THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1942

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The first part of this article, which appeared in the January issue of the REVIEW, discussed the effect of the Act* on excess profits tax rates and the various elements of adjusted excess profits net income, current excess profits net income, and the invested capital credit. Without further preliminaries, except to note that this portion of the article has also been prepared without the benefit of revised Treasury regulations, and to call attention to the continuation of the reference outline in the footnote,1 the analysis of the remaining excess profits tax provisions will be continued.

I. THE INVESTED CAPITAL CREDIT

Three principal changes have been made in the determination of the excess profits credit based on invested capital. These relate to the rate of return allowed; the basis of assets in determining invested capital; and the effect of certain intercorporate exchanges and liquidations.

(1) Rate of Return

The return on invested capital free of excess profits tax is reduced, under the Act, insofar as the larger companies are concerned. The prior rate had been 8% on the first $5,000,000 of invested capital, and

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* See note 2 of the first part of this article for an explanation of the terminology employed.

1. See note 4 in the first installment of the article, 91 U. OF PA. L. REV. 394, 396.

The outline of this portion of the article follows:

I. The Invested Capital Credit
   (1) Rate of Return
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V. Conclusion.
Two additional brackets are added by the Act, reducing the allowable return on the portion of invested capital between $10,000,000 and $200,000,000 to 6%, and to 5% on the portion in excess of $200,000,000. This scaling down of the larger credits is not retroactive.

(2) Basis of Assets

Property (other than money) paid in for stock, as paid-in surplus, or as a contribution to capital, is included in equity invested capital at its original (i.e., unadjusted) basis in the hands of the taxpayer for determining loss. Prior to the Act, the rule was that if property had been disposed of before the taxable year in question, the basis of such property for invested capital purposes was determined in accordance with current law, i.e., as if the property were still held at the beginning of the year. If the basis was a substituted ("carry-over") basis, it was adjusted in the customary manner for determining loss with respect to the period before the property was paid in, in accordance with section 113 (b) (2) of the Code.

The Act changes the latter two rules. If property has been disposed of, the basis is now determined by reference to the law in effect at the time of disposition, but without regard to March 1, 1913, value. If disposed of prior to March 1, 1913, its basis is to be fair market value at the time paid in. And in the case of a substituted basis, the adjustments for the period before the property was paid in are the adjustments applicable under section 115 (1) for determining earnings and profits, rather than under section 113 (b) (2).

The new provisions are an outgrowth of the fact that accumulated earnings and profits as of the beginning of the year are included in equity invested capital. If property is disposed of in a prior year, and gain or loss is computed on a basis other than that used in determining invested capital, the total invested capital would be distorted. Thus if the invested capital basis were in excess of the basis used in determining earnings or profits, an inflated invested capital would result, either through an increased profit or decreased loss taken into

2. This allowance was fixed by section 201 of the Revenue Act of 1941. The original allowance was a flat 8%. Excess Profits Tax Act of 1940, Section 714.
3. Act, Section 217; Code, Section 714. The change was explained on the ground that the earlier allowance "is deemed too liberal in the case of many heavily capitalized companies whose earnings over long periods of normal operations have not equalled this allowance." See House Report, 20.
4. Code, Section 718 (a) (2).
5. Act, Section 218; Code, Section 718 (a) (2).
6. Code, Section 718 (a) (4).
7. The discussion assumes the existence of an accumulation of earnings. Deficit corporations do not present this problem so long as they retain the deficit, since deficits are not reflected in invested capital. See p. 538 infra.
earnings or profits. On the other hand, if the earnings or profits basis were the greater, the converse results would follow.

Since 1934 the basis for determining loss has been cost. Under the Revenue Acts of 1924 to 1932, however, such basis was the greater of cost or March 1, 1913 value; and prior to that date it was the lesser of the two. The new rule applies the law of the year of disposition, but since it eliminates consideration of March 1, 1913 value, it is in effect still a rule of cost, and to that extent is identical with the rule in force prior to the Act.

