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THE EXCESS PROFITS TAX PROVISIONS OF THE
REVENUE ACT OF 1942

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The development of an adequate excess profits tax is one of the more difficult of our current governmental problems. In the first instance, it calls for an exercise of sound judgment by Congress on policies and objectives, leading to a tax structure consistent with the best interests of the nation at war. Policy issues are fraught with perplexing considerations. Inordinate war-created profits must be effectively recaptured in the interest of maintaining morale, equitably distributing the war costs, and preventing the exploitation of general sacrifice for private gain. At the same time, a production system which is based in part, at least, on the incentive of immediate profits must be maintained at capacity output; war investment and expansion must be encouraged by the offer of reasonable protection against post-war deflation; and severe economic dislocation should not be intensified by oppressive taxation. The taxing system is effective as a means of recapturing excessive profits for public purposes only if the measure of "normal profits" is not or cannot be unjustifiably inflated; and the tax rate must be very high. Yet it is no less imperative, if the system is to be fundamentally fair and equitable, that normal profits be confiscated under the guise of excessive profits in as few cases as possible.

To those at all familiar with the subject, there is no need to emphasize the technical complexities involved in the translation of the will of Congress into statutory provisions, as the policy decisions are made and remade. The solution of this problem is found in continuous study of the statutory defects which come to light, and full exploitation of the energy and skill of legislative technicians.

The third phase—the system in operation—is equally vital. It is the proof of the pudding as to whether the laws are so constructed as to lend themselves to the practicable administration of both the collection of revenue and the operation of the taxpayer’s business. There is much room here for a constructive and positive contribution, for the ultimate value to society of the legislative effort, once crystallized into statutory form, will depend greatly on the application of the law by both taxpayer and tax-gatherer.

Unquestionably, even moderate success may be achieved only by a combination of unbroken consideration by Congress of the practical

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problems and questions of policy flowing from the tax, expert translation by the technicians of Congressional decisions into appropriate legal terms, and intelligent and wise administration of the statutory provisions, until the tax is no longer with us.\(^1\) All this must be implemented by wide dissemination of knowledge and information with respect to the tax among those affected by it.

The Revenue Act of 1942\(^2\) contains numerous amendments to the excess profits tax provisions of the Internal Revenue Code, which in their new form represent approximately two and one-half years’ intensive work.\(^3\) While certain known defects are still not entirely cured, time will inevitably reveal still more weaknesses, and much depends on the administration of the statute, the basic framework of a reasonably ade-

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\(^1\) The functioning of the excess profits tax was roundly criticized, after the close of the last war, by Secretaries of the Treasury William G. McAdoo, Carter Glass, and David F. Houston. See Joint Hearings before the Committee on Ways and Means and the Committee on Finance on Excess Profits Taxation, etc., 76th Cong., 3d Sess. (1940) 319-320.

\(^2\) Pub. L. No. 753, 77th Cong., 2d Sess. (Oct. 21, 1942). The Revenue Act of 1942; the Revenue Bill of 1942 (H. R. 7378, 77th Cong., 2d Sess. (1942)) as it passed the House of Representatives and later the Senate, prior to conference; the Ways and Means Committee report thereon (H. R. REP. No. 2333, 77th Cong., 2d Sess. (1942)); the Finance Committee report thereon (S. REP. No. 1631, 77th Cong., 1st Sess. (1942)); the Conference Committee report thereon (H. R. REP. No. 2586, 77th Cong., 1st Sess. (1942)); the Hearings before the Ways and Means Committee, House of Representatives, on the Revenue Revision of 1942 (77th Cong., 1st Sess. (1942)); the Hearings before the Committee on Finance, United States Senate, on H. R. 7378 (77th Cong., 1st Sess. (1942)); and the Internal Revenue Code (as amended by the Revenue Act of 1942 unless otherwise noted) will be respectively referred to as the “Act”; the “House Bill” and the “Senate Bill”; the “House Report”; the “Senate Report”; the “Conference Report”; the “House Hearings”; the “Senate Hearings”; and the “Code”.

\(^3\) The Revenue Act of 1940, Pub. L. No. 656, 76th Cong., 3d Sess. (June 25, 1940), contained a form of excess profits tax (the “LaFollette amendment”) as it passed the Senate, but these provisions were eliminated in conference. On July 1, 1940, the President in a special message to Congress requested the enactment of an excess profits tax. See H. R. REP. No. 2894, 76th Cong., 3d Sess. (1940). A sub-committee of the Committee on Ways and Means was immediately appointed, and it reported on August 8, 1940. Proposed Excess-Profits Taxation and Special Amortization—1940, REPORT OF A SUB-COMMITTEE OF THE COMMITTEE ON WAYS AND MEANS, 76th Cong., 3d Sess. (1940). The Ways and Means Committee held joint hearings on the subject on August 9-14, 1940; and the Finance Committee later held independent hearings on September 3-5, 1940, after a bill had been introduced and passed in the House. Joint Hearings, note 1 supra; Hearings before the Committee on Finance on H. R. 10413, 76th Cong., 3d Sess. (1940). Pub. L. No. 801, 76th Cong., 3d Sess. (Oct. 8, 1940) (hereinafter referred to as “The Second Revenue Act of 1940”), containing the excess profits tax, was then enacted, with the intention that work would be continued on technical improvements, notably with respect to the “relief” provisions. See H. R. REP. No. 3002, 76th Cong., 3d Sess. (1940) 52; 86 Cong. Rec. 19503 (1940).

A number of these improvements were enacted in Pub. L. No. 10, 77th Cong., 1st Sess. (March 7, 1941) (“The Excess Profits Tax Amendments of 1941”). Further changes were made in Pub. L. No. 250, 77th Cong., 1st Sess. (Sept. 20, 1941) (the “Revenue Act of 1941”). The latter Act was to have been followed forthwith by an “administrative” bill devoted to additional technical changes; but these were ultimately deferred for incorporation in the Revenue Act of 1942, which was in the official legislative mill from March 3, 1942, the opening of the House Hearings, to October 21, 1942, the date of the President's signature. It will thus be seen that excess profits tax legislation has been continuously active since early 1940. Nevertheless, a number of known problems still remain for solution in later legislation.
quate system of excess profits taxation seems to have been laid. However, the primary function of this article is neither to review the judgment of Congress on the policy issues involved in the new amendments, nor to appraise the skill demonstrated by the legislative technicians who are responsible for the reflection of that judgment in the Code. Emphasis is here placed almost exclusively on analysis of the effect of the new provisions as they stand. A brief glance even at the only moderately complicated provisions will suffice to demonstrate that explanation in itself is ample justification for the discussion.

I. EXCESS PROFITS TAX RATES

Theoretically, the taxation of excess profits at the rate of 100% is justified. As a practical matter, however, the tax rate should fall somewhat short of 100% in recognition of the margin of error in deter-

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4. Limitations of space make it necessary to assume on the part of the reader a working knowledge of excess profits tax principles in effect prior to the Act. It should also be noted that this article has been prepared in advance of promulgation of Treasury regulations based on the Act.

For convenience in the use of this article, an outline of the first part thereof follows:

I. Excess Profits Tax Rates
II. Adjusted Excess Profits Net Income
III. Current Excess Profits Net Income
   (1) Capital Gains and Losses
   (2) Mining and Timber Operations
      (a) Mining Properties in General
      (b) Coal and Iron Operations
      (c) Timber Properties
      (d) Bonus Income
      (e) Exempt Minerals
   (3) Net Operating Loss Deduction Adjustment
   (4) Excess Profits Net Income Placed on Annual Basis
   (5) Tax-exempt Bond Premium
   (6) Income Abnormalities
      (a) Tax for Current Year
      (b) Tax for Future Years
      (c) Multiple Reallocations
      (d) Exhaustion of Tax Saving
      (e) Abnormal Income from Exploration
   (7) Installment Sales and Long-term Contracts
      (a) Installment-basis Taxpayers
      (b) Long-term Contracts
   (8) Credit for Dividends Received

IV. The Income Credit
   (1) Capital Gains and Losses
   (2) Averaging the Base Period Net Income
   (3) Capital Reductions
   (4) Supplement A
      (a) Existence of Component and Acquiring Corporations
      (b) Surviving Components
      (c) Base Period and Base Period Income
      (d) Averaging the Base Period Income
      (e) Net Capital Changes
      (f) Effective Date of Amendments

A similar outline of the second part of the article will also appear. This will cover the invested capital credit; the general relief provisions; inconsistencies; and various miscellaneous changes.
mining normal profits and of the value of retained profits as an incentive to efficient, economical and full-capacity production. Graduated rates reaching a maximum of only 60% were imposed on excess profits prior to the Act, and the excess profits tax was deductible in computing normal and surtax. The Act has fundamentally revised this procedure. Normal profits and excess profits are now to be segregated by the application of a new credit, in computing normal and surtax net income, in an amount equal to the adjusted excess profits net income. Normal profits will then be subject only to the normal and surtax; excess profits will be subject only to excess profits tax; and neither tax will be deductible in computing the other.

This simplified procedure was a logical incident of the new policy of taxing excess profits at the near-confiscatory flat rate of 90%, and restricting the combined normal and surtax on normal profits to the relatively moderate war-time rate of 40%. Certainly excess profits should first be exhausted in preference to normal profits as a source of revenue in time of war.

The brunt of the 90% rate is broken somewhat, at least theoretically, by (a) the limitation of the excess profits tax to an amount which will bring the combined normal tax, surtax, and excess profits tax to 80% of the surtax net income; and (b) the crediting to the

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5. The President's message of July 1, 1940 (see note 3 supra) requested enactment of a "steeply graduated" excess-profits tax. The Second Revenue Act of 1940 contained a rate structure graduated from 25% to 50% in six brackets ranging from adjusted excess profits net incomes of less than $20,000 to those in excess of $500,000. These rates were increased ten percentage points in each bracket, to run from 35% to 60%, in the Revenue Act of 1941.

6. Code, Section 23 (c), prior to the Act. In taxable years beginning in 1940, excess profits net income was reduced by the current income tax (Code, as amended by the Second Revenue Act of 1940, Sections 711 (a) (1) (A), 711 (a) (2) (C)) but the excess profits tax was not deductible in computing income tax. This procedure was reversed by the Revenue Act of 1941, for taxable years beginning in 1941. Section 202 (c). The latter treatment resulted in taxing as "excess profits" funds paid over to the Treasury in the form of income taxes, whereas the former resulted in the payment of income tax on income taken away by Congress as excess profits. This matter was the subject of sharp disagreement. See, for example, colloquy of J. Cheever Cowdin and Hon. Jere Cooper, House Hearings, 317-326.

7. Act, Section 105; Code, Sections 13 (a) (2), 15 (a), 23 (c) (1) (B), and 26 (e).

8. Act, Section 202; Code, Section 710 (a) (1). The Treasury advocated before the Committee on Ways and Means a further increase over existing law of fifteen percentage points in each bracket, resulting in a 50% to 75% structure. House Hearings, 17. Thereafter the Committee on Ways and Means tentatively approved a rate of 94% with a 14% post-war rebate, but later reported the Bill with an 87½% rate and no rebate provision. House Report, 19. This rate was raised to 90% by amendment on the floor of the House (see House Bill, section 202) and was thereafter supported by the Treasury in conjunction with a post-war refund of 10% of the tax in limited circumstances. Senate Hearings, 7. This combination ultimately was adopted. See note 11 infra.

9. Act, Section 105; Code, Sections 13 (b) (1), 15 (b) (3). Special treatment for the smaller corporations is retained, with some revision.

10. Act, Section 202; Code, Section 710 (a) (1). For this purpose, the surtax net income is computed without allowance of the new credit for income subject to excess profits tax. Note that utilities may now deduct their payments of preferred stock dividends in determining surtax net income. Act, Section 105; Code, section
taxpayer of a post-war refund in the amount of 10% of the excess profits tax. The former limitation will apply only to those companies whose excess profits exceed their normal profits roughly four times; and while it may be surprising that such companies are singled out for special protection against additional taxes, the reason lies in the fact that they are principally war goods enterprises whose vitality and growth must be nurtured. On the other hand, the latter "buffer" will have general application, but may have little meaning, looking to the over-all effect rather than to particular cases, if Congress is forced (as will probably be the case) to maintain or increase corporate tax rates in order to make good on the promise of refund.

The adoption of a flat rate of tax has probably settled the question whether the tax should apply on the basis of the ratio of excess profits to normal profits, rather than on fixed dollar amounts of excess profits. It also has the worthwhile effects of eliminating sharp controversy as to (1) whether the complicated provisions of Supplement B of prior law relating to the "highest bracket amount" were justifiable; and (2) whether the excess profits tax or the income tax should be deductible. In addition, one obstacle to reporting the income of affiliated corporations on a consolidated basis, namely the aggregation of more income into the higher brackets, also disappears.

A special rule has also been inserted to prevent an undue delay in the application of the new rates, and method of determining the base for the income and excess profits tax, to corporations having fiscal years beginning in 1941 and ending subsequent to June 30, 1942. Since the excess profits tax amendments in general take effect only with re-

15 (a). This relief has the additional effect of lowering the 80% ceiling for such companies.

11. Act, Section 250; Code, Sections 780-783, inclusive. This credit reduces the ultimate effective excess profits tax rate to a maximum of 81%, and something less if the combined tax limitation of 80% is operative. The credit is to be converted into non-interest bearing bonds, which will also be non-negotiable and non-transferable until after the cessation of hostilities in the present war. However, all or part of the credit may also be currently taken on account of debt payments, in an amount equal to 40% of progressive debt reductions below the September 1, 1942 level.

12. As first approved by the Senate, the Second Revenue Act of 1940 contained a bracket structure which combined both elements, but it was eliminated in conference in favor of dollar amounts alone. H. R. Rep. No. 3002, note 3 supra, at 43. It may still be plausibly argued, however, that the retained excess profits should be a percentage, say 10%, of normal profits, not of excess profits. Under the Act, two corporations, each having $1,000,000 of excess profits, will be allowed to retain $100,000 thereof, even though this additional $100,000 results in doubling the peacetime profits of the one and only slightly increasing such profits of the other. However, a fixed maximum, such as a percentage of normal profits, would tend to limit the incentive created by the retention of a percentage of all excess profits earned.

