May, 1941

University of Pennsylvania Law Review

And American Law Register

FOUNDED 1852

Copyright 1941, by the University of Pennsylvania

VOLUME 89

MAY, 1941

No. 7

RELIEF FROM EXCESS PROFITS TAX

ROSWELL MAGILL †

The excess profits tax¹ contained in the Second Revenue Act of 1940² was the result of a message sent to Congress by the President a few days after he signed the First Revenue Act of 1940.³ An excess profits tax amendment had been added to the latter act in the Senate, but had been eliminated by the Conference Committee, reputedly with instructions to the Treasury's representatives to perfect a bill on the subject for the consideration of the congressional financial committees in the fall. Following the President's recommendation of "the enactment of a steeply graduated excess profits tax, to be applied to all individuals and all corporate organizations, without discrimination,"⁴ a subcommittee of the Committee on Ways and Means spent about five weeks in the preparation of a report on this tax,⁵ and on the related subjects of special amortization of emergency defense facilities, and of suspension of the Vinson-Trammell Act, which act contained pro-

† A. B., 1916, LL. D., 1940, Dartmouth College; J. D., 1920, University of Chicago. Under Secretary of the Treasury, 1937-1938; Professor of Law, Columbia University School of Law; author, *TAXABLE INCOME* (1936); co-author, *CASES ON TAXATION* (3d ed. 1940), and *CASES ON CIVIL PROCEDURE* (3d ed. 1939); and of numerous articles in legal periodicals.

1. Since 1933, a capital stock tax and a so-called excess profits tax have been continuously in effect, the purpose of the latter admittedly being to induce corporations to declare a fair value for their stock, subject to the former tax. The name of this earlier form of excess-profits tax—levied upon that portion of the corporation's net income as exceeded 10 per cent. of the adjusted declared value of its capital stock—was changed to "Declared Value Excess-Profits Tax" by § 506 (a) of Second Rev. Act of 1940, see note 2 *infra*. For a discussion of the act as a whole, see Notes (1940) 40 COL. L. REV. 1408, 54 HARV. L. REV. 311, 50 YALE L. J. 285.

2. Pub. L. No. 801, 76th Cong., 3d Sess. (Oct. 8, 1940) tit. II.

3. Pub. L. No. 656, 76th Cong., 3d Sess. (June 25, 1940).

4. As finally enacted, the bill is inapplicable to individuals; and was estimated to apply to only about 70,000 of the almost 500,000 active corporations which file returns, H. R. REP. NO. 2894, 76th Cong., 3d Sess. (1940) 3.

5. *Proposed Excess-Profits Taxation and Special Amortization—1940*, Report of a subcommittee of the Committee on Ways and Means, 76th Cong., 3d Sess. (1940).

visions for the limitation of profits upon the construction of aircraft or naval vessels. The bill was finally introduced on August 27, passed through the various legislative stages in House and Senate, and was signed just six weeks later.

A fundamental question in the formulation of the bill was to determine the base for computing excessive profits. All agreed that excessive profits should be taxed in the emergency; but how are excessive profits to be defined? Two definitions were proposed, and in the end, both were accepted, notwithstanding that they lead to widely different results in particular cases. One method defines the profits subject to the tax as those exceeding eight percent of the taxpayer's invested capital for the taxable year.⁶ The other method defines the profits subject to the tax as those exceeding 95 percent of the taxpayer's average net income for the years 1936 to 1939 inclusive.⁷ The taxpayer has an option as to which method it will employ in any given year.⁸ Consequently, a corporation making a high rate of return on its invested capital as defined in the act⁹ will be drawn toward the average income method. A corporation with a record of low earnings or deficits in the past 4 years may be impelled toward the invested capital method.

Although the tax was advocated as preventive of war millionaires, neither of the two optional methods will actually separate war profits from other income. The increase in profits which may be subjected to the tax under the average income method may and often will be wholly due to causes quite unconnected with the war. Air transportation, for example, has greatly increased in recent years; on an average income basis, corporations so engaged would have heavy excess profits taxes to pay.¹⁰ Yet the business is not a war-baby; and indeed it may suffer directly from the concentration of aircraft manufacture on war contracts, and from the increased prices of aircraft and gasoline. Moreover, some of the years 1936 to 1939 inclusive yielded subnormal profits in some industries. 1940 may produce no more than a normal return, not due at all to defense expenditures, and yet it may be necessary to pay a considerable excess profits tax.

6. § 714.

7. § 713.

8. § 712.

9. Section 718 defines "equity invested capital" in general, as money paid in or property paid in, to the extent of the basis for determining gain or loss, and earnings and profits as of the beginning of the year, with sundry deductions and adjustments. Section 719 defines "borrowed invested capital", 50 per cent. of which is includable in invested capital.

10. Section 727 (h) confers an exemption, however, upon corporations subject to the provisions of Title IV of the Civil Aeronautics Act, in the gross income of which there is includable compensation for air mail transport, if its adjusted excess profits net income for the year is zero or less after excluding this compensation.