The change lies in the application of the law of the year of disposition in determining whether a new or a substituted (“carry-over”) basis is to be used. The principal occasion for a difference is the case of a disposition, prior to 1932, of property acquired on a “reorganization” pursuant to which an interest greater than 50% but less than 80% remained in the same persons. If the property were still kept, the basis would carry-over from the predecessor. But under the law in effect in 1928, for example, a new basis would have to be determined; and if 1928 was the year of disposition, such basis would govern, under the amendment contained in the Act, in determining invested capital.

This method of determining basis for purposes of invested capital conforms to that prescribed in section 115 (1) of the Code for the purpose of determining earnings or profits, and thus prevents the discrepancies outlined above.

The second part of the new rule requires, in case such basis is a substituted basis, that it be adjusted, for the period prior to being paid in, in the same manner as basis is adjusted in computing earnings and profits. That is, depletion and depreciation adjustments are determined by reference to cost rather than March 1, 1913 value, discovery value, or percentage depletion. Since the taxpayer’s earnings and

8. See Code, Sections 113 (a), 113 (a) (14).
9. E. g., Revenue Act of 1934, Section 113 (a) (14).
10. I. e., since the 1916 Act. Compare 1918 Act, Section 202 (a) and Revenue Act of 1921, Section 202 (b). But see United States v. Flannery, 268 U. S. 98 (1925) and McCaughn v. Ludington, 268 U. S. 106 (1925).
11. Revenue Act of 1932, Section 113 (a) (7); Code, Section 113 (a) (12).
12. Revenue Act of 1928, Section 113 (a) (7).
13. Section 115 (1) (1) refers to the adjusted basis for determining gain, without regard to March 1, 1913 value, under the law applicable in the year of disposition. The references to the basis for gain in the one case, and for loss in the other (in each case, without regard to March 1, 1913 value) leads to the same figure—cost. The adjustments prior to sale or other disposition will already have been reflected in the earnings account, and therefore the use of unadjusted basis for invested capital is proper.
14. In determining earnings and profits available for dividends, depreciation or depletion on March 1, 1913 value, if greater than cost adjusted for depreciation or depletion sustained prior to such date, is allowed; but the excess of such deductions over cost basis depletion and depletion is restored to earnings and profits as increase in value prior to March 1, 1913, realized thereafter. Code, Sections 115 (l) and (m); Reg. 103, Section 19.115-3; H. R. Rep. No. 2894, 76th Cong., 3d Sess., 41-43.
profits with respect to the property will be computed in light of such rules, the amount at which the property is taken into invested capital must be consistently determined.

Finally, the new rule provides that property disposed of prior to March 1, 1913 shall be included at its value when paid in. Strictly speaking, in such a case the basis for computing earnings and profits, and for invested capital prior to the Act, is cost, i. e., the value of the shares when issued for the property. Such value may not correspond with the value of the property although the contrary is the usual situation. Where the values do not correspond, a distortion will occur if depletion and depreciation deductions, and gain or loss, are based on the cost rather than the value of the property for the purpose of computing earnings or profits, and the value of the property is used in computing property paid in as capital for excess profits tax purposes.

(3) Exchanges

The amended provisions controlling the effect on invested capital of tax-free exchanges between corporations, other than intercorporate liquidations (which will be separately discussed below), may be divided into three parts: (a) the general rule laid down in section 760 of Supplement C of the Code; (b) the special rule with respect to deficits in the case of "identity" reorganizations, contained in sections 718 (a) (7), 718 (b) (5), and 718 (c) (5); and (c) the new rule, applicable only to railroad reorganizations, stemming from sections 112 (b) (9) and 113 (b) (20).

(a) The General Rule.—Although not deleted from the Code, Section 751, relating to the determination of borrowed and equity invested capital upon certain tax-free exchanges, will not apply to any taxable year beginning after December 31, 1941. A new provision, section 760 contained in the new Supplement C, will govern the effect of such exchanges upon the invested capital credit in 1942 and later years. Moreover, at the election of the taxpayer, the new provision may be applied retroactively to all taxable years beginning after December 31, 1939. The new section 760 is, however, merely a modified version of old section 751, the purpose of the revision being to elimi-
inate the loose draftsmanship of section 751 and to clear up the confused status of bonds issued on a tax-free exchange.