13. Code, Section 752, prior to amendment by the Act. Section 229 of the Act deleted these provisions retroactively as of the date of their original enactment, thus creating refund possibilities for those taxpayers who may have applied Supplement B in computing taxes in prior years.

14. See note 6 supra.
spect to taxable years beginning after December 31, 1941, such corporations would determine their excess profits tax under prior law even though more than half of their year falls in 1942. Accordingly, the Act requires payment of a tax equal to the sum of a tax computed under prior law and pro-rated for the period up to July 1, 1942, plus a tax computed under the revised rate structure and tax base, pro-rated for the period subsequent to June 30, 1942.

II. ADJUSTED EXCESS PROFITS NET INCOME

As under prior law, the adjusted excess profits net income, i.e., the amount subject to excess profits tax, consists of the excess profits net income minus the sum of (1) a specific exemption of $5,000, (2) the excess profits credit, representing "normal" profits, determined on either the income or invested capital method, and (3) the portion of such credit, in limited circumstances, not used in other years.

Substantial revision has been made in the application of unused credits. Prior to the Act, if the credit was larger than the excess profits net income, the difference was available for use in offsetting excess profits net income in the following year; and to the extent not required in that year to offset such income in its entirety, such unused credit might also be used in the second succeeding year. This provision was inserted in recognition of the fact that the conventional one-year accounting period is too short for accurately measuring the extent of excess profits. It operated, however, in one direc-

15. Act, Section 201.
16. Act, Section 203; Code, Section 710 (a) (3). Comparable treatment is also provided with respect to income tax. Act, section 140; Code, Section 108. The House Bill (Section 129) proposed treatment similar to that in effect prior to 1934 (see Revenue Act of 1932, Pub. L. No. 154, 72d Cong. (June 6, 1932, Section 105), laying down the general rule that fiscal year taxpayers, having a taxable year embracing two calendar years with different laws, should apply the changed law to the portion of the fiscal year falling in the second calendar year. Objections were raised that a complicated double tax accounting system would be required; that dividends had already been computed and paid in 1942 with provision for taxes at the 1941 rates only; and that in some cases the taxable years had closed and returns were filed. The Senate met these objections by limiting the provision to a single year, applying it only to companies enjoying the delayed impact more than six months, and then only with respect to the portion of the year subsequent to the June 30 dividing line. See House Report, 34, 91-92; Senate Report, 33-35, 180.
17. Code, Section 710 (b). The House Bill had increased the specific exemption to $10,000, in order to compensate small corporations for the more severe treatment afforded them under a flat tax rate, as compared with the graduated scale previously in force. See House Bill, section 203; House Report, 19, 138. This provision was deleted by the Senate, and the change was accepted by the House in conference. See Conference Report, 58. The Senate had increased the specific exemption from $5,000 to $10,000 in the Second Revenue Act of 1940, but the increase had also been abandoned in conference. H. R. Rep. No. 3002, note 3 supra, at 43, 44. Thus each house of Congress has reversed its position on this point.
18. Code, Sections 710 (b) (3), 710 (c), prior to amendment by the Act.
19. The unused credit carry-over was originally inserted by the Senate in the Second Revenue Act of 1940 for the benefit of a very limited class of corporations processing certain commodities, and was extended in conference to a one-year carry-
tion only. That is, if low profit years preceded high profit years, the carry-over prevented the imposition of the tax roughly until the aggregate profits (within the three-year span) exceeded the aggregate excess profits credits. On the other hand, if the trend happened to be reversed, with high profit years preceding low profit years, there was no comparable relief. The combination of declining profits at the close of the war and delayed maintenance expense is expected to make the latter situation rather common.\(^\text{20}\)

The new provisions include a two-year carry-back, as well as a two-year carry-over, of unused credits.\(^\text{21}\) Broadly speaking, a five-year span for the measurement of excess profits has thus been adopted. While the terminology employed in the new legislation is superficially forbidding, the procedure upon analysis becomes quite simple. The basic principle of the section is that if all the credit for a given year is not required to offset fully the excess profits net income of that year, the unused portion of the credit becomes available for use in the second and first preceding years and first and second succeeding years in the order named until exhausted. In determining the amount of the unused credit needed in each of such years, effect is first given to any applicable carry-overs or carry-backs of unused credit arising in any year or years prior to the year in which the unused credit in question arose.\(^\text{22}\) As under prior law, the specific exemption is excluded from the computation in order to prevent its being carried forward (or backward).

The new provisions are effective with respect to taxable years beginning after December 31, 1940, and an unused credit in 1942 may be carried back to 1941, but no further. The amount of an unused credit is to be determined in accordance with law applicable to the year in which the credit arose, with the exception of years beginning in 1940, to which the law applicable to years beginning in 1941 is applied for this purpose.\(^\text{23}\) Finally, an unused credit for a taxable year of less than

\(^{20}\) See Senate Report, 51-52.

\(^{21}\) Act, Section 204; Code, Sections 710 (b) (3), 710 (c). The net operating loss deduction has also been revised along similar lines. Act, Section 153; Code, Section 122.

\(^{22}\) For a good illustration of the operation of the section, see Senate Report, 181-183.

\(^{23}\) The Revenue Act of 1941 inaugurated the policy of computing unused credits in prior years on the basis of current law. See Section 202 (e); Code, Section 710 (c) (1), prior to amendment by the Act. The House Bill proposed to continue this
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twelve months is reduced to a part of such credit pro-rated on the ratio of the number of days in the taxable year to the number of days in the twelve months ending with the close of the taxable year.\(^4\)

III. CURRENT EXCESS PROFITS NET INCOME

Few changes applicable to corporations generally have been made in the determination of excess profits net income, whether the income or the invested capital credit is used. Since the excess profits tax is no longer deductible in computing income tax, the disallowance of the excess profits tax deduction in converting normal-tax net income into excess profits net income is changed to a disallowance of the new income tax credit for income subject to excess profits tax.\(^5\) The prior provisions allowing the computation of deductions limited to a percentage of net income (e.g., contributions to charity), or net income from specific property (percentage depletion), on the basis of net income before deduction of excess profits tax have, for similar reasons, been abandoned.\(^6\)

(I) Capital Gains and Losses

In conformity with the revised treatment of capital gains and losses for income tax purposes,\(^7\) the Act "excludes" from excess profits net income gains and losses from sales or exchanges of capital assets held for more than 6 months, as compared with 18 months under prior policy, making the unused credit for 1940 and 1941 depend upon "the law applicable to taxable years beginning in 1942." See Section 205 (c). Because of numerous and frequent changes in the excess profits tax law, this policy would have required a continuous recomputation of the excess profits credit and net income for preceding years. The Senate therefore abandoned such policy, except as indicated in the text for the year 1940 (presumably on the theory that the recomputations had already been made). It should be noted, however, that numerous retroactive amendments to the Code and corrections flowing from the audit of prior years' returns will nevertheless frequently require the recomputation of credits and income in computing unused credit carry-overs and carry-backs.

The principal effect of using 1941 law for 1940 will be the non-deductibility of the income tax in determining the unused credit for 1940. On the other hand, the use of the applicable rather than current law with respect to 1941 will prevent the reduction of 1941 unused credits on account of the lowering of the rate of return on invested capital for 1942. See Act, Section 217; Code, Section 714.

24. Act, Section 204; Code, Section 710 (c) (2). Under prior law, the absence of a pro-ration clause, coupled with the requirement that the excess profits net income for the short period be placed on an annual basis, resulted in an unused credit equal to an amount that would have been available for a full year. See Senate Report, 183-184.

25. Act, Section 206; Code, Sections 711 (a) (1) (A), 711 (a) (2) (C). See p. 397 supra.

26. Act, Section 206; see Code, prior to amendment by the Act, Sections 711 (a) (1) (G), 711 (a) (2) (I).

27. See Act, Section 150; Code, Section 117.
Although such gains or losses are "excluded," they still may ultimately affect excess profits tax liability. Thus, an excluded net long-term loss apparently may be reflected in excess profits net income for subsequent years via the net capital loss carry-over, which converts the loss into a short-term loss for the purpose of computing net income in the succeeding five years (unless earlier consumed). As such, the loss might then offset short-term gains which otherwise would have been subject to excess profits tax. Conversely, a net long-term gain, although "excluded," may become in effect subject to tax by offsetting in whole or in part a net short-term loss which would otherwise have been carried forward to reduce excess profits net income in a later year by offset against short-term gains. In addition, a net long-term gain may reduce a net operating loss (unless fully offset by a net short-term loss), thus becoming indirectly subject to excess profits tax in another year by reason of the decrease in the net operating loss deduction available in computing excess profits net income. Similarly, a net long-term loss may offset a short-term gain, thus increasing the net operating loss deduction.

The Act deletes from the Code the last sentences previously appearing in sections 711 (a) (1) (B) and 711 (a) (2) (D), which expressly excluded from excess profits net income the excess of gains over losses on the sale or exchange of depreciable property held for more than 18 months. These provisions had indirectly allowed the deduc-

28. Act, Section 207; Code, Sections 711 (a) (1) (B), 711 (a) (2) (D). The Act shifts the terminology from "long-term capital gains and losses" to "gains and losses from sales or exchanges of capital assets held for more than 6 months." No significance is seen in this change. See Code, Sections 117 (a) (4), 117 (a) (5).

29. Act, Section 150 (c); Code, Section 117 (e).

30. Act, Sections 150 (e), 207; Code, Sections 117 (e), 711 (a) (1) (B), 711 (a) (2) (D). The "exclusion" of long-term gains and losses in computing the excess profits net income of a given taxable year is an adjustment to "normal-tax net income . . . for such year," and therefore would not seem to require such an exclusion in computing capital gains and losses in prior years, even though for the purpose of determining the capital loss carry-over in arriving at current normal-tax net income. Note also that the terms used in the excess profits tax provisions have the same meaning as in the income tax provisions. Code, Section 728.

31. Act, Section 150 (e); Code, Section 122 (d) (4). The net operating loss deduction is available in computing excess profits net income, with certain adjustments. See pp. 408-411 infra.

32. Act, sections 207 (a), 207 (c). Prior law is also amended, for taxable years beginning after December 31, 1939, but before January 1, 1942, by adding to the computation gains and losses from involuntary conversions of depreciable property not taking the form of a sale or exchange. Act, section 208. The destruction of insured depreciable property by fire, for example, is not a "sale or exchange" (Helvering v. William Flaccus Oak Leather Co., 313 U. S. 247 (1941)) and without this retroactive amendment, a gain so realized in such a taxable year would have been included in excess profits net income even though involuntary and non-recurrent. This assumes, of course, that the non-recognition provisions of section 112 (f) of the Code were not met by reinvestment or establishing a replacement fund. The provision has also been
tion for excess profits tax purposes of an excess of such losses over such gains. However, a similar result (the holding period being shortened to 6 months) is achieved under the amended provisions by reason of changes in the income tax treatment of capital gains and losses. The differences are that the computation is broadened to include: (a) sales and exchanges of land used in the business (which is no longer a capital asset for purposes of computing capital gains and losses), not included in inventory or held primarily for sale to customers in the ordinary course of business, and held for more than 6 months; and (b) involuntary conversions of such land, and depreciable property and other capital assets held for more than 6 months.

If recognized gains from the sale or exchange of such land and depreciable property, plus recognized gains from the involuntary conversion thereof and of other long-term capital assets, exceed recognized losses from such transactions, the gains and losses are treated as long-term capital gains and losses. In such case they will (as under prior law) be "excluded" in computing excess profits net income. On the other hand, if the losses exceed the gains, they are treated as ordinary gains and losses and the net loss will offset excess profits net income.

Under prior law a long-term gain or loss on land was excluded as a capital gain or loss. Now, however, such a gain may reduce or eliminate a net long-term loss on depreciable assets (or such other transactions as are included in the computation) which would otherwise have been deductible for excess profits tax purposes. On the other hand, a long-term loss on the disposition of land is now deductible, except to the extent offset by a net long-term gain on the remaining transactions.

Involuntary conversions not in the form of a sale or exchange resulted in ordinary income or loss under prior law, and therefore were fully reflected in excess profits net income. However, such conversions of capital assets (or depreciable property), if in the form of a sale or exchange, were treated on the same plane as voluntary conversions, i.e., long-term gains and losses on capital assets were excluded from excess profits net income, and in the case of depreciable property, were included in the computation of gains and losses on such property.

improved by referring only to "recognized" gains and losses, and by making section 117 (h) explicitly control the holding period.

33. As it first passed the House, the Second Revenue Act of 1940 treated long-term gains or losses on depreciable assets as capital gains or losses, but the Senate revised the treatment in order to allow the deduction of a net loss on such assets for excess profits tax purposes. See H. R. REP. No. 3002, note 3 supra, at p. 44.

34. Act, Section 151; Code, Section 117 (a) (1).

35. Act, Section 151; Code, Section 117 (j). Similar treatment is afforded banks with respect to gain or loss on the sale or exchange of debt securities. A net loss thereon (regardless of holding period) is treated as an ordinary loss. Act, section 150 (d); Code, section 117 (1).
Under the revised provisions, a long-term loss by involuntary conversion not a sale or exchange (for example, an uninsured fire loss) will no longer be deductible if exceeded by a net long-term gain on the remaining transactions included in the computation. On the other hand, a gain of that type will now become subject to excess profits tax only indirectly by reducing or eliminating any deductible net loss on the remaining transactions that may exist.

As in the case of long-term gains and losses on the disposition of land, gains on long-term capital assets by reason of involuntary conversions taking the form of a sale or exchange, instead of being merely excluded, will now serve to reduce or eliminate a deductible net loss on the remaining transactions; and a loss in such a case, heretofore excluded, will become deductible, except to the extent offset by a net gain on the other transactions.

The "golden thread," so far as one is discernible, in these rules with respect to gains and losses under the excess profits tax is that non-recurrent gains (i. e., voluntary and involuntary gains on capital assets, and on land and other physical assets used in the business) do not represent excess profits; and that net losses on operating assets such as land and depreciable property used in the business, whether or not voluntary, and on the involuntary conversion of all capital assets, should be allowed as a matter of relief.