Again, the methods do not separate weak corporations from strong, reserving heavier rates of taxation for the latter. To be sure, very small corporations are exempted entirely; and the rate scale is constructed so that rates increase with volume of profits, irrespective of percentage of return, thereby somewhat favoring smaller corporations. Nevertheless, the average earnings method tends strongly to favor the well-established corporation with a steady income as against its smaller competitor whose income has been rapidly increasing in the base years and in 1940. The former may have much larger profits, a much larger invested capital, and altogether a much stronger financial position, and still pay decidedly less excess profits tax. The well-established corporation with a steady income is also favored as against a feast-and-famine enterprise, one whose large earnings in 1940, for example, contrast with deficits in 1936 or 1938. To be sure, the invested capital method may offer hope to such corporations as railroads, with relatively great capitalization and low return. Invested capital, however, is not present worth but is, in general, money or property paid in to the corporation.¹¹ If the corporation has been successful, invested capital is apt to be much less than present worth, and it may be much less than capital and surplus as reported to stockholders.¹² Moreover, the allowable eight percent return is not a high return, and is fixed for all types of business, whether risky or established. All things considered, then, rapidly growing businesses; businesses with heavily fluctuating earnings; businesses where the degree of risk is commonly great; businesses which have engaged in developing new processes and patents that are now becoming successful; businesses whose assets are now worth greatly in excess of costs; contractors on projects requiring several years to complete; and businesses in which personal service is a major factor are apt to find themselves at a disadvantage as compared to the well-established, steadily earning enterprise.

In this state of affairs, provision was inevitable for special relief for some of the cases regarded as abnormal. Relief took two major forms: a series of exemptions and qualifications scattered through the Act, to meet particular, hard cases¹³; and two sections¹⁴ providing more generally for the adjustment by the Commissioner of abnor-

11. See §§ 718 and 719, and note 9 *supra*.

12. For example, if the corporation has acquired property through a reorganization, its basis may be much less than its worth at the time acquired, or at the present time.

13. Many of these appear in § 711, in the form of adjustment to the excess profits credit.

14. Sections 721 and 722 provide for adjustments in cases of abnormalities; § 723 provides a method for the determination of equity invested capital by the Commissioner in cases in which it cannot be determined under § 718.

malities in income and capital. The Ways and Means subcommittee had expressed the opinion¹⁵ that provision for special assessment was much less necessary than it was under the World War excess profits tax. The bill as reported by the Ways and Means Committee contained a section¹⁶ for the computation of equity invested capital when the Commissioner found it could not be determined under general rules; but otherwise the relief provisions were entirely of the first type noted above. The Senate, however, added two sections somewhat similar to those which appeared in the final act. One of these gave authority for adjustments in the event that the taxpayer's income for a particular year had been distorted by the inclusion of five designated forms of income.¹⁷ The second took the following mildly amusing form:

"The Commissioner shall also have authority to make any adjustments which abnormally affect income or capital, and his decision shall be subject to review by the United States Board of Tax Appeals."¹⁸

In conference, the five designated cases in Section 721 became six,¹⁹ and an elaborate plan for the computation of the tax was added. Section 722 became:

"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."

Senator George, the author of the original amendment, gave notice on the Senate floor during the Senate's consideration of the conference report, that he would later present additional provisions to further the purposes of this section in preventing exceptional hardship.²⁰

15. H. R. REP. NO. 2894, 76th Cong., 3d Sess. (1940) 8.

16. Section 721 of the House bill.

17. The Senate report describes these as follows

"(1) Income arising out of a claim, award, judgment, or decree, or out of interest on any of the foregoing;

"(2) Income received with respect to a contract whose performance required more than 1 year;

"(3) Income resulting from the exploration, discovery, prospecting, research, or development of tangible property, patents, formulas, or processes, providing that such exploration, etc., extended over a period of more than 1 year;

"(4) Income which is required to be included for the taxable year as a result of a change in the taxpayer's accounting period or method of accounting;

"(5) Income received by the lessor of real property on the termination of the lease as a result of improvements on the property during the lease."

SEN. REP. NO. 2114, 76th Cong., 3d Sess. (1940) 15.

18. Section 721½ of the bill as passed by the Senate.

19. The added paragraph reads: "Dividends on stock of foreign corporations, except foreign personal holding companies."

20. 86 CONG. REC. 19573 (1940).

Consequently the Treasury devoted much time during the winter to the formulation of amendments to the relief provisions, which finally took the form of rather extensive changes throughout the Act. It was a formidable task, since the Act is one of the most complicated tax laws in our history, and since the draftsmen attempted to provide specifically for the numerous, distinct, unusual situations in which the general provisions of the law lead to an apparently unfair result. Their work has been well done. They have evidently considered the hard cases carefully, and have dealt as generously with them as they felt they could, within the general framework of an excess profits tax law.

The original language of Section 722 was entirely eliminated; the original Section 721 was completely rewritten; extensive additions were made to Sections 711, 713; and Sections 732, 733 and 734 were added. The bill, presumably discussed in advance with the Congressional leaders, was officially introduced in the House as H. R. 3531 on February 24, 1941; referred to and reported by the Ways and Means Committee on the same day;²¹ and passed unanimously by the House on the following day. It was reported by the Senate Finance Committee on February 27, and passed in the Senate on March 3. Unanimity in this case was probably due to Treasury assurances that the bill operated only to protect and assist taxpayers, not to increase their burdens. The general purposes of the bill are to make more specific the cases in which relief may be granted and to clarify the administrative procedure, including review by the Board of Tax Appeals. Nevertheless, the fact that it was thought necessary to press these amendments through for adoption only two weeks before the first returns were to be made; and to make the amendments retroactively effective to a taxable year that began 14 months ago, is one more indication that the original excess profits tax law was adopted without adequate preliminary study and preparation. This was no fault of the draftsmen. It cannot yet be known how well or how poorly the amended law will operate in practice. More amendments next year are by no means precluded.

A brief consideration of the relief sections in the 1917-1921 excess profits tax laws is a useful preliminary to a detailed study of the present provisions. In general, the 1917-1921 laws emphasized invested capital and not average earnings as the base for the general computation of the excess profits subject to the tax. The principal ground for relief under the 1918 and 1921 laws was the Commissioner's determination that there was a gross disproportion between the tax as regularly computed and the average tax on representative corporations

21. H. R. REP. NO. 146, 77th Cong., 1st Sess. (1941).

engaged in a like or a similar trade or business.²² Serious questions were therefore presented in the determination of what were representative corporations similarly engaged. The scope for the exercise of administrative judgment and discretion was large, as was the number of cases in which the taxpayer deemed itself entitled to relief. Hence the administration of the section presented real difficulty. The Commissioner much prefers to administer such a section as the original 721, fairly definite in its specification of the cases in which action may be taken; than such a section as the original 722, quoted above, or the 1918-21 relief provisions. It is doubtless for reasons such as these that the Congress changed the basis for relief in the present law by eliminating any reference to the use of comparatives.