The definition of "exchange", which limits the scope of the section, has been simplified to refer to all cases in which one corporation receives property from another and the basis in the hands of the transferee is determined by reference to the basis in the hands of the transferor, for purposes of computing equity invested capital under section 718 (a).\(^{19}\)

It will be recalled from the discussion above that under section 718 (a) the basis of property disposed of prior to the taxable year is determined by reference to the law in effect in the year of disposition, and that prior to 1932 a reorganization resulted in a carry-over basis only if an 80% interest or control was retained.\(^{20}\) If some or all of the property acquired on a reorganization prior to 1932 is still or was thereafter held, however, the basis of such property under the 1932 and subsequent Acts is carried over if the retained control is 50% or more. Consequently, under the "tax basis" rule of the new definition of an "exchange", when tied in with the amendments to section 718 (a), the portion of a group of assets acquired on the same pre-1932 reorganization (for example, 75% control is retained) and disposed of prior to 1932 will be taken into invested capital at cost, whereas the portion of such assets held subsequent to 1932 will be taken in at the predecessor's basis adjusted in accordance with section 115 (1). However, this troublesome complexity will, in many cases, be ultimately corrected through the earnings account.

The more significant deviation from old section 751, however, is in the treatment of indebtedness. The old rule, although in many respects unclear, apparently treated the additions to equity capital of the transferee on the exchange as the basis of the transferred assets (net of liabilities assumed, liabilities to which the property was subject, and "boot") whether the new securities issued in consideration for the transfer were exclusively stock, or a combination of stock and debt securities.\(^{21}\) In the latter case, the debt securities, not having reduced equity capital, were sought to be excluded from borrowed capital.\(^{22}\)

\(^{19}\) Act, Section 230 (a); Code, Section 760 (a) (1). The corresponding prior provisions, Sections 750 (a) to 750 (c), specified in detail the transfers contemplated ("reorganizations", transfers to a "controlled corporation", and contributions to capital or paid-in surplus) without limiting the provisions to cases where the basis carried over. It was quite possible, for example, where the carry-over of basis on a reorganization depended upon the retention of a certain interest or control in the same persons, for a transfer upon a reorganization to occur without a carry-over basis. See p. 535 supra.

\(^{20}\) See p. 4, supra.

\(^{21}\) Code, Section 751 (a).

\(^{22}\) Code, Section 751 (b). See Reg. 109, Section 30.751-2.
The effect of a reorganization involving the issuance of new debt securities is in substance to convert equity capital into borrowed capital; and it will be seen from the above that section 751 specifically legislated this conversion out of the statute—to the serious disadvantage of the Treasury. The new section 760 reverses the old rule by reducing equity capital (i.e. carry-over basis net of assumed liabilities, those to which the property is subject, and "boot") in the amount of the new debt securities, and no longer excluding them from borrowed capital.

In so doing, it makes possible a minus adjustment to the transferee's daily invested capital in the event that the new debt securities exceed the net basis of the transferred assets.\(^{23}\) In case the transferee is a newly-organized corporation and receives extremely appreciated properties, it may even begin existence with an invested capital "in the red" which must be restored by capital subsequently paid in, or by an earnings accumulation, before a plus amount giving rise to a credit will be available.\(^{24}\) Moreover, the minus adjustment is permanent, with the result that upon the elimination of the debt securities by repayment, even though from earnings later accumulated, a further loss of invested capital is incurred.\(^{25}\)

(b) "Identity" Reorganizations.—Although a surplus in earnings or profits as of the beginning of the taxable year is an element of invested capital,\(^{26}\) a deficit in such account does not in the ordinary case reduce the credit. This is the so-called "deficit rule." Upon a tax-free reorganization involving a transfer of assets from one corporation to another, however, a deficit of the transferor comes into play. The addition to the invested capital of the transferee or successor corporation on account of the transfer is determined by reference to the aggre-

\(^{23}\) Code, Section 760 (c).

\(^{24}\) For example, suppose assets of a speculative nature, having a net basis of $1,000,000, are proved and thus acquire an appreciated value of $3,500,000. They are transferred to a new corporation in exchange for all its stock, having a par and fair market value of $1,000,000, and new long-term bonds in the face amount of $2,500,000. Under Section 719 (b), 50% of $2,500,000, or $1,250,000 is included as borrowed invested capital, and the reduction of daily invested capital under Section 760 (c) is $1,500,000. This leaves $250,000 "deficit" in invested capital, resulting in no credit.