(2) Mining and Timber Operations

Special treatment is afforded mining and timber-cutting taxpayers who increase their production, in the form of an exemption from excess profits tax of all or a portion of the income (determined under precise limitations) derived from the added production. The basis for this relief lies principally in the facts that a war economy demands increased production of numerous minerals, and the mechanics of the excess profits tax are such as possibly to discourage such production. Because these industries derive their income from wasting assets, accelerated production may subject a greater portion of the total profits obtainable from the mineral deposit or timber block to the present high excess profits tax, and possibly make available a lesser aggregate of excess profits credits to offset such income by shortening the number of excess profits tax years over which the income is realized.

(a) Mining Properties in General.—The general rule applicable to mining properties affords a sliding scale of relief depending upon

36. Act, Section 209; Code, Sections 711 (a) (1), 711 (a) (2) (K), and 735.
37. See Senate Report, 38; House Report, 27, 149. See also statement of Henry B. Fernald, House Hearings, 3179, 3180-3183.
38. Including non-metallic mining properties, such as limestone, slate, talc, etc. Act, Section 209 (c); Code, Section 735 (a) (7).
the rapidity with which the mineral deposit is depleted by the accelerated production ("excess output"). The amount of "excess output" is the excess of production in the current year over average annual production during the base period ("normal output"). The income to be deducted or excluded in computing excess profits net income is the normal profit on a portion of the excess output. For this purpose, the normal rate of profit is the average net income per unit of production derived from the mining property during the base period ("normal unit profit"); and the portion of the excess output, with respect to which the exclusion or deduction is allowed, is a varying percentage of the total excess output, depending upon the proportion of the deposit which is depleted by the increased production ("exempt excess output").

Thus, if the excess output is more than 50% of the recoverable mineral units, the normal profit on all the excess output is excluded or deducted; but if the excess output falls between 5% and 10% of the recoverable units, the normal profit on only 20% of the excess output is excludible. Between these extremes there are seven other graduated brackets. No exclusion is available if excess output is less than 5% of recoverable deposits.

It should be noted that any increase in the profit per ton of production, as compared with the base period, in effect remains subject to excess profits tax. This is consistent with the rationale of the provi-

39. See Senate Report, 188.
40. Act, Section 209 (c); Code, Section 735 (a) (5). For this purpose, the base period consists of taxable years beginning after December 31, 1935 and before January 1, 1940. Average monthly production during the aggregate period or periods of actual operation during the base period is first determined, and then placed on an annual basis by multiplying by 12. If uncontrollable physical factors normally require a cessation of production, provision is made for reducing the "normal output" to the average monthly production multiplied by the number of months in the year during which production is regularly carried on. Although the Conference Report (p. 60) suggests that the Commissioner may allow the latter adjustment in his "discretion," the statute seems mandatory, although the adjustment is to be made under Treasury regulations.

41. Act, Section 209 (c); Code, Section 735 (a) (9). The net income with respect to base period production is computed by allowing a depletion charge "in accordance with the basis for depletion applicable to the current year." This may mean one or both of the following: (a) if the property has changed hands on a taxable transaction, or if the depletion rates are re-set for any other reason, cost depletion on the current basis shall be allowed; and (b) the method of taking depletion, e.g., cost rather than percentage, used in the current year shall be applied. If more than one mineral is extracted from the same property, a segregation will probably be required by Treasury regulations. See Senate Report, 188.

42. The "estimated recoverable units" consist of the units recoverable at the close of the current year plus the excess output for the year. Estimates may be based on estimates at the opening of the year with adjustment for the year's production, or may be revised during or at the close of the year. Senate Report, 188. In any event, however, they are subject to the approval of the Commissioner, whose determination is final and conclusive. Act, Section 209 (c); Code, Section 735 (a) (10).

43. Act, Section 209 (c); Code, Sections 735 (a) (11), 735 (b) (1). The exclusion is also limited to the amount of net income, after depletion, for the current year on all excess output.
sion, namely, that production should not be retarded for fear of subject-
ing normal profits to excess profits tax.

The new provision is to be applied on a property-by-property basis. Only those properties which were in operation during the base period for 6 months or more qualify for the relief. It is immaterial, however, that the property may have been owned or operated by another taxpayer during the base period, as the normal profit derived from the operation of the mine by any person during the base period is the measuring rod. This may, of course, present practical difficulties in securing the necessary information where the properties have changed hands.

(b) Coal and Iron Operations.—The above-described rule would offer no advantage to many coal and iron companies, either because unrecovered deposits are frequently very large, with the result that the excess output is less than 5% thereof; or the rate of profit, after depletion, during the base period was a low or minus quantity due to severely depressed conditions. Accordingly, an alternative measure of relief is available to such companies upon election pursuant to Treasury regulations. Under the alternative rule, the exclusion or deduction from excess profits net income is 50% of the current profit (“unit net income”) on the excess output (computed as under the general rule).

(c) Timber Properties.—The inclusion of timber properties in the scope of this relief came about by amendment on the floor of the Senate. As the bill passed the Senate, it would have excluded at the option of the taxpayer either (i) income derived from the production of logs in excess of governmental quotas, or (ii) income derived from governmental bonus payments on account of log production. By revision in conference, the alternative rule provided for coal and iron mines (but not the general rule) was made available to timber-cutting tax-

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44. See Conference Report, 60. Compare Act, Section 209 (c), Code, Section 735 (a) (6), with Reg. 193, Section 19.23 (m) (1), dealing with the application of percentage depletion on a property-by-property basis. The definition of a "property" for these two purposes is virtually identical. Presumably, the various percentage depletion problems will have a direct influence on the interpretation of the new provision. Note that the new provision deals with income from production during the year, whereas depletion generally is based on sales during the year.

45. Act, Section 209 (c); Code, Section 735 (a) (5).

46. Ibid.

47. It is also provided that if a constructive average base period net income is established by a taxpayer pursuant to section 722 of the Code, a "fair and just" amount to be used as the "normal output" and "normal unit of profit" is to be determined for purposes of applying this provision. Act, Section 222; Code, Section 722 (f).

48. See Senate Report, 40.

49. Act, Section 209 (c); Code, Sections 735 (a) (12), 735 (b) (2). The "unit net income" for the current year is ascertained by dividing the net income (after depletion) from the property by the number of units produced. Under this rule the rate of profit during the base period is immaterial.

50. See Senate Bill, Sections 209 (a), 209 (b).
payers. That is, 50% of the current profit ("unit net income") on excess output (computed as under the general rule) is excluded from excess profits net income.51

As in the case of mining properties, the new provisions are applied to timber on a property-by-property basis, the "timber block" being the property unit. A timber block "includes all the taxpayer's timber which would logically go to a single given point of manufacture." In addition, the timber block must have been an operation unit existing as of December 31, 1941, and must have been acquired by the taxpayer on or before such date.52

(d) Bonus Income.—In addition to the foregoing, the Act contains special provisions (retroactive to taxable years beginning after December 31, 1940) excluding from excess profits net income the income derived from bonus payments by agencies of the United States Government on account of the production in excess of a specified quota of depletable minerals or timber.53 Such bonuses, designed to accelerate production of vital materials, would be largely neutralized if payment of them to the taxpayer by a war agency were followed by a 90% recovery through the excess profits tax.

This exclusion is limited to the net income (after depletion) attributable to the production above the quota; and it is available in lieu of, not in addition to, the "excess output" relief described above, if both are applicable. That is, if income attributable to "excess output" under the rules outlined above also includes such bonus payments, the taxpayer is entitled to an election, pursuant to Treasury regulations, as to which form of relief shall be applied with respect to the portion of such income attributable to the excess output above the quota.54

(e) Exempt Minerals.—The final touch of mining relief takes the form of an expansion of prior law with respect to the complete exemption from excess profits tax of income attributable to the mining in the United States of certain crucial minerals. To the exempt list are added nickel, sheet mica, tantalum, and vanadium.55

51. Act, Section 209 (c); Code, Section 735 (b) (3). See Conference Report, 59-60.
52. Act, Section 209 (c); Code, Section 735 (a) (8).
53. Act, Section 209 (c); Code, Section 735 (c). This provision first appeared in somewhat different form, as section 213 (e) of the House Bill. See House Report, 27, 149.
54. Act, Section 209 (c); Code, Section 735 (d).
55. Act, Section 226; Code, Section 731. Note that Section 204 of the Revenue Act of 1941 had eliminated this exemption. It might also be noted that a provision in the Senate Bill (Section 128), providing for the carry-over of mining losses sustained in 1938 and 1939 in effect as far as 1942, was deleted in conference. See Senate Report, 96; Conference Report, 40.
(3) **Net Operating Loss Deduction Adjustment**

Excess profits net income is computed by making specified adjustments to normal-tax net income.\(^{56}\) Prior to the Act, the adjustments made no reference to the net operating loss deduction, then based on the carry-over of operating losses from the preceding two years.\(^{57}\) As a result, the net operating loss deduction for both income and excess profits tax purposes was identical, even though the concepts of normal-tax net income and excess profits net income were by no means parallel. During the passage of the Act, an attempt was made, in a technical amendment voted on the floor of the Senate, to harmonize the deduction with the computation of the excess profits tax base \(^{58}\) in certain major respects by appropriate adjustments to the deduction for excess profits tax purposes; and in conference the provision was further revised.\(^{59}\)

To grasp the new provision, it must first be realized that there are several basic steps in the computation of the net operating loss deduction for income tax purposes: (a) the “net operating loss” for each of the two years preceding and the two years subsequent to the current year is determined, this figure in each case being the excess of deductions over income, with a series of adjustments designed to approximate more closely than statutory net income the true business or economic loss; \(^{60}\) (b) the “net operating loss carry-back,” and the “net operating loss carry-over,” based on the net operating losses of the succeeding and preceding two years, reduced to the extent used in other years, are then computed; \(^{61}\) and (c) finally the “net operating loss deduction” is computed by aggregating the carry-overs and carry-backs to the current year, and reducing the aggregate under a specific formula which seeks to apply the carry-overs and carry-backs first to any real or business income not subject to tax.\(^{62}\)

With this background, the new provision will be more readily understood by viewing it as prescribing the following additional adjustments, for excess profits tax purposes, in each of the foregoing basic steps:

(a) In computing the net operating loss (regardless of whether the income or the invested capital credit is used either in the current year

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\(^{56}\) See Code, Sections 711 (a), 13 (a) (2).

\(^{57}\) Code, Section 122, prior to amendment by the Act. The Code now provides a two-year carry-back of operating losses as well as the two-year carry-over (without duplication). See Act, Section 153; Code, Section 122.

\(^{58}\) See Senate Bill, Section 210.

\(^{59}\) See Conference Report, 60; Act, Section 210; Code, Sections 711 (a) (1) (j), 711 (a) (2) (l).

\(^{60}\) See Code, Sections 122 (a), 122 (d). For example, interest wholly exempt from tax is included in gross income, and depletion is confined to actual depletion of capital by disregarding percentage and discovery value depletion.

\(^{61}\) See Act, Section 153; Code, Section 122.
or in the year in which the loss arose) the excess profits tax is disallowed as a deduction. This adjustment will affect the determination of net operating losses arising in all years beginning after December 31, 1940, for the Act continues the allowance of the excess profits tax as a deduction in computing the net operating loss deduction for income tax purposes, even though the deduction has been eliminated for other purposes. This adjustment is theoretically sound, for it corresponds to the non-deductibility of the income tax in the computation of net operating losses for income tax purposes. As a practical matter, however, it is far-fetched to assume that an excess profits tax would be incurred in a year in which a net operating loss arose except, perhaps, in the case of some heavily-indebted taxpayers whose interest deductions account for a large measure of the operating loss.

The remaining adjustment to the net operating loss computation is applicable only if the invested capital credit is used in the year in which the loss arose (but regardless of the credit used in the current year) and consists of the disallowance of 50% of the interest on borrowed capital in that year. This adjustment corresponds to the disallowance of such interest in computing excess profits net income when the invested capital credit is used. It seeks to harmonize the determination of the loss with the basis on which taxable excess profits would have been determined had the year been a profitable one, but not necessarily with the basis on which excess profits in the current year are determined.

(b) In carrying an operating loss back two years, it is applied first against the earlier of the two years, and to the extent not needed to offset "net income" (specially computed) in that year, it is then available for use in the later year to which it is being carried back. Comparable procedure is followed in carrying an operating loss forward two years. That is, a loss is applied chronologically.