The latest amendments, though enlarging the specifications of the cases in which relief can be granted, refrain from references to the situations of comparable corporations as a possible basis for relief. Obviously the Treasury still wished to avoid the use of comparatives. The amendments also eliminate the general authority originally granted to the Commissioner in Section 722 to adjust abnormal capital or income. The question remains whether a tax on excess profits can be fairly administered without more general relief provisions.

SECTION 721

Section 721 relates solely to abnormalities of income, not of capital. The recent amendments have made it clear that the abnormalities referred to are not abnormalities in the base period years, but only in 1940 and succeeding years.²³ Section 721 as amended cannot operate to reduce the average earnings credit, and thus to increase the tax for 1940; but if excess profits tax rates are increased and the general structure of the tax is retained, the section might operate to increase the tax in some year in the future.²⁴

The application of the section as amended turns on two express conditions precedent, one stated in the alternative. It must appear, first, that there is includible in the taxpayer's gross income an item of "abnormal income". Six classes of abnormal income are specified, but they are not exclusive. In this respect the 1941 amendments broaden the original law. Second, it must appear that it is abnormal for the taxpayer to derive income of such a class; or if not abnormal,

22. See §§ 327 and 328 of both laws.

23. The section refers to abnormal income includable in the gross income of the taxpayer "for any taxable year under this subchapter", i. e., a taxable year beginning after December 31, 1939 (see § 710).

24. See, however, § 721 (d), limiting the increase in tax for the future taxable year.

that the amount of the income exceeds 125 percent of the average amount of gross income of the same class for the four previous taxable years.²⁵ The Ways and Means report in interpreting Section 721(b) states²⁶ another condition: the abnormal item of income must be found attributable to other taxable years. Thus an increase in business raising an item of income above 125 percent of the base period income will not result in the exclusion of the increased income from excess profits net income. The 125 percent requirement was substituted by the 1941 amendments for the former vague test of gross disproportion between the income received in the current year and income of the same class received in the four previous years. It will reduce the Commissioner's burdens, and provides a fair, though arbitrary, test.

The six classes of income designated do not for the most part require extended explanation or interpretation.

"(a) Arising out of a claim, award, judgment, or decree, or interest or any of the foregoing." One corporation represented at the Senate hearings²⁷ was about to receive an income tax refund for 1926-30 of \$600,000, with \$300,000 interest. Although the interest had accrued over 14 years, it would all be taxable income for 1940. If the item met either of the two conditions of abnormality or disproportion already considered, there seems to be good reason for granting appropriate relief. Similar considerations would apply to the case of a judgment giving rise to income.²⁸

"(b) Constituting an amount payable under a contract the performance of which required more than 12 months." Taxpayers undertaking the performance of contracts requiring more than 12 months to complete may, at their options, report the total profit in the year of completion. Contractors who have previously elected this basis had no reason to anticipate excess profits taxation upon the net income.²⁹ Because of the accounting method followed, the base period net income may be abnormally low, and the profits of several years may be reportable in a single excess profits tax year.³⁰ Under the conditions precedent previously discussed, relief could be granted only if the profit reportable in 1940, for example, was more than 125 percent of the average amount of gross income of that class reportable in the four

25. If the taxpayer was not in existence for four previous taxable years, the test years are those during which it existed.

26. See note 21 *supra*.

27. *Hearings before the Committee on Finance on H. R. 10413*, 76th Cong., 3d Sess. (1940) 223; *cf. id.* at 360.

28. Consider, e. g., such a case as *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359 (1931), in which the corporation received in 1920 a judgment for \$192,000 compensatory for the cost of work it had performed, which was held to be income.

29. See *Hearings*, note 27 *supra*, at 221.

30. See *Hearings*, note 27 *supra*, at 272, 479-80, 491-2.

previous years, since it is normal for the taxpayer to derive income of this class. Suppose the income ran 1936, \$100,000; 1937, \$150,000; 1938, \$75,000; 1939, \$500,000; 1940, \$1,000,000. The condition to relief has been satisfied, the 1940 income being five times the average of the preceding four years, although only twice that of the immediately preceding year. The case becomes stronger, of course, if there is no income of the class, or less income, in the preceding four years;³¹ or a greater disparity between the 1940 income and that received previously. The regulations provide for the allocation of income from such contracts to the various years in the proportion that expenditures each year bear to total expenditures.³²

"(c) Resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae or processes, or any combination of the foregoing, extending over a period of more than 12 months." A number of witnesses in the hearings spoke of instances in which a considerable amount of income was about to be realized in 1940 from the development of patents,³³ or from mining,³⁴ while the base period net income and the invested capital was small. In some of these cases, the income was directly attributable to the war. Nevertheless, such income shares with long-term contract income the characteristic of being attributable to work done over a period of years. It is reasonable, therefore, that it should not all be subjected to an excess profits tax in a single year, if the amount reportable is abnormal or disproportionately large. These generally applicable requirements would usually make the section inapplicable to the situation of a company having recurrent income from the named sources, comparable in size to that received in the taxable year.

