changed that the past earnings are not fairly representative of present earning power.

2. The corporation experienced abnormally low net earnings during one or more years of the base period.

3. The taxpayer corporation is materially prejudiced by the time of incorporation.

II. Abnormalities affecting the taxpayer's income for the taxable year.

A. When the taxpayer has received "income" during the taxable year which is not properly attributable to its income-producing activities of that year.

B. When the taxpayer's expense deductions have been abnormally low during the taxable year, because sums properly attributable to business expenses of that year have not actually been paid during that period.

None.

Note: This chart relates to general relief provisions open to any taxpayer affected by the type of abnormality in question, although subject to the qualifications and limitations set forth in the text. It does not purport to indicate the specific sections (such as §§ 725-727) which offer either complete exemption from, or limitations upon the amount of, the tax on stipulated types of enterprises which might otherwise require relief because of abnormal conditions usually inherent; nor alternative provisions for computation of the excess profits credit, such as § 742, which diminish the number of taxpayers which may be affected by abnormalities rather than providing for relief of such conditions.