63. Act, Sections 210 (a), 210 (b); Code, Sections 711 (a) (1) (J) (i), 711 (a) (2) (L) (i).
64. Act, Section 105 (e) (3); Code, Section 122 (d) (6).
65. See note 7 supra; Act, Section 105 (e); Code, section 23 (e) (1) (B).
66. Note that the new credit for income subject to excess profits tax is not allowed in computing net operating losses, either in connection with income or excess profits tax, since it is a credit applied in arriving at normal and surtax net income after net income is determined, rather than a "deduction" in computing net income. See Act, Sections 105 (a), 105 (b), 105 (d); Code, Sections 13 (a), 15 (a), 21, 26 (e). This is proper, however, for in computing the net operating loss deduction, the aggregate of carry-backs and carry-overs is reduced by the excess of an amount equivalent to business income over statutory normal-tax net income computed, inter alia, without such credit. Act, Section 105 (e); Code, Section 122 (e).
67. See note 63 supra. If a loss is incurred, however, it is likely that no credit was used. Probably the credit used in computing the unused excess profits credit carry-over would control.
68. Code, Section 711 (a) (2) (B).
69. Act, Section 153 (a); Code, Sections 122 (b) (1), 122 (b) (2).
The new excess profits tax adjustment in this phase relates to the determination of "net income" in the year or years to which the loss has been previously applied. The additional adjustments for excess profits tax purposes consist of those outlined in (a) above, that is, the disallowance of the excess profits tax as a deduction, and also of 50% of interest on borrowed capital if the invested capital credit is used in such year or years. Again, however, it is immaterial which credit is used in the current year.²⁰

(c) Finally, the net operating loss deduction for income tax purposes consists, as indicated above, of the aggregate of the operating loss carry-backs and carry-forwards to the current year. However, if the statutory concept of normal-tax net income for the current year is less than the net income for such year specially computed to reflect an amount corresponding more closely to true business income, then the operating loss deduction (which, as indicated above, is also computed on the latter basis) is applied first against the difference—which in effect represents business income free from tax. This is accomplished by reducing the aggregate of the carry-backs and carry-overs by the amount of such difference, to arrive at the ultimate net operating loss deduction.²²

The new excess profits tax provision in the Act is designed to base such reduction, for excess profits tax purposes, on a comparison of the excess profits net income (specially computed to represent "business" excess profits net income) with the statutory excess profits net income,²³ in lieu of a comparison of the income tax net income (specially computed) with statutory normal-tax net income. In making the special computation of excess profits net income for this purpose, the income tax adjustments reflecting business income are made, except that (i) long-term capital gains and losses are excluded entirely; (ii) no credit for dividends received is allowed; and (iii) no credit for interest on government bonds exempt from normal tax is allowed.²⁴

These changes are retroactive to the beginning of the excess profits tax, i.e., to all taxable years beginning after December 31, 1939.²⁵

Together with the new provisions for carry-backs of unused excess

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²⁰ See note 63 supra.
²¹ Code, Section 13 (a) (2). For this purpose, normal-tax net income is computed without the net operating loss deduction or the credit for income subject to excess profits tax. See note 66 supra.
²² Code, Section 122 (c). See note 62 supra.
²³ For this purpose, excess profits net income is computed without the net operating loss deduction. Act, Sections 210 (a), 210 (b); Code, Sections 711 (a) (1) (J) (ii); 711 (a) (2) (L) (ii).
²⁴ Act, Sections 210 (a), 210 (b); Code, Sections 711 (a) (1) (J) (ii), 711 (a) (2) (L) (ii).
²⁵ Act, Section 210 (c).
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profits credits, they will in many instances require the redetermination of tax liability in all excess profits tax years thus far, with possible refunds or deficiencies in tax.

(4) Excess Profits Net Income Placed on Annual Basis

The excess profits credit represents normal profits for a full year's operations. In the case of a short year the credit must therefore be proportionately reduced, or the excess profits net income built up, in order to prevent the avoidance of tax. Prior law met this problem by placing excess profits net income on an annual basis at the rate of income effective for the short year. That is, excess profits net income was multiplied by the number of days in the twelve months closing with the short period (normally 365), and the result was divided by the number of days in the short year, thus giving a year's excess profits net income constructed at the rate of excess profits net income earned in the short period. A tentative excess profits tax was then computed by using this constructed excess profits net income, and to determine actual tax liability, the tentative tax was pro-rated on the basis of the number of days in the short year to the number in the twelve months.\(^76\)

The Act not only retains this provision as the general rule (with minor language changes), but also adds an alternative solution which in effect permits the substitution, for the constructed year's income in the above formula, of the actual twelve months' excess profits net income which would have been included in the period had it not been cut short.\(^77\) That is, the excess profits net income for the twelve months beginning with the first day of the short taxable year is computed as if such period were a taxable year under the law applicable to the short year.\(^78\) The credits applicable in determining adjusted excess profits net income for the short year are then applied, and the tentative excess

\(^76\) Code, Section 711 (a) (3), prior to amendment by the Act.

\(^77\) Act, Section 213; Code, Section 711 (a) (3). A comparable income tax provision has also been enacted. Act, Section 135; Code, Section 47 (c). The latter provision is the first to place corporate income on an annual basis for income tax purposes. Unlike the excess profits tax provision, is applies only if the short period is occasioned by a change in accounting period. Consequently, it is possible for the situation to arise in which income is placed on an annual basis for the one tax but not for the other. The Act is defective with respect to the determination of the credit for income subject to excess profits tax in such a case. Act, Section 105 (d); Code, Section 26 (e).

Note that a short period for which a return is required is now by statute clearly a “taxable year”. Act, Section 135 (d); Code, Section 48 (a). This change is made to overcome the implications of Helvering v. Morgan's Inc., 293 U. S. 121 (1934). The reports indicate that the change is “clarifying” rather than substantive. See House Report, 90; Senate Report, 107.

\(^78\) The twelve months may end prior to the close of an actual accounting period; and in order to determine income for the twelve months only, certain items will have to be pro-rated since accounting records do not show daily income. The Treasury regulations doubtless will cover this problem. Cf. House Report, 88-89; Senate Report, 105-106. Where the consolidated returns regulations are applicable, they may prescribe a different rule as to the period to be used. Ibid.
profits tax computed. The pro-ration of the tentative tax in this case is on the ratio of the excess profits net income for the short period to the excess profits net income for the twelve months' period.

This treatment is applicable, of course, only where it will reduce the tax below that resulting under the old rule, i. e., where the rate of earnings in the short period is higher than the average rate for a full year, as may easily occur in a seasonal business. A "floor" is placed beneath the reduction, however, by prescribing that the excess profits net income for the twelve months used in the computation shall not be less than for the short period. This fixes the minimum tax at that which would have been due without placing the income on an annual basis, and in effect excludes from the section the case where a net loss in excess profits net income is incurred in the period after the close of the short year but within the twelve months.

The tax in the first instance is computed and the return is made under the general rule. Subsequently an application is to be made, pursuant to Treasury regulations, for a redetermination under the new alternative rule. If the application is timely and otherwise in accordance with the regulations, it is deemed a claim for refund or credit; and if denied, will form the basis for a suit thereon.

Short taxable years frequently result from liquidations, with the result that the actual twelve months' earnings, had the year not been cut short, are non-existent. Accordingly, the Act provides that if prior to one year from the date of the beginning of the short period the taxpayer has disposed of "substantially all" of its assets, the excess profits net income for the twelve months period ending with the close of the short period shall be substituted in the formula. In this case it appears that the new formula may be used in the first instance when the return is made, but that application must nevertheless be made to the Commissioner, as in the other cases, to retain the benefit thus derived.

The new rule is retroactive to taxable years beginning after December 31, 1939, i. e., to all excess profits tax years.

(5) Tax-exempt Bond Premium

Interest from government bonds, whether wholly exempt or exempt only from normal tax, is not included in excess profits net income; and if the invested capital credit is used, such bonds are treated as

79. It is indicated, with respect to the income tax provision, that if a corporation "ceases business and distributes so much of the assets used in that business that it cannot resume its customary operation with the remaining assets, it has distributed substantially all its assets." House Report, 89; see also Senate Report, 106.

80. Cf. House Report, 89; Senate Report, 106. Any further adjustment in this case will be by deficiency rather than refund.
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“inadmissable assets” and thus reduce the invested capital credit. However, a taxpayer using such credit may elect to include all such interest in excess profits net income, in which case the bonds become “admissible assets.” The Act contains new income tax provisions providing for the amortization of premium on such bonds by corporate taxpayers. To coordinate the above-described election with the amortization provisions, it is now provided that the amount included in excess profits net income in the event of election shall be the interest income reduced by the applicable amortization of premium under such provisions.

(6) Income Abnormalities

Section 721 of the Code provides a measure of relief in certain cases where “abnormal” income is accrued or received during the year, primarily in those cases where a block of income is artificially aggregated in a single year but nevertheless flows from income-producing efforts exerted over a period of years. The relief takes the form of allocating the abnormal income, for excess profits tax purposes, over the years (both past and future) to which it is economically attributable. This may divert all or a portion of the abnormal income to earlier years in which no tax was due, or to years prior to the excess profits tax; to excess profits tax years beginning prior to January 1, 1942, in which a lower and graduated rate structure was in effect; or to subsequent years in which no excess profits tax will be due or in which the rate of tax may be conceivably lowered, thus resulting in a tax saving.

Sections 721 (c) and (d) of the Code, prior to the Act, respectively prescribed the rules for computing the tax payable in the current year (i.e., the year in which the abnormal income would be reportable in the absence of section 721), and in any future year to which a portion of the abnormal income is allocable. Briefly, the section provides for the classification of all income into separate categories according to the nature of its source (including but not limited to six specifically described classes); and income derived from any class during the year is deemed “abnormal” if it is “abnormal” for the taxpayer to derive income of such class, or if the amount is abnormally large (i.e., if it exceeds 125% of a previous average of similar income).

A possible weakness in the section is its failure to provide relief in the case of abnormal income not representing “war profits” with respect to which there is no logical basis for allocation to other years.

Without, however, increasing the average base period earnings for the income credit. Prior to the Act, the statute did not cover this point expressly, but the Treasury so interpreted it. See Reg. 109, Section 30.721-3. This construction was contrary to an express statement in the Senate Report on the Second Revenue Bill of 1940. See Sen. Rep. No. 2114, 76th Cong., 3d Sess. (1940) 16. However, the Act has validated the Treasury regulation. See Act, Section 221; Code, Section 721 (e).
tion or all of the abnormal income was allocated. The fundamental scheme of these sections was to require payment, for the current year, of whatever excess profits tax for that year, and whatever additional excess profits tax for prior years, would have been due if the abnormal income had in fact arisen in the years and amounts as redistributed—without, however, increasing the total tax. Similarly, in future years the tax was to be increased to the same extent as would have been the case if the income had been derived in accordance with the allocation under the section. However, in any case the increase in tax in the future years was not intended to exceed the tax saving in the past which resulted from the redistribution of income, since the section was intended to reduce the tax rather than increase it.

Although the foregoing were the general objectives of sections 721 (c) and (d), they fell short of their mark because of technical errors in draftsmanship—principally the failure to allow for the carry-over of net operating losses and unused excess profits credits in determining the tax that would have been due in the various years involved had the income been actually derived as reallocated. To cure these defects, sections 721 (c) and (d) have been completely rewritten.87

(a) Tax for Current Year.—The reallocation of income to prior years may increase excess profits taxes up to and including the current year in various ways: (i) it may increase the excess profits tax in the years to which allocated directly, because of the additional income; (ii) it may increase excess profits tax in other years prior to the current year by reducing the operating losses and unused excess profits credits, arising in the year to which allocated, which would otherwise have been available in such other prior years through the operation of carry-overs; and (iii) it may similarly increase the excess profits tax in the current year by reduction or elimination of a net operating loss or unused excess profits credit carry-over from the prior year or years to which the income is allocated.

The revised section 721 (c) does not specify the excess profits tax payable for the current year (which is inferentially left to law applicable in the absence of section 721), except in the sense that it fixes a maximum limit thereon. This limit consists of the sum of the tax due

87. Act, Section 221; Code, Sections 721 (c), 721 (d), 721 (e). See explanation in Senate Report, 194-197. Note that the explanation makes no reference to the new carry-back of net operating losses and unused excess profits credits. See pp. 390-401 supra. Apparently the revisions in Section 721 were prepared before the carry-back policy was adopted, and the new language was not adjusted to such policy. For simplicity, the section will be explained in the terms in which it was conceived, i. e., with respect to the problem of carry-overs. While the effect of carry-backs under the new language is somewhat obscure, it is believed that the clearness of legislative purpose plus the play in the statute created by ambiguities leave room for securing the proper result by Treasury regulation, pending any retroactive legislative remedy of this weakness.
for such year excluding the income which is allocated to other years (past or future), plus the above-described increases in tax in either the past years or the current year resulting from the reallocation. If no tax saving in the current year would result from the application of section 721 (c), it apparently is not to be applied in such year.88

(b) Tax for Future Years.—Under revised section 721 (d), any income allocated to a future year becomes in the first instance a part of the gross income thereof for all excess profits tax purposes. However, the tax for any future year to which income is reallocated is limited so as to prevent an increase in the tax, on account of the reallocation, which will exceed the net tax saving from the reallocation thus far. This limit consists of the tax due without including the reallocated income, plus the decrease in tax in the year in which the income arose resulting from the application of the limitation in section 721 (c) on the amount of such tax. Of course, if section 721 (c) did not result in a reduction of tax in that year, no tax increase in the future year by reason of reallocation of income thereto would be permitted.

If any years have intervened between the current year and the future year in question, additional tax may result (i) in the intervening years either directly because of the allocation of income to such years, or indirectly because of decreases in carry-overs resulting from attributing income to some or all of such years; and (ii) in the future year in question because of a similar decrease in the carry-over. These increases in tax will also offset the tax saving in the current year, and therefore are also to be deducted from the tax saving in the current year in applying the limitation on tax in the future year in question.

(c) Multiple Reallocations.—Under the foregoing rules, income may be reallocated to a future taxable year from more than one previous year.89 In such case the above limitations on the tax in the future year are separately applied to each reallocation chronologically, beginning with the reallocated income having the earliest taxable year as its source. In each case the tax in the future year arrived at after applying such limitations to the previous reallocations, if any, is regarded as the basic tax which is to be adjusted when applying the limitations to the reallocation in question; and as a starting point, the gross income and other amounts necessary to determine the adjusted excess profits net

88. For example, there may have been no tax liability in the absence of Section 721 (c) for the current year because of large carry-overs from earlier years. Since Section 721 (c) merely determines a maximum, it could have no application to a year in which no tax is due. Presumably, the carry-back is also to be given effect in determining whether Section 721 (c) is applicable.

89. Abnormal income from several classes derived in the same year are aggregated in the computation of "net abnormal income", which is then treated as a single item. See Act, Section 221; Code, Section 721 (e) (i).
income are to be considered such amounts as would produce such a tax.\textsuperscript{90}

It is also possible for several amounts of income to be reallocated to a prior year from different current years. In such case, pursuant to Treasury regulations, the allocations will be given effect chronologically, and in computing the increase in tax flowing from one reallocation, any prior reallocations will first be given full and continuing effect.\textsuperscript{91}

The third type of problem in multiple reallocations is that in which income is allocated to a future year, and subsequently in such future year other abnormal income develops which is allocated to previous years. Thus the "future" year for the first item of abnormal income would become a "current" year with respect to the latter abnormal income, and both subsections (c) and (d) would apply thereto. In such case subsection (d) is first applied without regard to subsection (c). Amounts representing the necessary gross income, etc. to arrive at a tax equal to the tax determined by so applying subsection (d) are computed. Then subsection (c) is applied on the assumption that such amounts are in fact the tax and income involved prior to the application of subsection (c).\textsuperscript{92}

(d) Exhaustion of Tax Saving.—It has been pointed out above that the basic philosophy of section 721 is that it shall not increase tax. This policy is further implemented by a new paragraph providing two additional controls:

(i) If a future year is reached in which the past tax saving (\textit{i.e.}, the decrease in tax for the current year diminished by the increase in tax in intervening years) no longer exceeds the increase in tax in the future year (the limitation on the tax in such future year under subsection (d) thus becoming effective), any allocation of income to subsequent future years is thereafter disregarded.