"(d) 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 accounting." The Electrolux Corporation had applied for permission to change its method of reporting income for 1940 and later years from the installment to the accrual basis. If the application were granted, the condition would be the reporting in 1940 of the profits on sales made in prior years, to the extent that such profit had not been reported previously.³⁵ Counsel stated that the profit actually accruing in 1940 would be about

31. Cf. *Joint Hearings before the Committee on Ways and Means and the Committee on Finance*, 76th Cong., 3d Sess. (1940) 330.

32. U. S. Treas. Reg. 109, § 30.721-3. The original excess profits tax regulations under the 1940 law were promulgated February 8, 1941. The new amendments will, of course, necessitate new regulations.

33. See, e. g., *Joint Hearings*, note 31 *supra*, at 115, 245, 331.

34. *Hearings*, note 27 *supra*, at 216, 373.

35. U. S. Treas. Reg. 103, § 19.41-2.

\$2,000,000; the profit not previously reported would be \$3,000,000.³⁶ The latter amount would be apt to turn out to be "excess profits", since total 1940 profits thus computed would greatly exceed prior years' reported earnings. Some special computation is therefore appropriate. The Regulations specify as possible changes in accounting methods the sort just mentioned, i. e., a change from the installment method to the straight accrual method; a change in inventory method, or a change from the reserve method to the specific charge-off method for the treatment of bad debts.³⁷ Suppose the taxpayer has obtained permission for a change in accounting period from a fiscal year ending April 30, 1939 to a calendar year basis. Had the accounting period not been changed, none of the income for the first four months of 1940 would have been subjected to the excess profits tax, since it is applicable to taxable years beginning after December 31, 1939.³⁸ Is the corporation entitled to special relief? Literally it seems so, although the corporation may thereby escape a liability which its competitors, always on a calendar year basis, will have to bear. It is unlikely that the Treasury meant to achieve this result, or will further it willingly. The Regulations do not mention it, nor do the 1941 amendments.

"(e) In the case of a lessor of real property, amounts included in gross income for the taxable year by reason of the termination of the lease." Under *Helvering v. Bruun*,³⁹ a lessor who by default of the lessee regains possession of land on which his tenant has erected a building, realizes income to the extent of the net fair market value of the building in the year in which he resumes possession. Income of this kind is apt to be abnormal both in amount and in occurrence, even for a recipient engaged in owning and leasing property. To put it another way, income so realized would frequently turn out to be the excess profits subject to tax, under the general rules of computation; yet such profits, being abnormal, are not an equitable basis for the tax.

"(f) Dividends on stock of foreign corporations, except foreign personal holding corporations." Dividends from foreign corporations, particularly in these times, may be paid with much less regularity and hence in greater individual amounts, than dividends from domestic corporations. For example, exchange restrictions may have blocked the payment of dividends for some of the base years. The relief provision is broad enough to include liquidating dividends, which might result in considerable gains, out of line with normal earnings of past years.

36. *Hearings*, note 27 *supra*, at 468, 474; *Joint Hearings*, note 31 *supra*, at 152, 154.

37. U. S. Treas. Reg. 109, § 30.721-5.

38. § 710 (a).

39. 309 U. S. 461 (1940), 53 HARV. L. REV. 1206.

Following the listing of cases in which special relief is to be granted under this section, the section concludes with the method of computation of the tax. There is first to be determined, under the Treasury regulations⁴⁰ the amount of the listed items of income which is properly attributable to years both before and after the taxable year in question. This in itself will be no easy task in a number of the instances listed, such as income resulting from research or patents, or from a judgment. Next, the tax for the taxable year shall be computed; and shall not exceed the sum of (1) the excess profits tax computed on the corporation's other income, with the items in question omitted, so far as attributable to another taxable year; plus (2) the aggregate additional excess profits tax which would have resulted for any past year, computed with the addition to gross income of the portion of the items in question assigned to such past year. Although Section 721 (c) (2) reads "the aggregate of the increase in the tax under this subchapter which would have resulted for *each previous taxable year* to which any portion of such net abnormal income is attributable." Section 30.721-2 of the regulations under the original Section 721 apparently limited the amounts to be added to the tax for the current year under this computation to the increases in excess profits taxes for 1940 and subsequent years. In other words, if parts of the net abnormal income were allocated to 1939 or previous years, no excess profits tax would be computed thereon. The amendments do not substantially change the 1940 law in this respect, so presumably the official interpretation will continue in effect.

The excess profits tax for the *future* year, to which some portion of the listed income may have been assigned, is to be determined after the inclusion of the amount in question in gross income.⁴¹ Some question might arise as to the power of the two parties, the Commissioner and the taxpayer, to agree that some of an amount constituting income for 1940 under general judicial and legislative rules, should be subjected to excess profits tax for 1943. Nevertheless, Congress has authorized this kind of treatment in general terms; the result will obtain only on a taxpayer's application addressed to the Commissioner, and the Board or a court will therefore be unlikely to upset what has been done. Moreover, the Commissioner will probably avoid difficulty by inviting the taxpayer to enter into a final closing agreement as an integral part of the grant of relief, thereby eliminating any question of judicial review.

40. The applicable U. S. Treas. Reg. 109 is quite elaborate in prescribing methods for allocation. Nevertheless, cases will almost certainly arise which do not readily fall within the stated rules.

41. § 721 (d) as amended.

SECTION 722

The particular provisions of Section 721 cover only a few specific cases of hardship. The general power to adjust abnormal income applies (1) to items of income, not to general conditions affecting a business as a whole; and (2) only to cases in which portions of the abnormal income are found to be attributable to other years. Abnormalities in the computation of invested capital are not affected at all. Congress, stimulated by the facts that the specific relief originally afforded in Section 721 would not be effective in some of the cases presented in the hearings, and that experience in administration would disclose still other cases, adopted Section 722 in 1940 as a general catch-all relief provision. Unfortunately the section was so broad—it contained no standards by which abnormality was to be judged—that the Commissioner could hardly know how to act under it. The regulations subsequently adopted did little more than paraphrase the law.⁴² Hence the Treasury felt driven to prepare a further bill of particulars, and to eliminate the original broad grant of power.