(ii) In addition, the income allocated to the future year in which the past tax saving first becomes exhausted is also to be disregarded to the extent that it is not required to bring the increase in tax in such year up to the point of exhaustion of the past tax saving. This rule is for the purpose of preventing such income from increasing tax in a still later year by reducing a carry-over from the future year in question.

\textsuperscript{90} See Senate Report, 196. An example is there given which indicates that in the case of multiple allocations, say two, to a future year, the second or later allocation is included in gross income of the future year when computing the limitation on tax resulting from the first allocation. See Act, Section 221; Code, Section 721 (d) (2).

\textsuperscript{91} Act, Section 221; Code, Section 721 (e) (2). See also Senate Report, 195-196.

\textsuperscript{92} Act, Section 221; Code, Section 721 (e) (3).

\textsuperscript{93} Act, Section 221; Code, Section 721 (d) (3).
(e) Abnormal Income from Exploration.—Finally, subsection (f) has been added to section 721, to the effect that if a constructive income credit is allowed the taxpayer under section 722 (discussed below) and such credit reflects abnormal income of an excess profits tax year from exploration, discovery, prospecting, research, etc. within the meaning of section 721 (a) (2) (C), no portion of such abnormal income is to be attributed under section 721 to the base period or to any other year not subject to the excess profits tax. This provision is a counterpart of the refusal to increase base period income under the general rule by reason of allocating abnormal income retroactively thereto. In the latter case, the abnormal income escapes a direct excess profits tax through allocation to a period prior to the effective date of the tax, but is nevertheless indirectly taxed to some extent in any year in which excess profits tax is incurred (i. e., possibly many times over) by failure to build up the credit. In the former, the building up of the credit will tend to relieve the severity of such rule, and apparently the new subsection (f) is intended to counteract this effect by confining such income to excess profits tax years.

The revised provisions of section 721 are retroactive to the beginning of the excess profits tax, i. e., to taxable years beginning after December 31, 1939.

(7) Installment Sales and Long-Term Contracts

The Act contains special relief provisions, somewhat similar in effect to section 721, for certain taxpayers whose income is artificially aggregated in one or more excess profits tax years because of their method of accounting with respect to installment sales and long-term contracts.

(a) Installment-Basis Taxpayers.—Dealers regularly selling personal property on the installment plan have an election to spread the gross profit on such sales over the period of collection, in lieu of reporting the entire profit on the accrual basis in the year of sale.

94. Act, Section 221. This provision originated in Section 213 (c) of the House Bill, which would have excluded such income entirely from the operation of Section 721. The final provision will at least permit reallocation of the portion of such income which is attributable to years, other than the current year, subject to the excess profits tax.

95. See note 86 supra. Since the basic theory of Section 721 is to arrive at tax results comparable to those which would have been the case if abnormal income had been realized on a normal basis, the amount attributable to the base period logically should increase the income credit—which is intended to reflect all normal profits—either under the general rule or by inclusion in a credit reconstructed under Section 722. And in each case, the amount attributable to base period years should not be subject to excess profits tax.

96. Act, Section 221 (b).

97. Code, Section 44 (a) ; Reg. 103, Section 19.44-1. The election, once made, is revocable only with the consent of the Commissioner. Reg. 103, Section 19.41-2. Theoretically, the straight cash basis of reporting income might also be used, but business and accounting practice is to the contrary.
expense and other deductions are taken in the year incurred, however, despite the deferment of the gross income. During level periods of installment selling, this failure to correlate the deduction of direct and general expenses (other than cost of goods sold) attributable to a given sale with the income of that sale does not seriously distort net income. However, the present scarcity of consumer goods, the federal restrictions on installment selling, and in some cases the conversion of consumer installment businesses to war activities have resulted in a sharp decrease in such selling. The deferred income has thus fallen into current years without the offsetting selling expense which would be available in a period of normal selling volume, and in some cases on top of substantial income from newly-undertaken war activities. In addition, income from current sales is to a lesser extent deferred, because under government supervision the installment term has been shortened and the down payment increased. This artificial enlargement of excess profits net income would have been partially avoided if the installment basis of reporting income had not been elected in the first instance. As a remedy, the Act allows a further election to return retroactively to the ordinary accrual method of accounting, for excess profits tax purposes only.98

The election is available if either of the following conditions exist:

(i) The average volume of "credit extended" to purchasers on the installment plan (i.e., dollar amounts of new credit granted) in the four taxable years preceding the first taxable year beginning after December 31, 1941,99 was more than 125% of the volume of such credit extended to installment purchasers in the taxable year; or

(ii) The average of the outstanding installment accounts receivable at the end of each such four years was more than 125% of the amount of such accounts receivable at the end of the taxable year.100

Of the four years on which the average is based, only those for which income was computed on the installment basis are to be in-

98. Act, Section 222 (d); Code, Section 736; House Report, 26, 150; Senate Report, 42-43, 207-209. It should be noted that Section 721 of the Code (under prior law as well as present law) allows relief, in the form of allocating income to other years, in the case of "abnormal income" produced in the taxable year by a change in the taxpayer's method of accounting. Code, Section 721 (a) (2) (D). The instant situation is more or less the reverse, i.e., it is desired to change the method of accounting in order to avoid abnormal concentration of income. The Commissioner probably had power to grant some relief administratively, even without special legislation, by allowing a retroactive change from the installment method of accounting on conditions similar to those imposed in the new provision.

99. For calendar year taxpayers, the years 1938-1941 are thus taken as a standard. The House Bill, following the pattern of Section 721, referred to the four years preceding the year of election, rather than to fixed years. See House Bill, section 213 (f).

100. This basis for election was inserted by the Finance Committee principally for the benefit of installment houses whose accounting systems would not readily reflect the facts pertinent to the first ground for election. See Senate Report, 42.
THE EXCESS PROFITS TAX PROVISIONS

cluded; and if the taxpayer was not in existence for the four such taxable years, those years during which it was in existence are to be used.

The election is to be made in the "return" for the year, and pursuant to Treasury regulations the facts on which it is based must be established by the taxpayer. In case of election, the income from installment sales for each prior excess profits tax year is to be "adjusted . . . to conform to such election." This adjustment presumably will be nothing more than a recomputation of excess profits net income as if income from installment sales had been reportable on the accrual basis in such years. Income from installment sales made in pre-excess profits tax years (i.e., years beginning prior to January 1, 1940) will be excluded from excess profits net income in any later year. The base period years (as in the case of section 721) will not be disturbed. So far as the year for which the election is made and subsequent years are concerned, the return of installment income will be continued on the accrual basis for excess profits tax purposes.

Provision is also made for the determination of any deficiency or overpayment of income or excess profits tax, in the prior years, resulting from the readjustment of income.

101. This, too, was a Finance Committee revision. See Senate Report, 208.
102. The House Bill used the phrase "first return." See Section 213 (f). This change is not without real practical significance. Cf. Code, Section 114 (b) (4), prior to amendment by section 145 of the Act, requiring the election of percentage depletion in the "first return . . . in respect of a property." This language has been held to prohibit election by an amended return filed after the due date. Riley Investment Co. v. Com'r., 311 U.S. 55 (1940). Cf. Code, Section 1202, providing for the declaration of a capital stock value by a corporation "in its return for such declaration year . . . which declaration of value cannot be amended . . .." This terminology permits amendment prior to the due date of the return (Haggar Co. v. Helvering, 308 U.S. 389 (1940)), but not subsequent thereto (Helvering v. Lerner Stores Corp., 314 U.S. 463 (1941)), even though the amended return is filed within a period for which an extension might have been granted. Scaife Co. v. Com'r., 314 U.S. 459 (1941).

103. Section 213 (f) of the House Bill limited the Commissioner's specific power to prescribe regulations to the recomputation of gross income on the accrual basis. The expansion of this authority to include the qualification for relief under the prescribed conditions should avoid many disputes. For example, the application of the basic conditions of the section where a short taxable year is involved may be clarified by regulation.

104. The House Bill referred to the determination of "gross income," rather than "income," on the accrual basis. Section 213 (f).

105. See House Report, 150; Senate Report, 208. See note 86 supra.

106. The election apparently is not intended to affect the method of accounting for income tax purposes. The amount of income subject to excess profits tax will be affected, however, and this will in turn control the credit under Section 26 (e) of the Code, thus influencing normal-tax and surtax net income. In addition, for the period in which the excess profits tax was deductible (see note 6 supra) any adjustment to excess profits tax liability would affect income tax liability.

107. See note 106 supra.

108. The statute of limitations is extended for this purpose until two years from the date of election (Act, Section 213 (f); Code, Section 736 (c)), pursuant to provisions similar to those governing barred adjustments under Section 124 (amortization election) of the Code. See also Code, Sections 3801 (income tax inconsistencies) and 734 (excess profits tax inconsistencies).
The election is irrevocable, except that if the taxpayer establishes, pursuant to Treasury regulations, in any year that the conditions on which the election is allowed do not exist, the election may in effect be revoked and the installment method of reporting income be reinstated for such year and all future years. Such action would be final and conclusive, no further election being available.\textsuperscript{109}

(b) \textit{Long-Term Contracts}.—Section 721 of prior law made provision for the redistribution of "abnormal" income from contracts the performance of which required more than a year.\textsuperscript{110} As indicated above, the revision of section 721 has confirmed the Treasury's view that a redistribution of income under that section should not affect the computation of the income credit.\textsuperscript{111} Long-term contract income is now removed from the scope of section 721, however, and specially treated so as to permit the redistribution of abnormal income from such contracts on the "percentage of completion" method of accounting, and in so doing, to reconstruct the base period income to the extent altered by the recomputation on such method.\textsuperscript{112}

The Act provides an irrevocable election,\textsuperscript{113} somewhat comparable to that prescribed for installment-basis taxpayers, in the event that abnormal income\textsuperscript{114} from such contracts is received, to report income for excess profits tax purposes from all such contracts (past, present, or future) on the percentage of completion method.\textsuperscript{115} In such case, the net income of the taxpayer is adjusted for excess profits tax purposes for all prior years subject to the excess profits tax, and for the base

\textsuperscript{109} The opportunity to reconsider originated with the Finance Committee. See Senate Report, 42, 208.

\textsuperscript{110} Code, Section 721 (a) (2) (B).

\textsuperscript{111} See note 86 supra.

\textsuperscript{112} Act, Section 222 (d); Code, Section 736 (b).

\textsuperscript{113} There is no opportunity to reconsider, as in the case of installment basis taxpayers. See note 109 supra. The election is to be made in the "return" for the taxable year (see note 102 supra) in accordance with Treasury regulations. Section 736 (b) of the Code also allows the election, within 6 months after the enactment of the Act, with respect to "a taxable year the return for which was filed prior to the date of the enactment of the Revenue Act of 1942." And Section 222 (c) of the Act makes the new Section 736 (b) applicable only to years beginning after December 31, 1941, unless the taxpayer elects, in accordance with Treasury regulations and within 6 months from the enactment of the Act, to have the new provision apply to all taxable years beginning after December 31, 1939. This will allow the taxpayer to base its election on any prior excess profits tax year which meets the abnormality requirement, if 1942 does not qualify.

\textsuperscript{114} The test of abnormality is the same as under Section 721, \textit{i. e.}, if the income of the class in question is not normally derived by the taxpayer, or if normally derived, exceeds 125\% of the average gross income of the same class for the four preceding taxable years (or those in which the taxpayer was in existence).

\textsuperscript{115} The completed contract method of reporting income from contracts extending over more than a year has the effect of throwing all the income into the year of completion, whereas the percentage of completion system allows income to be taken up as the work progresses. The latter method may result, \textit{inter alia}, in the utilization of the excess profits credit for several years. See Senate Report, 208.
period, "to conform to such election," and refund or deficiency (as in the case of the installment-basis election) in income or excess profits tax is provided for.\footnote{116} Section 721 in effect has become inapplicable in 1942 and all future years to income from long-term contracts, and also in all prior years if the application of the new provision is elected.\footnote{117}

(8) Credit for Dividends Received

Section 211 of the Act revises section 711 (a) (2) (A) of the Code to deny taxpayers using the invested capital system any credit, in computing excess profits net income, for dividends received on stocks which are not "capital assets"—principally, stocks held by dealers for sale to customers in the ordinary course of business.\footnote{118} This provision is consistent with the treatment of such stocks as admissible assets in computing invested capital.\footnote{119} Since they in effect are included in invested capital, the income therefrom should be fully included in excess profits net income.\footnote{120}

In its prior form, section 711 (a) (2) (A) allowed the credit for dividends received, without limitation, on dividends from all corporations except dividends on stock of foreign personal holding companies; and it was further provided that the section should not apply to dividends on stocks which are not "capital assets." Since the credit for dividends received as provided in section 26 (b) of the Code (and as reflected in excess profits net income except to the extent modified by section 711 (a) (2) (A)) is limited to 85% of dividends on domestic stocks, the result was properly to include in excess profits net income in their entirety dividends from foreign personal holding companies.\footnote{121} However, 85% of the dividends from domestic stocks not qualifying as "capital assets" were excluded from excess profits net income as the result of the mere non-application of section 711 (a) (2) (A), since the provisions of section 26 (b) were thus allowed to remain applicable. As indicated above, this result was improper in view of the admissibility of such assets in computing invested capital.

\footnote{116} See note 108 supra. In this case, in determining the income tax effects of the adjustment of excess profits net income, it appears that any increase in excess profits tax in any year on account of such adjustment is to be attributed to the year in which the income would have been reported in the absence of the election. This apparently was intended to prevent an increase in the deduction for excess profits tax, in the years in which such tax was deductible (see note 6 supra), on account of income which for income tax purposes arose in another year. The regulations may clarify this question.

\footnote{117} Act, Sections 222 (d), (e), and (f); Code, Section 736 (b).

\footnote{118} Code, Section 117 (a).

\footnote{119} Code, Section 720 (a) (1) (A).

\footnote{120} Senate Report, 189-190.

\footnote{121} The stock of a foreign personal holding company is an admissible asset. Code, Sections 720 (c) (1) (A), 720 (a) (2).
The correction is retroactive to the beginning of the excess profits tax.\textsuperscript{122}

IV. THE INCOME CREDIT

The income credit survived the Act, Treasury opposition to its availability having apparently subsided.\textsuperscript{123} The conflicting views (indicated in the footnote) as to the proper method of measuring profits not subject to excess profits tax are due to the lack of agreement on the objective, \textit{i.e.}, is it to measure normal peacetime profits (conversely, "war" profits), \textit{reasonable} profits, or both? If the purpose is merely to segregate war profits, normally high earning companies should be permitted to retain high earnings and normally low earning companies should be confined to low earnings. In such case a credit resting fundamentally on prior earnings experience, over a period reflecting normal operations, would be the exclusive yardstick, however high or low. On the other hand, if it is desired also to permit low earning companies to retain a portion of their war profits as compensation for their long suffering, an alternative measure (such as a "fair" return on "invested capital") greater than such an earnings credit is required. And if it is desired also to reduce normally high profits to a lower level, an alternative maximum measure below the level of such earnings credit is necessary. Note, however, that neither of the latter two \textit{desiderata} is embraced by the simple objective of recapturing war-created profits; and each requires a difficult value judgment as to the amount an enterprise should reasonably be permitted to earn, whether or not from war sources.

\textsuperscript{122} Act, Section 211 (b).

\textsuperscript{123} A Ways and Means subcommittee originally undertook the study of excess profits tax legislation in the preparation of the Second Revenue Act of 1940, and the Treasury submitted to it a plan based on invested capital alone (\textit{Joint Hearings}, note 1 supra, at 69), but the Chief of Staff of the Joint Committee on Internal Revenue Taxation thought a standard based on earnings experience essential (\textit{id.}, at 103). The Treasury felt that the income credit would give some taxpayers a "tremendous advantage." \textit{Finance Committee Hearings}, note 3 supra, at 137. In the House a compromise was effected, under which the return on invested capital was limited, within a specified percentage range, to the rate of return earned during the base period; and the use of the straight income credit was penalized by more steeply graduated tax rates and an additional special tax. The Senate eliminated the disparity in rates and additional tax, and also dropped the reflection of earnings experience in computing the invested capital credit. These changes were accepted in conference, except that the differential tax was in effect retained by reducing the income credit to 95\% of the base period average, rather than 100\%. H. R. REP. No. 3002, note 3 supra, at 42-44, 48-49. The Treasury continued to oppose retention of the income credit in connection with the Revenue Act of 1941, but the Ways and Means Committee was adamant. H. R. REP. No. 1040, 77th Cong., 1st Sess. (1941) 23-24. On the contrary, the Committee attacked the invested capital method by approving an additional tax on companies whose currently increased earnings were escaping excess profits tax by reason of a large invested capital. \textit{id.}, at 25, 43-45. This provision was eliminated by the Finance Committee, and not restored in conference. S. REP. No. 673, 77th Cong., 1st Sess. (1941) 13, 37; H. R. REP. No. 1203, 77th Cong., 1st Sess. (1941) 12. Finally, the Treasury did not renew its objections to the income credit in connection with the Act.
Although fundamental principles have been retained, a number of changes have been made in the income credit, relating principally to the treatment of capital gains and losses in the base period; the determination of average base period net income; the capital reductions of affiliated corporations; and Supplement A, under which the income credit of certain reorganized corporations may be determined.

(i) Capital Gains and Losses

Prior to the Act, sections 711 (b) (1) (B) and 711 (b) (2) of the Code, in prescribing the treatment of capital gains and losses in the base period for the purpose of computing the income credit, in effect applied the same rules applicable to capital gains and losses, under sections 711 (a) (1) (B) and 711 (a) (2) (D), in determining excess profits net income for the current year. This policy is continued (with one exception noted below). The rules presently in effect with respect to capital gains and losses in computing excess profits net income in the current year are discussed above.¹²⁴

There was in force before the Act a one-year net short-term capital loss carry-over, available in offsetting short-term gains for the first time in 1941. Consistently, base period net income was computed, in determining 1940 excess profits tax, without the application of any such capital loss carry-over during the base period; and for 1941 by applying, throughout the base period, a one-year short-term net capital loss carry-over available against short-term gains, and taking the first such loss carry-over from the year preceding the beginning of the base period.¹²⁵

Under the Act, the one-year short-term capital loss carry-over has become a five-year net capital loss carry-over (without distinction as to holding period), effective with respect to losses incurred in 1942 and later years. For the year 1942, however, the one year short-term carry-over from 1941 is preserved to the extent of short-term gains in 1942.

To dovetail these changes, in a similar fashion, with the determination of base period net income, it would be necessary (a) to retain the one-year short-term carry-over during the base period in computing excess profits tax liability for 1942, and (b) to provide a net capital loss carry-over for the base period in computing tax liability for 1943 and later years, dating such carry-over from the first to the fifth year preceding the beginning of the base period in keeping with the length of the carry-over applicable to the current year. Under the Act, how-

¹²⁴. Act, Section 207; see pp. 401-404 supra. The same policy is adopted with respect to income from retirement of bonds, which will now be excluded if the bonds have been outstanding 6 months or more, in lieu of 18 months. Act, Section 207 (f); Code, Section 711 (b) (1) (C).

¹²⁵. I. e., from the taxable year beginning after December 31, 1934. See Code, Sections 117 (d), 117 (e), 711 (b) (2), prior to amendment by the Act.
ever, no capital loss carry-over of any kind is allowed during the base period in determining tax for 1942; and a five-year capital net loss carry-over, dated from one year prior to the base period, is to be applied in arriving at base period net income in succeeding years.\textsuperscript{126}

\textbf{(2) Averaging the Base Period Net Income}

The choice of base period years and the method of determining the average income in those years, in order to arrive at the income credit, has also been a sharply contested issue. Industry representatives have consistently urged a standard based on an average of the three best years of the four included in the base period.\textsuperscript{127} The rule in force prior to the Act, namely, a base period \textsuperscript{128} average computed by treating a deficit in one year (the largest deficit in the case of more than one) as zero rather than a minus quantity, originated in the House version of the Second Revenue Act of 1940. The Senate changed the provision to adopt in the normal case an average of the best three years, by allowing the exclusion of one year from the computation entirely. This change was deleted in conference.\textsuperscript{129} The alternative "normal growth" provision, stepping up the average in the event of increased earnings in the latter half of the base period, was added by the Excess Profits Tax Amendments of 1941.\textsuperscript{130}

The Act retains intact the "normal growth" alternative, but changes the general average to reflect a compromise between prior law and an average based on the best three of the four years. The new provision in the first instance computes the average of all years in the base period, including all deficits as minus quantities. However, if the monthly average excess profits net income of one year in the base period is less than 75\% of the monthly average of the remaining years, the average is recomputed by substituting for the low year an amount based on income at the rate of 75\% of such monthly average for the other

\textsuperscript{126} Act, Section 207 (g); Code, Section 711 (b) (2). The House Bill would have applied the 5-year rule in determining 1942 tax. Under that bill the status of 1941 was in doubt, as the bill stated that the 5-year rule should not apply, in the base period, for the purpose of computing tax for any taxable year beginning before January 1, 1941. See Section 206 (d).

\textsuperscript{127} See, for example, statement of Ellsworth C. Alvord, representing the Chamber of Commerce of the United States, Senate Hearings, 1779-1780. See note \textsuperscript{123} supra, for general disagreement as to the nature and function of the income credit.

\textsuperscript{128} The base period for this purpose consists of the taxable years beginning after December 31, 1935 and before January 1, 1940. Thus short taxable years may result in a base period containing more than four taxable years. In the case of a corporation not in existence throughout the 48 months preceding the beginning of its first taxable year under the excess profits tax, the base period is such 48 months. See Code, Section 713 (b).

\textsuperscript{129} H. R. Rep. No. 3002, note 3 supra, at 47-48. Where the base period included more than four years, the Senate proposal would have adopted an average of the best years excluding the worst year.

\textsuperscript{130} Section 4.
years. Only one such year's income is thus increased, and in the event two or more qualify, the year most favorable to the taxpayer is used.\(^\text{131}\)

This change is more advantageous to the taxpayer than prior law in that (a) relief is available even in the absence of a deficit year, and (b) in the event of a deficit year, such year is "built up" to a plus amount rather than merely to zero. However, the new rule is slightly less advantageous than the proposal based on the best three of the four years, since under the Act the fourth year is included at only 75% of the average of the best three years, thus bringing the general average down to 93.75% of the three year average.\(^\text{132}\)

The Act also redefines a "deficit" for this purpose. Under the new definition interest on federal securities exempt from normal tax is also deducted from gross income in computing a deficit,\(^\text{133}\) together with the dividends received credit and the allowable deductions, as under prior law. Under the old rule the interest income would have reduced or wiped out an operating deficit, since such income is included in gross income in the first instance and was not eliminated under the definition as it then stood.\(^\text{134}\) The new rule is consistent with the policy of not subjecting partially tax-exempt interest to excess profits tax in the current year.\(^\text{135}\)

\(\text{(3) Capital Reductions}\)

Under section 713 (g) of the Code, the income credit is adjusted for capital changes occurring since the base period.\(^\text{136}\) To prevent taxpayers from raising new equity capital, investing it in securities the income from which is not subject to excess profits tax (tax-exempt bonds and domestic stocks), and then using the increased credit (resulting from the capital addition) to offset business income otherwise subject to tax, a capital addition is reduced by any post-base period net increase in "excluded capital," i.e., tax-exempts and domestic stocks.\(^\text{137}\) Prior

\(^{131}\) Act, Section 215; Code, Section 713 (e).

\(^{132}\) The new method also applies in the case where the base period contains more than four taxable years, or where the taxpayer was not in existence throughout the entire base period and uses a constructed income (under Section 713 (d) (2) of the Code) for the portion in which it was not in existence. See Senate Report, 191.

\(^{133}\) Act, Section 214; Code, Section 713 (c).

\(^{134}\) The amendment was explained to the Finance Committee by a representative of the Legislative Counsel's Office as necessary in order to determine the "true loss." Senate Hearings, 104. A "true" or "economic" loss would include a reflection, instead of an elimination, of such interest.

\(^{135}\) Excess profits net income is based on normal-tax net income, from which such tax-free interest has been eliminated. Code, Section 13 (a).

\(^{136}\) The adjustments are based on increases or decreases of equity capital, termed "capital additions" and "capital reductions." Borrowed capital is not recognized for purposes of the income credit. A net capital addition increases the income credit 8% of the addition, and a net capital reduction decreases it 6% of the reduction. Code, Section 713 (a) (1).

\(^{137}\) Code, Section 713 (g) (3).
to the Act, an increase in excluded capital had no effect, however, in the absence of a capital addition.

The latter fact created, theoretically at least, a broad "loophole" in the law. Corporations using the income credit might have transferred a part of their income producing assets to existing or newly-created subsidiaries. This would have led to a reconstructed bracket structure under the "highest bracket amount" provisions of old section 752 of the Code, in order to neutralize the splitting of the income; and the invested capital of the subsidiary attributable to the transferred assets would have been determined, under section 751, by reference to the adjusted basis of the assets, thus preventing the stepping up of invested capital on account of unrealized appreciation. However, the income credit of the parent would not have been reduced. The subsidiary would then report on the invested capital method, and the total credit taken by the two corporations against the total income would exceed that previously available to the parent alone.

Section 216 of the Act adds to section 713 (g) a new subsection (5) for the purpose of closing the "loophole." As is often the case with a legislative cure for tax avoidance, the new provision does not fully "plug" the loophole, and is prejudicial to transactions having no tax motivation.

Briefly summarized, the new provision establishes a capital reduction (not merely an offset to the capital addition, if any) of a corporation, based on increased holdings of the stock of affiliates. In the usual case, this capital reduction for any day is the net balance (in terms of aggregate adjusted basis for determining loss) of acquisitions and dispositions, since the base period, of stock in corporations which are, with the taxpayer, members of a "controlled group." The adjustment is limited, however, to the net increase in excluded capital since the base period. To avoid a duplicate adjustment by diminution of a net capital addition as well as increase of the capital reduction on account of the same item, the increased holdings in affiliates' stocks are in effect removed from excluded capital—that is, excluded capital is reduced by the increase in capital reduction under the section. The definition of

138. Since repealed retroactively. Act, Section 229 (a).
139. Now embodied in new Supplement C. See Act, Section 230; Code, Section 760.
140. Except in the case where a capital addition had occurred, to the extent that the increase in excluded capital represented by the stock in the subsidiary offset such addition.
142. The capital adjustment computations are on a daily basis, and include for each day, the transactions up to and including the prior day. Paragraph (A) of the new provision is defective in that it literally includes acquisitions, but not dispositions, on the current day as well.
"controlled group" is virtually the same as that contained in the existing provisions with respect to "new capital." 143

The provision is written in terms of affiliates' stock acquired or disposed of since the base period. It overlooks the ability of a parent to transfer assets, as a contribution to capital or paid in surplus, to a subsidiary in existence before the beginning of the base period without acquiring any additional stock. In addition, the net balance of acquisitions and dispositions is measured in terms of the basis of the shares in the affiliates; and such shares held prior to the excess profits tax are also included in the computation. 144 By combining the disposition of high basis shares previously held (for example, a portfolio of depreciated and undesirable securities in affiliated companies held merely as investments) and transferring to the new company low basis assets in order to keep the basis on the acquired shares at a minimum, it might still be possible to eliminate or minimize the capital reduction while creating additional credit for the subsidiary. Or a corporation having a group of high basis "cats and dogs" qualifying as excluded capital and held prior to the imposition of the excess profits tax might clean them out, replace them with the new subsidiary's stock having an equal basis, and escape the capital reduction—which is limited to the net increase in excluded capital subsequent to the base period. Moreover, the additional specific exemption, and the excess of the credit based on the subsidiary's invested capital over the loss of credit by the parent, 145 will also prevent full elimination of the tax advantage.