(1) The leading question posed by the original section was whether the normal growth of a business is an abnormality. Increases in profits may be attributable to new management, intelligent research, the development of new processes, advertising, or increasing popularity of product due to a gradual development in or shifts of public taste. In the particular case, these causes for increasing income may have little or nothing to do with defense expenditures or the war. Frequently the war can be shown to be a dampening force upon the development or sales of the product. Of course, if profits do not exceed about eight percent of invested capital, and if invested capital increases as profits increase, the corporation is not much concerned with the tax. There are many more cases, however, in which the profit ratio is much higher, because, by hypothesis, these are growing businesses in which capital would normally require a higher return as a condition to investment. The hardship becomes particularly manifest if the corporation is competing with an established company having a past record of steady profits. The latter may be making an equally large return upon invested capital, and yet, because of its substantial average earnings, be subject to a less rate of tax and possibly a less absolute amount of tax than its smaller, rapidly growing competitor.

It seems unfair to deny relief in this class of cases, merely because the rate of return on invested capital is more than eight percent, so long as corporations generally are not being held to an eight percent

42. U. S. Treas. Reg. 109, § 30.722-1.

return. It seems unwise as well as inequitable to tax growing corporations more heavily than corporations which have already reached the stability of greater maturity and greater financial strength. Nevertheless, the Commissioner would naturally hesitate to open the doors to relief in all such cases, since they will be numerous, and since he would be compelled to work out fair standards for a tax of large size, not only without the assistance of any statutory yardstick but also with the handicap of the confusion caused by the dual basis for the tax itself.

The 1941 amendments seek to meet this situation by an extensive addition to Section 713, providing for the determination of the excess profits credit, based on income. Under Section 713 (f), if the corporation's earnings for the last half of the base period exceeded its earnings for the first half, it may compute its base period net income as follows. The excess of excess profits net income for the second half of the base period over that for the first half, divided by two, is added to the excess profits net income for the second half of the base period. The sum is then divided by 24 and multiplied by 12, in order to place the total on an annual basis. If this amount is not more than the highest excess profits net income for any taxable year in the base period, it becomes the average base period net income; otherwise, the highest excess profits net income for any taxable year in the base period will be used.⁴³

Although this amendment is certainly an improvement over the general provisions of the original law, it still does not give much effect to the growth factor which will be found in particular cases. At most, the highest net income during the base period is substituted for the average base period net income. If the corporation has continued to grow since 1939, even from causes having little or nothing to do with defense expenditures, the excess profits tax may be heavily applicable. The discrimination in favor of the strong, matured competitor corporation with steady earnings, as compared to its smaller, but rapidly

43. The illustration given in the committee report (H. R. REP., *op. cit.* *supra* note 21, at 7) is as follows: Excess profits net income: 1936, \$100,000; 1937, \$200,000; 1938, \$300,000; 1939, \$400,000. Computation under § 713 (f):

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

growing rival, may still be present. The provision needs further attention, in the direction of a direct allowance for the percentage of growth, in cases of corporations organized within, say, the past fifteen years, no part of the net earnings of which are attributable to contracts for the production of articles contributing to national defense.

(2) Section 722 as amended is intended to permit adjustments of abnormal base period net income in cases of two principal kinds: (a) Where the character of the taxpayer's business as of January 1, 1940 differs from that of one or more of the base period years; and (b) Where normal production, output, or operation in one or more of the taxable years in the base period has been interrupted or diminished because of abnormal events. The section goes on to define these cases more exactly. The first rule is: "High prices of materials, labor, capital, or any other agent of production, low selling price of the product of the taxpayer, or low physical volume of sales owing to low demand for such product or for the output of the taxpayer, shall not be considered as abnormal."⁴⁴ The second rule is that the character of the taxpayer's business on January 1, 1940 shall be considered different from its previous character *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
- "(D) the taxpayer was in existence during only part of its base period; 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."

The report⁴⁵ gives examples of each of these possibilities. For the most part, what is generally meant is clear, but obviously the application will frequently involve very difficult questions of degree, for example in cases falling within (A) and (B). There is nothing in the report to indicate that (E) may not as well apply to the acquisition of a small competitor as well as one of more or less similar size.

If the taxpayer establishes that these statutory conditions are complied with, it may apply to the Commissioner for relief, but it may

44. § 722 (b) as amended.

45. H. R. REP., *op. cit. supra* note 21, at 11.

not claim the benefit of Section 722 in computing its excess profits tax originally. Thus, appeals from the action of the Commissioner under this section will normally be claims for refund. This aspect of the section will be considered later. If the section is to be applied, the taxpayer must show what the average base period net income would have been, had the character of the business been the same throughout the base period, or had normal production been maintained. If there has been a change in character of business, the average base period net income may not exceed the excess profits net income established for the last taxable year in such period,⁴⁶ a provision which may seriously limit its operation but which was necessitated by the hypothetical character of any reconstructed income for years previous to the last one. There is no similar limitation if the base period net income is abnormal solely because of an interruption to normal production.

To cut down the number of applications for relief which would otherwise flow to the Commissioner, Section 722 (c) provides that the section shall not be operative unless the excess profits tax as regularly computed is at least six percent of the taxpayer's normal tax net income, and the application of the relief provision reduces his tax by at least ten percent.⁴⁷ Section 722 (d) was designed as a corollary: if the section is applied, the tax shall not be less than six percent of the taxpayer's normal tax net income, plus ten percent of the tax saving due to the application of Section 722. The purpose was evidently to level out discrepancies in tax which otherwise might be brought about between companies granted relief under Section 722, and companies which just failed to meet the requirements of Section 722 (c). The two sections are nevertheless open to some criticism: Section 722 (c) for setting up a purely arbitrary standard for relief, and Section 722 (d) for establishing a contingent fee therefor, when a similar fee is not charged for the very many other kinds of relief scattered through the act.