On the other hand, the provision will in some instances apply where the tax-avoiding split-up is not present. Suppose corporation A owns indirectly (through several intermediate corporations similarly connected) non-voting preferred stock of corporation B exceeding in value 50% of the total value of B's several classes of stock. B has no capital addition. The management of B, which is by no means controlled by A, purchases some preferred stock of A in the open market as an investment. Without more, B suffers a reduction in its income credit. Yet even if B had bought its own shares as an investment, apparently no capital reduction would have been suffered; 146 and, of course, none would have occurred if the purchased stock had been that of a non-affiliate.

143. Code, Section 718 (a) (6). A connecting link or more than 50% of total combined voting power, or of total value, is enough to bring a corporation within the chain of corporations constituting the "controlled group."

144. Shares disposed of prior to the day in question are included in the computation of shares held at the beginning of the first excess profits tax year at their basis under the law in effect at disposition.

145. Due to a rate of return on invested capital (maximum 8%) higher than the rate of adjustment for capital reduction (6%).

The new provision applies only to taxable years beginning after December 31, 1941.

(4) Supplement A

The Second Revenue Act of 1940 contained elaborate provisions, known collectively as "Supplement A," relating to the determination of the income credit of a taxpayer which has absorbed through certain tax-free transactions other businesses having base period experience. These provisions were seriously defective, from the standpoint of both basic policy and drafting technique. Consequently, the Supplement has been thoroughly overhauled in the Act.

As in the earlier discussion, an assumption (however dubious) that the reader has a working knowledge of Supplement A under prior law is necessary. It may clarify the discussion, however, to state generally that the purpose of the Supplement is to draw together the separate base period incomes of the various enterprises ("component corporations") that have been coalesced, via tax-free transfers of assets, in the formation of the presently existing business; and to include such experience in the income credit of the taxpayer, i.e., the corporation now holding the aggregated business assets (the "acquiring corporation"). With this background, the changes introduced by the Act will be discussed, for the most part in the order in which they occur in the Supplement as rewritten.

(a) Existence of Component and Acquiring Corporations.—Section 740 (c), prior to the Act, defined a "qualified" component corporation as a component corporation in existence at the beginning of the taxpayer's base period. This provision appeared in prior law for the purpose of allowing the inclusion of the base period experience of only such components. There was no valid reason, however, for excluding the earnings experience of component corporations which came into existence during the base period. Accordingly, the Act has corrected this defect by allowing the inclusion of the base period experience of all

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147. Code, Sections 740-744, prior to amendment by the Act. These provisions were at first limited to acquisition of assets from other corporations. The Excess Profits Tax Amendments of 1941 added provisions relating to the absorption of partnerships and proprietorships. Section 8.

148. For an excellent analysis and criticism of the many deficiencies of these provisions, see Alvord, A Preliminary Analysis of the Excess Profits Tax Act of 1940, (1940) 64-74.

149. Act, Section 228; Code, Sections 740, 742, 743.

150. A component not actually in existence on such date, but which had absorbed a component having such existence, was also "qualified." See old Section 740 (f).

151. Section 742 (a) (2) of prior law, containing the formula for computing average base period net income under Supplement A, allowed the inclusion of base period income of "qualified" component corporations only.
components which in fact were in existence before January 1, 1940; and the old section 740 (c) has been dropped.

In conformity with this change, the Act has also extended Supplement A to acquiring corporations in existence before January 1, 1940, or having a component or components in existence before such date, rather than requiring such existence at the beginning of the base period. In addition, Supplement A is now applicable, without election, to all corporations meeting this requirement, if the average base period net income under the Supplement is greater than under section 713. Under prior law, a corporation only constructively in existence prior to January 1, 1940, (by reason of having a component actually in existence prior to such date) was compelled to use Supplement A, and one actually in existence prior to such date was put to an election between Supplement A and section 713. This meant that the former was deprived of the "normal growth" formula; and the latter had to choose between (i) including the experience of qualified components under Supplement A, and (ii) using only its own base period experience, a constructed income for the period it was not in existence, and the availability of the growth formula, under section 713. Now the taxpayer is in effect entitled to the greatest of the regular or general average method; the growth provision; the Supplement A method; or the Supplement A—growth method. Moreover, only one set of computations need be submitted on the return, without disclaimer (as under prior law) of other methods, and the return is to be audited on the method so used. The taxpayer is not precluded, however, from shifting his method so long as the year remains open for adjustment.

(b) Surviving Components.—A new section 740 (c) has been inserted, however, for an entirely unrelated purpose. It is possible for a component corporation to retain its existence as a separate taxpayer even though its business has been absorbed by an acquiring corporation on a tax-free exchange. For example, a corporation may

152. See Senate Report, 264. January 1, 1940, is the dividing line because, as will be explained more fully below, the component’s income for its taxable years beginning in the calendar years 1936-1939, is taken into account. A component coming into existence after December 31, 1939, would have no such taxable years.

153. For the limited purpose of Section 742 (d), the concept of a “qualified” component has been continued and the definition transferred to that section. Note, however, that a component not actually in existence at the beginning of the taxpayer’s base period might have become qualified, by absorption of a component having such existence, under old Section 740 (f). With the revision of that section, the effect of Section 742 (d) may be materially altered.

154. This change is brought about by a revision of Sections 712, and 740 (f), and the repeal of old Section 741 (a). See Act, Sections 228 (a), 228 (b), and 228 (e) (i).

155. Compare the first paragraph of old Section 742 with the section as revised by Section 228 (c) of the Act.

156. Old Section 741 (b) is repealed. See Act, Section 224 (b).

transfer all its assets to a new corporation in exchange for all the latter's stock. The first corporation may not be then liquidated, however, and may acquire a new set of operating assets by using the stock of the second corporation (or the proceeds of a sale thereof) as funds for the purchase of the new assets.

Prior to the Act, the first corporation was literally entitled to the use of its base period experience with respect to the transferred assets in computing its excess profits credit, for the purpose of determining excess profits tax on the income from the new assets. Moreover, the second corporation was entitled to the use of the same base period experience in computing its excess profits tax.

If the transfer occurred during the base period, the first corporation could use the base period experience on the transferred assets for the portion of the base period during which it held such assets, and also its experience during the remainder of the base period with respect to the new assets. On the other hand, the second corporation could not only use the income from the first set of assets during both the latter portion of the base period in which it held such assets, and also the first part of the base period, during which those assets were held by the first corporation; but in addition the second corporation was literally permitted to use the base period experience of the first corporation with respect to the second set of assets subsequently acquired by that corporation.

These results were unsound in that the second corporation might be allowed in its credit a reflection of income from two different sets of assets for the same period, including income from assets which it never owned either currently or during the base period. On the other hand, the first corporation would be entitled to use base period experience from properties which it no longer operated, against current income from an entirely different set of assets—which might differ substantially and therefore not be properly compared in determining excess profits.158

The situation might be further complicated in various ways. Thus, the second corporation might one or more times go through the same process of transferring the assets received from the first to a further acquiring corporation, and entering a new business; the first corporation might also repeat the process theoretically any number of times, and it might in one or more of such transactions acquire its new assets on a tax-free exchange, thus becoming an acquiring corporation in its own right; and either corporation might ultimately go out of existence.

158. There could, of course, be constant factors of greater or lesser importance, e.g., the same management, retained personnel, contacts in the trade, general similarity of the two sets of assets, etc.
on the last transaction on which it became a component corporation. In addition, these transactions might occur during the base period (thus splitting the base period income from any one group of assets into various parts), or subsequent to the base period. Finally, any of the corporations involved might have a string of one or more components from prior transactions, some having remained in existence after their operating assets had been absorbed and/or representing an amalgamation of various predecessors.

Although complex situations may thus arise, and the effect of new section 740 (c) is not readily apparent on its face, the new rule is tacitly founded on a rather simple basic principle, namely, that on all such tax-free exchanges the base period earnings experience shall follow the group of assets from corporation to corporation. This will be seen most readily from an illustration. Assume the following series of transactions:

(a) A — All assets—Group No. 1 → B
    A ← All stock of B

(b) A — All stock of B → C
    A ← Assets—Group No. 2

(c) A — All assets—Group No. 2 → D
    A ← All stock of D

(d) A — Voting Stock of A → E
    A ← All assets—Group No. 3

(e) A — All assets of A → F
    A ← All stock of F

(f) A is liquidated upon transaction (e).

(g) F liquidates D under section 112 (b) (6) of the Code.

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159. The statute is written in terms of the income of the corporation from which assets are acquired on specified exchanges, not income from any particular assets, and it is not to be implied from the text that income is traced to specific assets. Indeed, any particular assets may be lost, depreciated, depleted, destroyed, sold, etc. The text first discusses the general effect of the section, rather than its mechanics, and the thought is that when the transfer of the existing group of assets occurs, all base period experience (since the last transfer not qualifying under Section 740 as a transfer from a component to an acquiring corporation) is immediately diverted exclusively to the transferee.
Under the new section, B would be entitled after transaction (a) to use the base period income of A from the assets in Group No. 1; the base period income from such assets in the hands of any components of A which may have earlier held the assets for all or a portion of the base period; and if transaction (a) occurred during the base period, its own experience with respect to such assets for the portion of the base period subsequent to transaction (a). On the other hand, if B should dispose of such assets by becoming a component of another corporation, it would lose such base period experience to the transferee corporation in the same manner that A lost such experience to B. Finally, in no case would B get the benefit of any base period experience of A, C, E, or F with respect to the assets in Group No. 2 or Group No. 3, unless B ultimately came into possession of those assets (as in the case of F with respect to Group No. 3, discussed below) through absorption of D and/or F.

A will lose to B its base period experience, and that of any of its components, with respect to the assets in Group No. 1. It will also acquire no base period income on the assets in Group No. 2 prior to their transfer to A, since on such acquisition C did not become a component of A, the exchange not being a tax-free exchange described in section 740 (a). C will retain such experience until it passes such income on to any corporation of which it may become a component, or goes out of existence. However, if transaction (b) occurred during the base period, the income from such assets throughout the portion of the base period in which A held them will be available to it. But upon A’s transfer of the assets to D, such experience will be lost to A and attributed to D, for use by D until transaction (g) occurs, upon which such experience will go to F.

The result of transaction (d) is to attribute to A the base period income from the assets in Group No. 3 previously available to E on the above principles, and to deprive E or a corporation which may later absorb E of such experience. A will in turn lose such experience (plus any added experience if transaction (d) occurred during the base period) upon the transfer of such assets to F in transaction (e).

The foregoing should make clear the working principle of the new section 740 (c). To turn to its mechanics, it excludes the excess profits net income of a corporation, for any period before the day after a tax-free exchange upon which such corporation becomes a component corporation, in computing the excess profits credit of (i) such

160. See Act, Section 228 (a); Code, Section 740 (c) (1).
161. The section includes exchanges which are required by Section 740 (a) to be followed by liquidation of the transferor. See Senate Report, 215; House Report,
component corporation,\textsuperscript{162} or (ii) of "an acquiring corporation of which the acquiring corporation in such transaction is not a component."\textsuperscript{163} There is also excluded in both instances the excess profits net income of any components that the component corporation in question may have previously acquired. In addition, the capital addition or capital reduction, immediately before the exchange or for any prior period, of the component corporation (or its earlier components) is also disregarded.\textsuperscript{164}

The foregoing rules apply only for the purpose of computing the excess profits credit for taxable years beginning after December 31, 1941.\textsuperscript{165} Nor do they apply in the application of the "normal growth" formula (discussed below) except in limiting under such formula the average base period net income (or the Supplement A average base period net income) to the largest year in the base period.\textsuperscript{166}

If the taxpayer becomes a component corporation on a transaction in the course of a taxable year beginning after December 31, 1941, it is in effect given the average base period net income (or Supplement A average base period net income) which it would have received in the absence of such transaction, pro-rated in light of the number of

\textsuperscript{151} Thus the transfer by a wholly-owned subsidiary of all its assets to a corporation other than the parent, in exchange for voting stock, followed by a liquidation of the subsidiary by the parent, would not transfer the income experience of the subsidiary to the parent. Such experience would belong exclusively to the transferee of the assets. Similarly, a corporation completely liquidated but not dissolved would not, if revived by new capital, retain the base period income passed on to an acquiring corporation immediately prior to the liquidation.

\textsuperscript{162} That is, a component which has remained in existence. Otherwise, its excess profits credit would not be computed.

\textsuperscript{163} That is, of an acquiring corporation which has not absorbed the transferee of the assets, thus becoming entitled to the base period income excluded by the section. To refer to transaction (a) in the illustration stated above, A is the component corporation, and D is an acquiring corporation of which "the acquiring corporation (B) in such transaction (i.e., transaction (a)) is not a component." Thus, neither A, subsequent to transaction (a), nor D upon acquiring A (in transaction (c)) subsequent to such transaction, would be entitled to include base period income of A prior to transaction (a).

\textsuperscript{164} As will be discussed more fully below, when a component is absorbed after the close of the base period, its capital addition or reduction is transferred to the acquiring corporation.

\textsuperscript{165} The privilege to elect retroactive application of the changes in Supplement A (discussed below) does not apply in this instance.

\textsuperscript{166} See Code, Sections 713 (j), 742 (b). This rule is no boon to the taxpayer, as the average base period income is in effect limited to the best base period year subsequent to the transfer of the old assets to the acquiring corporation. Moreover, in view of the rule, the loss of base period income in the first half of the base period to acquiring corporations will not be available in establishing the increased income in the latter half, as required under the normal growth formula.
days in the year before the day after such transaction. However, the entire capital addition or reduction before the exchange, rather than a pro-rated portion, is disregarded. Correspondingly, the remainder of the pro-rated base period income, and all the capital addition or reduction, of the component are transferred to the acquiring corporation for such year.

Finally, it is now expressly provided that the acquiring corporation on a tax-free exchange (or a corporation of which such acquiring corporation becomes a component) must exclude the excess profits net income of the component corporation on such exchange for any period beginning with the day following the exchange. This provision is retroactive to all taxable years beginning after December 31, 1939.