There being no general relief provisions now remaining, it is important to consider whether the revised sections afford adequate opportunity for caring at least for known exceptional cases. A fair sample of the main categories of these cases was presented in the hearings last summer. It may be profitable briefly to review their facts, and the application of the law, as amended, to them.

Case 1. Representatives of the canning industry testified that it is a feast and famine business; that profits in 1936 far in excess of the ten-year average were succeeded by small losses in 1937 and very great

46. See § 722 (b) (3) as amended; H. R. REP., *op. cit. supra* note 21, at 11, 12.

47. H. R. REP., *op. cit. supra* note 21, at 12-13.

losses in 1938.⁴⁸ 1939 produced about average profits. The average earnings basis would be useless to such a corporation, should 1940, for example, produce profits on the scale of 1936. The invested capital method would also result in a sizeable excess profits tax. The canners wanted a provision for a carry-over of the unused excess profits tax credit of the years in which losses were realized. The original act contained a limited credit provision of this sort,⁴⁹ but only for corporations whose normal tax net income is not over \$25,000. There was therefore some question whether larger corporations could be given relief, perhaps of a different sort, under Section 722 as it originally stood. The 1941 amendments clarify this situation,⁵⁰ and enlarge the scope of the credit by (1) removing the \$25,000 limitation; and (2) permitting the unused excess profits tax credit to be carried over for two years. This is an important move in the interests of equity, and one that is likely to be fairly expensive to the revenues.

Case 2. A corporation has a record of steady operating losses, part of which are attributable to costs of development of a patent.⁵¹ The corporation has obtained no tax benefit from the deduction of the development costs, since there was no income against which to offset them. The corporation (manufacturing a sub-machine gun) now expects to show net income, nearly all of which will be "excess profits" under either definition. Is the corporation entitled to relief under the law as amended. In particular, may the Commissioner permit the restoration of the patent development costs to invested capital?

Case 3. A valve company had a rate of return on invested capital of 2.8 percent for 1936-39, whereas earnings in previous years have ranged from 10 to 15 percent. The base years' income was subnormal, due to a general remodelling and overhauling of the company's line.⁵² Is it entitled to relief on the theory that its base period earnings were abnormal?

Case 4. A casting company, reorganized in 1932, shows invested capital at about 50 percent of the replacement costs of its assets. Its average earnings for 1936-39 are less than anticipated earnings for 1940.⁵³ Is the disparity between invested capital and replacement costs an abnormality?

48. *Hearings, loc. cit. supra* note 27, at 343-7.

49. Section 710 (b) (3): "In the case of a taxpayer the normal-tax net income of which for the taxable year is not more than \$25,000, the amount by which the excess profits credit for the preceding taxable year (if beginning after December 31, 1939) exceeds the excess profits net income for such preceding taxable year."

50. § 710 (b) (3), § 710 (c) as amended.

51. *Cf. Hearings, loc. cit. supra* note 27, at 332; *Joint Hearings, loc. cit. supra* note 31, at 331.

52. *Joint Hearings, loc. cit. supra* note 31, at 333.

53. *Joint Hearings, loc. cit. supra* note 31, at 334.

Case 5. An advertising agency requires \$1,000,000 capital to enable it to carry accounts for its clients. Its stock is all owned by officers, employees, and their families. An investment banking firm likewise requires \$1,000,000 capital; its stock is held by its officers and their associates in the business. In either case, the success of the enterprise is due to the personal services of the men who are the principal stockholders. It is doubtful whether either corporation qualifies as a personal service corporation under Section 725. The question is whether capital is a material income producing factor? If so, that section affords no relief. Of course, many personal service corporations would be adequately cared for by the average earnings provisions generally applicable; investment bankers with fluctuating incomes, for example, might not be. Can either corporation qualify for relief under other provisions?

Although guesses as to the mode of handling these cases are hazardous, the formulation of some opinions is requisite, if only as a basis for determining how far Treasury rulings and regulations may be expected to go, and how far new legislation will be required.

Section 722 as amended permits an adjustment of base period net income only in the situations therein specifically described, and contains no general authority to the Commissioner to adjust abnormalities. The fact that 1936-39 was an abnormal period in the particular industry, as compared to industries generally, does not present a case for relief under Section 722 as amended, although arguably it did under the original section. Under the amended section, the abnormality must be shown to be one peculiar to the particular corporation, apart from conditions which affected all business during the years 1936-39. It must consist either of a change in the character of the business, or an interruption in normal production by abnormal events. *Case 3* is covered by the amended section if the change in the company's line was far-reaching, or if the production was interrupted because of the remodelling or overhauling; to determine this more facts than those outlined at the hearings would be required. Another example of one of the cases aimed at may be the situation of Marshall Field & Co.,⁵⁴ described in the hearings. During three of the base years the company was engaged in liquidating its wholesale business. The retail stores showed profits ranging from a low of \$3,734,000 in 1938 to a high of \$4,893,000 in 1939. Losses in the wholesale business, however, cut the reported net income to \$873,000 in 1936; there was a loss of \$2,613,000 in 1937; and a profit of \$226,000 in 1938. The liquidation of the wholesale business having been finished, the

54. *Joint Hearings, loc. cit. supra* note 31, at 260.

1939 net income was that realized by the retail stores, \$4,893,000. Generally speaking, there was a change in the character of the business; did this change fall within the precise specifications of Section 722 (b) (2)? Was "there a difference in the products or services furnished; or a difference in the capacity for production or operation? A tough-minded administrator may argue that the liquidation of one branch of the business did not involve these exact changes; a more reasonable interpretation would include them. If the case presents a problem, however, it suggests the incompatibility of those twin congressional aspirations: equitable relief to be available in *all* hard cases; and exact specification of the *sole* cases in which relief is to be given. The amendments adopt the latter alternative, following the general drafting policy evidenced at least since 1924, of meticulously detailed statutory provisions.⁵⁵ It has frequently been questioned whether this policy has worked out satisfactorily; certainly the flood of tax litigation could hardly have been greater under more general statutory provisions. In any event, here was an appropriate place for a more general concession of powers to the official charged with the administration of the law. Granted that the Commissioner should be given more definite standards for relief cases than appeared in the original Section 722, he should not have been inserted in the straight-jacket that these amendments provide. The Treasury cannot possibly know for many months the exact specifications of the claims for relief in all American businesses. It is a safe guess that not all of them are provided for by the present sections. The results will be either that the statute must again be amended; or that cases quite as deserving as the many specifically cared for must abide by the rigors of the law. Neither alternative is particularly palatable.

This criticism finds a further basis in the method of treatment of the situation outlined in *Case 2*. Section 733, inserted by the 1941 amendments, provides that the taxpayer may elect to capitalize such base period "expenditures for advertising or the promotion of good will" as under regulations may be regarded as capital investments. Appropriate adjustments, normally increases, of income tax liability for the base period years, due to the disallowance of these deductions, must be made.⁵⁶ Now expenditures for advertising and the promotion of good will are only two kinds of expenditures which fall within the twilight zone separating current expenses and capital expenditures although they are perhaps the principal ones. *Case 2* can obtain no relief under Section 733, yet the capitalization of patent development

55. See PAUL, *STUDIES IN FEDERAL TAXATION* (3d series 1940) 24, n. 81.

56. See § 734.

expenses is surely quite as justified as the capitalization of advertising costs. The section might better have been drawn in more general form.

Cases 4 and 5 present the inequities of an excess profits tax based on invested capital, and the difficulties of formulating adequate relief. Invested capital bears no necessary relation whatever either to present values, or to the investments of present stockholders. The return to the stockholder, or the ratio of profit to the present value of assets may be much less than eight percent, and yet a large excess-profits tax may be payable. Thus we are met at the start with the fact that the excess profits tax has no necessary connection with individual ability to pay, nor with the ability of the business to pay. *Case 4*, therefore, probably presents no abnormality in capital, for the circumstances there stated will be oft repeated in diverse businesses. *Case 5* may be normal, both as to income and capital, for the kinds of business there concerned. The seat of the trouble is simply that the personal service corporation definition is too narrow, and there is no other applicable provision for relief. Indeed it is hard to see what kind of relief provision could be drawn.

Even this brief discussion indicates that the law, as elaborately amended, does not eliminate all the known cases of hardships and even discriminations in application of the excess profits tax. It does not completely provide for the unknown situations, since the Commissioner has no general power to adjust abnormalities in invested capital, limited authority to adjust abnormalities in base period net income,⁵⁷ and not full power to adjust abnormalities in income subject to the tax. The principal known inequity—the case of the rapidly growing young corporation—is aided considerably, but the law freezes the base period net income at the 1939 level, and thus does not provide for continued growth thereafter not due to causes connected with the emergency. There is still need for a more general grant of authority to the Commissioner, or to some independent administrative agency,⁵⁸ to afford relief in hard cases.⁵⁹ In any event, the excess profits tax law, as amended, has not yet reached the perfection in its substantive provisions, which would enable business to accept with equanimity the

57. Note, however, § 711 (b) (1) (J), giving broad authority to the Commissioner to adjust abnormal deductions in the base period.

58. Compare the broad relief provisions under the British excess profits tax: 3 & 4 GEO. 6, ch. 29, § 27 (1940); and the Canadian provisions, STATS. OF 1940, 2d Sess., ch. 32, §§ 4, 5.

59. The discussion herein has been focussed on §§ 721 and 722 as amended. I have not referred to some of the other provisions which grant effective relief in particular situations, such as § 7 of the amendments, permitting insurance companies other than life or mutual to be included in consolidated returns with ordinary corporations; § 8, permitting the earnings of a predecessor partnership or sole proprietorship subsequently incorporated to be reflected in the base period credit of the corporation; and §§ 12, 13, 14 and 15.

severe increases in rates that are probably not far ahead. There is great need of much more hard work on the law by the Treasury, Congress, business men, and lawyers.

APPELLATE REVIEW

Neither Section 721 nor Section 722 expressly provide for review of Commissioner's determinations thereunder, but Section 732 added by the 1941 amendments contains explicit provisions on the subject, and the Ways and Means report⁶⁰ discusses appeals and review quite fully. The principal questions seem to be: I. What is the scope of review of the Commissioner's determinations under the two sections? II. Are determinations under either section reviewable by a federal court? III. What is the scope of judicial review of Board decisions?

I. Section 722 as amended specifically provides that "The taxpayer shall compute its tax and file its return under this subchapter without the application of the section."⁶¹ Section 721 contains no similar language. Since it provides for the allocation of abnormal income under Treasury regulations,⁶² the intention may be that the adjustments should be made in the original return, pursuant to the prescribed formulae. The regulations under the original Section 721 were not wholly clear as to whether the relief could be claimed in the original return, but evidently contemplated that it should be.⁶³ There is no insuperable difficulty in this procedure, since Section 721 is reasonably specific as to the classes of abnormal income, as to the methods for allocation, and as to the tax.