A major defect in the new section is that while depriving a surviving component, or its successors, of all or a part of the base period experience on the assets which have gone over to other corporations, it makes no provision for a substitute. Base period income thus lost may not be filled in by a constructive income based on invested capital, despite the fact such a fill-in would be available to another corporation coming into existence at the time the component was beginning anew. And if all the income experience is thus transferred, the invested capital credit alone is available. Not only should the loss of base period income be replaced in such a case, but the measure of the replacement should be not less than the earnings of the new assets acquired after the old assets are transferred, during the base period prior to such acquisition, if such assets were then operated by the preceding owner.

Indeed, it would seem that the principles of Supplement A in general should have been applied to all acquisitions of other businesses, whether

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167. Act, Section 228 (a); Code, Section 740 (c) (2). If the normal growth formula is used, whether under Supplement A or under Section 713 (f), the average base period income determined under such formula is similarly pro-rated. See Senate Report, 217.

168. See Senate Report, 217.

169. Ibid.

170. Act, Section 228 (a); Code, Section 740 (c) (last sentence).

171. Act, Section 228 (f).

172. Assume the simple case of corporation A, in existence January 1, 1936, transferring all its assets to a new corporation B, in exchange for all its voting stock, on January 1, 1938. (Both corporations are on the calendar year basis). A immediately converts the stock of B into cash, with the cash buys up the assets of a similar going business from corporation C and continues to operate. Corporation D, a competitor, is organized to begin business on January 1, 1938, with paid in capital in the form of cash, of a similar amount, and similarly purchases a going concern.

A loses its 1936-1937 income experience to B. Since A was in existence throughout its entire base period, it does not qualify for a "fill-in" for those years, based on its invested capital as of January 1, 1940, under Section 713 (d) (2) of the Code. On the other hand, corporation C would qualify for such a "fill-in." Supplement A makes no further provision for such a corporation as A. Accordingly, it would be forced to resort to invested capital, or to compute its income credit with only 1937 and 1938 income—unless it should succeed in establishing a constructive income credit under the general relief provisions (discussed below).
or not tax-free, with adjustments to prevent duplication of base period income.

(c) **Base Period and Base Period Income.**—Under prior law the base period of an acquiring corporation for any taxable year beginning in 1940 was the 48 months preceding the beginning of such year;\(^{173}\) and for any taxable year beginning in 1941 or later, the base period was "... the forty-eight months preceding what would have been its first taxable year beginning in 1940 if it had had a taxable year beginning in 1940 on the date on which the taxable year for which the tax is being computed began."\(^ {174}\) The latter absurdly written and unnecessarily complicated provision shifted the base period with any post-base period change in the accounting period of the acquiring corporation, or with its becoming a component of a further acquiring corporation having a different taxable year.

The Act has now "permanently anchored" the base period of an acquiring corporation to the four calendar years 1936-1939. The change is not retroactive unless the taxpayer so elects; and the amendment is not available to a taxpayer which became an acquiring corporation prior to September 1, 1940, the base period for the first taxable year ending in 1941 being applicable.\(^ {175}\)

Several corrections are made with respect to the base period income taken into account. Under prior law, the income of an acquiring corporation, and its components, included in Supplement A average base period net income was limited to that earned in their respective taxable years beginning after December 31, 1935, and ending with or within the acquiring corporation’s base period years; and the income of a component prior to the beginning of the taxpayer’s base period was also excluded. This rule was unsound in various situations. For example, if the taxpayer’s base period was the calendar years 1936-1939, the old rule excluded in the case of components using a fiscal year in the base period, both the income earned in 1936 until the close of the fiscal year beginning in 1935, and that earned in 1939 after the close of the fiscal year beginning in 1938. Only three years were thus reflected in the average.

Under the Act, the income of all taxable years beginning with or within the base period years (even though ending thereafter) is included.\(^ {176}\) It should be noted, in passing, that this provision may work

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\(^{173}\) Code, Section 740 (d) (1), prior to amendment by the Act.

\(^{174}\) Id., Section 740 (d) (2).

\(^{175}\) Act, Section 228 (a); Code, Section 740 (d); see House Report, 152-153; Senate Report, 217; Conference Report, 66.

\(^{176}\) Compare old Sections 742 (a) (1), 742 (a) (2) and 742 (f) (3) with new Section 742 (a) (1), as rewritten in Section 228 (c) of the Act. A deficit is determined as in revised Section 713 (c), i. e., partially tax-exempt interest, as well as the
to the taxpayer's advantage where the acquiring corporation or its component had a fiscal year beginning late in 1939 and ending late in 1940, in that a business uplift felt in 1940 may be partially reflected in the income credit.

As indicated above, prior to the Act, only the income of a "qualified" component—i.e., a component actually in existence at the beginning of the base period, or one which had "acquired" such a component—was includible, and in the latter instance, only for the period subsequent to the acquisition of the qualifying component. Moreover, the income of the acquiring corporation for the period prior to its becoming an acquiring corporation (if it was not actually in existence at the beginning of the base period) was also excluded. These were errors of draftsmanship in the Second Revenue Act of 1940, resulting from the failure to keep the Supplement in harmony with the rest of the bill as its basic policy was changed in the course of passage.

As also indicated above, the Act corrects these errors to the extent of allowing the inclusion of all excess profits net income of both the acquiring corporation and its components for their respective taxable years beginning in the base period. Moreover, for those base period years in which neither the acquiring nor any component corporation

deductions and the dividends received credit, is deducted from gross income, with the usual Section 711 (b) (1) base period adjustments. See p. 425 supra; Code, Section 742 (e) (4). If the only year of the taxpayer or any of its components beginning with or within any base period year is less than 12 months, the income or deficit is placed on an annual basis "in the same manner as is provided in Section 711 (a) (3)." Code, Section 742 (a) (2). Quaere whether this will allow the election of an actual 12 months' experience (possibly extending well into 1940) at the option of the taxpayer, along the lines of new Section 711 (a) (3) (B). See pp. 411-412 supra. The language of the latter section is not particularly appropriate but the "manner" of annualizing the income, or basic theory of the new section, is plain. An application of this provision would construct a portion of the income credit on the basis of actual experience. In other instances, where the income credit is constructed for a vacant period, it is done on the basis of a return on invested capital. See Code, Sections 713 (d) (2); 742 (e). If more than one taxable year begins within the base period year, the aggregate income or deficit is to be adjusted to "reflect income for a period of twelve months", pursuant to Treasury regulations. For the "guidance" of the Commissioner (see Senate Report, 219), the paragraph quoted below was inserted in the section:

"For the purposes of this section, a taxable year of a component corporation beginning within the base period which also begins with or within the taxable year of the acquiring corporation in which the acquisition occurred, or which also begins with or within the same base period year with which or within which began such taxable year of the acquiring corporation, shall be considered a taxable year of the acquiring corporation, and such taxable year shall be considered to have begun in the base period year with which or within which such taxable year of the acquiring corporation began."

177. See old Section 742 (f) (2); see note 151 supra.
178. See old Section 742 (f) (1).
179. The House version of that bill had required actual existence at the beginning of the base period as a prerequisite to any corporation's use of the income credit; and the Senate changed this requirement merely to existence prior to January 1, 1940, allowing a constructed income for the vacant period. The Senate prevailed. See H. R. Rep. No. 3002, note 3 supra, at 47; Code, Section 712 (a). But Supplement A was not revised to bring its limitations in line with this change in policy.
was in existence, a constructed income based on 8% of invested capital of each corporation as of the beginning of its first taxable year beginning in 1940, is allowed.\textsuperscript{180}

This "fill-in" of vacant periods is unduly limited, if consistency with the constructive income afforded by the general provisions for the income credit is desired. The Act does not allow a fill-in under Supplement A of a vacant period of any of the corporations in any base period in which any one of the taxpayer and its component corporations was in existence. This appears to be an arbitrary rule. Obviously, the fill-in, as in the case of the non-Supplement A taxpayer, should be for the entire vacant periods of all corporations absorbed into the system.\textsuperscript{181}

Finally, a provision is added to prevent duplications in the credit by the absorption of a component corporation stock in which had been previously acquired since the beginning of the base period in consideration for the transfer of the taxpayer's assets,\textsuperscript{182} rather than the issuance of its stock.\textsuperscript{183} The situation contemplated is that where assets go out of the system in the acquisition of stock of a corporation which later becomes a component, as by the cash purchase of all the stock of

\textsuperscript{180} Act, Section 228 (c); Code, Section 742 (e). This constructive income is available only if none of the corporations was actually in existence on December 31, 1936.

Corporations absorbed as components prior to the beginning of their acquiring corporation's first taxable year in 1940 are not included in the adjustment directly, since their assets will be included through the acquiring corporation. In constructing the income, an inadmissible asset adjustment based on the last year beginning in 1939 is made, including the assets taken over from any component during the year, as well as those remaining from previous acquisitions of components.

Where an acquiring corporation absorbs a component after such day but within the component's last taxable year beginning in the base period (i.e., in 1939), the component's income in the vacant period is similarly constructed as of the day it was taken over.

Finally, proper adjustments are to be made, pursuant to Treasury regulations, to prevent the doubling up of invested capital, for purposes of computing the constructed income, on account of the cross ownership of stock between the corporations involved, resulting in an increase in invested capital of the corporation issuing the stock without a corresponding decrease in the invested capital of the corporation acquiring such stock. For an example of the operation of this provision, see Conference Report, 66-67. Note that the examples given in the House Report (pp. 154-155) and the Senate Report (p. 220) are covered by new Section 742 (f) (1), discussed below.

\textsuperscript{181} It may have been thought that the absorption of an additional corporation into the system after the basic corporation had been organized is analogous to a capital addition during the base period, and consistently with the rule with respect to capital additions, the income prior to the absorption or addition should not be built up. The difficulty with this reasoning is that the rule with respect to capital additions is also unsound, in light of the purpose to reflect in the credit the normal profits of the business as it existed at the beginning of the excess profits tax, with adjustments for capital changes thereafter. Note, however, that the provision for putting a short year on an annual basis will fill in some vacant periods. See note 176 supra.

\textsuperscript{182} Act, Section 228 (c); Code, Section 742 (f). See note 184 infra. Note also that old Section 742 (e) (1) is dropped. This section was a weak attempt at eliminating "duplication," but was meaningless since it dealt with intercorporate dividends, which were not included in excess profits net income.

\textsuperscript{183} Stock acquired by tax-free exchange for other stock which in turn had been acquired by issuing the taxpayer's stock is also not within the section.
an existing corporation, later followed by a liquidation under section 112 (b) (6) of the Code. Two sets of assets are thus involved, and they will not be permitted to do double duty either by way of doubling up of income or through adjustments for capital additions. The Commissioner is broadly authorized to prescribe regulations governing the adjustment of income and capital changes of the acquiring corporation, without any objective, measure, or standard being expressed in the statute. The legislative history is somewhat more explicit, however, and it appears that the adjustments should be limited to those necessary to prevent duplications in the circumstances outlined in the statute.\footnote{184 See House Report, 155; Senate Report, 220-221; Conference Report, 67.}

(d) Averaging the Base Period Income.—The Act makes two basic changes in the process of averaging the includible income of the various corporations, once it has been determined. First, the principle discussed above\footnote{185 See pp. 424-425 supra.} whereby the lowest base period year is built up to 75% of the average of the other years, in lieu of being built up merely to zero, as under prior law, is now available under Supplement A.\footnote{186 Act, Section 228 (c); Code, Section 742 (b) (2). The change is effective only for taxable years beginning after December 31, 1941.} Second, the so-called “normal-growth” formula is also available under Supplement A.\footnote{187 Act, Section 228 (c); Code, Section 742 (h).} As in the case of the general rule, the two methods are exclusive.

(e) Net Capital Changes.—The provision (old section 743) relating to the capital changes of an acquiring corporation has been refined, and made more explicit, but the basic principle, i.e., simply to transfer the net capital addition or reduction of the component to the acquiring corporation, remains the same.\footnote{188 Act, Section 228 (d); Code, Section 743.} One major defect remains:

Suppose the taxpayer corporation acquires after the base period, in exchange for its voting stock, the assets of a component corporation which was organized after the base period and therefore has no base period experience.\footnote{189 Or which has lost its base period experience to another corporation of which it has previously become a surviving component.} The component will contribute nothing to the taxpayer’s income credit under Supplement A. Yet if Supplement A is used, the taxpayer will not be entitled to a capital addition on account of the acquisition of the assets of the component, and instead it will be given the capital addition (including the capital paid in upon the organization of the component subsequent to the base period) of the
component—which may vary widely from the assets held by the component at the time of absorption.\textsuperscript{190} The purpose of the provision is only to prevent a double use of income from the component's assets, first through the Supplement A average base period income and then through a capital addition on the acquisition of the component's assets. In the example given, no such duplication can occur, and if the section is applied as indicated, a distortion is inevitable.

(f) Effective Date of Amendments.—In the foregoing discussion of Supplement A, it has been pointed out that the amendment contained in new section 740 (c) (2), relating to the computation of the credit of a surviving component for the year in which the exchange occurs, is limited to such exchanges in taxable years beginning after December 31, 1941;\textsuperscript{191} and that the new 75\% build-up of the lowest base period year also applies only to such years.\textsuperscript{192} In addition, the rule that an acquiring corporation is deprived of a surviving component's or its successor's base period income subsequent to the transfer of the component's assets to the acquiring corporation is retroactive to the beginning of the excess profits tax.\textsuperscript{193} As to the remaining amendments, the taxpayer is given an election, pursuant to Treasury regulations, to have them all applied retroactively to the inception of the tax; but in the absence of such election, they will be applied only to taxable years beginning after December 31, 1941.\textsuperscript{194}

\textit{(To be Concluded)}

\textsuperscript{190} Thus assets acquired by the component for bonds, and then acquired in turn by the taxpayer for its stock when it absorbed the component, would not be reflected.\textsuperscript{191} See pp. 433-434 \textit{supra}.\textsuperscript{192} See p. 438 \textit{supra}.\textsuperscript{193} See p. 434 \textit{supra}; Act, Section 228 (f).\textsuperscript{194} Act, Section 228 (f).