On this basis, a controversy between the Treasury and the taxpayer will usually involve a deficiency under Section 721, and a claim for refund under Section 722. Section 729 provides that "all provisions of law (including penalties) applicable in respect of the taxes imposed by Chapter I, [the income tax] shall, insofar as not inconsistent with this subchapter, be applicable in respect of the tax imposed by this subchapter." Hence, the Board of Tax Appeals clearly has jurisdiction to review the Commissioner's determination of a deficiency under Section 721. The decision of the Supreme Court in *Blair v. Oesterlein Machine Co.*⁶⁴ confirmed the power of the Board to review determinations of the Commissioner under the special assessment provisions of the former excess profits tax. Review of a decision under the present fairly specific sections would present much less difficulty.

60. H. R. REP., *op. cit. supra* note 21, at 14-16.

61. § 722 (c).

62. § 721 (b).

63. See § 30.721-1.

64. 275 U. S. 220 (1927).

Section 732 provides explicitly for review by the Board of rejections of claims for refund under Sections 721, 722, or Section 711 (b) (1) (H) (I), (J) or (K).⁶⁵ The petition must be filed within 90 days after notice of disallowance of the claim is mailed by the Commissioner. The Board is granted the power, not only to approve or deny the claim for refund, but to find a deficiency for the year in question. The taxpayer assumes this risk by appealing, as he does in corresponding cases under existing law. Finally, subdivision (c) of the section provides that: "if in the determination of the tax liability under this subchapter 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." This is largely a confirmation of the judicially adopted rule under the prior excess profits tax. In the *Williamsport Wire Rope Co.* case⁶⁶ the Supreme Court concluded that "the determination whether the taxpayer is entitled to the special assessment was confided by Congress to the Commissioner, and could not, under the Revenue Act of 1918, be challenged in the court—at least in the absence of fraud or other irregularities."⁶⁷ The principal reason given was that "the considerations which demand assessment under Section 327 (d), and those which govern its computation in all cases, are facts concerning the situation of a large group of taxpayers which can only be known to an official or a body having wide experience in such matters and ready access to the means of information."⁶⁸ Moreover, if the Court of Claims were given jurisdiction to review, all the federal district courts would have it, "none of which have ready access to the information necessary to enable them to arrive at a proper conclusion in revising his decisions."⁶⁹ Determinations under the present Sections 721 and 722 are somewhat less difficult perhaps, since they involve to a lesser extent comparisons with other taxpayers. Decisions under either section however, involve a large element of administrative skill, possibly of administrative discretion. Hence the present statutory rule, supported by this page of history, is sound.

The Ways and Means report⁷⁰ points out that particular determinations under these sections may also involve questions independent of them, such as the amount of an abnormal item of income under

65. Providing for the disallowance of certain abnormal deductions for the base period.

66. *Williamsport Wire Rope Co. v. United States*, 277 U. S. 551 (1928).

67. *Id.* at 562.

68. *Id.* at 561.

69. *Id.* at 562.

70. H. R. REP., *op. cit. supra* note 21, at 15.

Section 721, or the year in which the income was realized. Review of these determinations is not confined to the Board, but the Commissioner's plan to allocate the income between the years in question would be reviewable only by the Board. As a practical matter, cases of this character will almost invariably be taken to the Board, not to the federal courts; and that result is plainly desirable.

II. It had been held that appellate courts have no jurisdiction to review the Board's decision sustaining the denial by the Commissioner of special assessment under the former excess profits tax act.⁷¹ Presumably the same conclusion would have been reached if the Board had granted special assessment and the Commissioner had appealed, since the ground of the decision is that a determination of this type is peculiarly within the competence of an administrative rather than a judicial tribunal. The same conclusions are required here by Section 732 (c).

III. The Commissioner has available in the final closing agreement⁷² an excellent device for forestalling litigation in those cases in which he grants relief under Sections 721 and 722, and indeed in any case in which he negotiates a settlement of disputes for a particular tax year. He can readily condition his decision upon the execution by the taxpayer of such an agreement, and in most instances, the taxpayer will execute it, since he can thereby avoid much future controversy respecting liability. If such an agreement is executed, it closes the road to all appeals by either party. Consequently, the Bureau will be much more active in determining beforehand whether closing agreements as to past or future transactions should be made; and much less litigation thereafter. For the most part, litigation will be confined to cases in which the Commissioner has refused to recognize any abnormality, and has therefore denied relief under Sections 721 and 722.

CONCLUSION

Since total federal receipts will probably pay little more than half of the federal outlays during the next two years; and since we will thereafter confront larger outlays than have been normal for the upkeep of our two-ocean navy and mechanized army, and for interest and amortization; we must expect considerable increases in federal taxes of all kinds. A tax on excess profits has obvious appeal as a major means of raising money: it sounds right, it applies to com-

71. *Duquesne Steel Foundry Co. v. Burnet*, 283 U. S. 799 (1931).

72. INT. REV. CODE § 3760 permits closing agreements either as to past or as to future transactions. Such agreements are finally determinative of tax liability, unless the law is changed, or there is fraud or a misrepresentation of material facts.

paratively few taxpayers, it has been widely used by Great Britain and Canada. Almost certainly the tax will be retained here for some years, despite its numerous inequities and discrimination between taxpayers. Moreover, its rates are apt to be increased. It is very important, therefore, that lawyers consider its operation in particular cases carefully, and use their ingenuity to devise means whereby it may be more fairly applied. If possible, the amendments in the interests of equal operation ought to be made in the basic sections, rather than in the relief provisions. Exemptions, qualifications, and special relief provisions may cause nearly as many inequities through favored treatment as they cure. The tax as it stands at present is not very sound and not very productive of revenue. Its defects challenge the Treasury, the Congress, and the bar to effect a cure before the discriminations of the tax unnecessarily injure our economy.