\(^{25}\) In the above example, an accumulation of earnings in the amount of $250,000 would offset the "deficit" in invested capital, still leaving invested capital at zero—despite a cash investment of $1,000,000; an accumulated surplus of $250,000; a funded debt of $2,500,000; and assets worth $3,500,000! If $1,250,000 in earnings were accumulated, the invested capital would rise to the $1,000,000 cash investment. If bonds in that amount were then paid off from the surplus, the invested capital would fall to $375,000. It would be necessary to accumulate a surplus of $2,500,000 if all the bonds were retired, in order to retain the $1,000,000 invested capital thereafter.

\(^{26}\) Code, Section 718 (a) (4).
gate basis of the transferred assets, adjusted to the date of transfer, as explained above.\textsuperscript{27} The loss of assets originally paid in and the adjustments reducing basis will reflect the deficit—with the result that invested capital, in the amount of the deficit, will disappear.

This rule leads to a difference in treatment—difficult to justify—between reorganized and unreorganized deficit corporations. Its more obvious inequities were seen, prior to the Act, in the case where the deficit corporation was in all major respects identical with the predecessor, \textit{e.g.,} in the case of a change in domicile from one state to another. Section 219 of the Act is designed to correct this unfairness, but only in extremely limited circumstances. Its narrow relief is available retroactively to all taxable years beginning after December 31, 1939.\textsuperscript{28}

The scheme of section 219 is to place the transferee corporation in the same position with respect to invested capital as the predecessor company prior to the reorganization, \textit{i.e.,} to leave equity invested capital unreduced by the occurrence of the deficit, but to require restoration of the deficit out of future earnings before including any plus amount of earnings and profits in invested capital. This is accomplished in part by adding to the invested capital of the transferee, as a separate item, an amount “equal to the portion of the deficit in earnings and profits of a transferor attributable to property received previously to such day,”\textsuperscript{29} thus restoring the deficit otherwise reflected through the operation of section 760 of the Code. The deficit is maintained, for the purpose of computing earnings and profits as an element of invested capital,\textsuperscript{30} by treating the transferee as if it had been in existence immediately before the beginning of the taxable year in which the transfer occurred and had then sustained a recognized loss in such amount.\textsuperscript{31} The transferor, on the other hand, receives the converse treatment under the section. Its equity invested capital is reduced in the amount of the deficit; and its earnings and profits are computed for excess profits

\begin{itemize}
\item \textsuperscript{27} See pp. 537, 538 \textit{supra}.
\item \textsuperscript{28} Act, Section 219 (d).
\item \textsuperscript{29} Act, Section 219 (a); Code, Section 718 (a) (7). Obviously, it will be impossible to attribute a deficit to particular property. This provision must mean that if less than all the assets are transferred, the deficit will be pro-rated in accordance with the proportion of the property transferred.
\item \textsuperscript{30} This will require a double computation of earnings and profits for tax purposes, as well as book surplus for corporate purposes.
\item \textsuperscript{31} Act, Section 219 (c); Code, Section 718 (c) (5). This rule would seem to follow as a matter of course under the general theory of Commissioner v. Sansome, 60 F. (2d) 931 (C. C. A. 2d, 1932). It is possible, however, that the “Sansome rule” may not apply to deficits. See Rudick, “Dividends” under the Income Tax Law (1941) 89 U. of Pa. L. Rev. 865, 896. In any event, the statutory rule should be read as at most ratifying and not duplicating the “Sansome” adjustment.
\end{itemize}
tax purposes as if a recognized gain had been realized immediately before the beginning of the taxable year of the exchange.82

The situation in which the new provisions may be applied is strictly limited by the following conditions: 88

(1) "Substantially all" the property of the transferor corporation must be transferred to the transferee corporation.84

(2) The latter corporation must have been "formed to acquire such property."

(3) The "sole consideration" for the transfer of the property must be the transfer of all the stock (except qualifying shares) of the transferee to the transferor or its shareholders. However, the assumption of the transferor's liabilities, and liabilities to which the property is subject, are disregarded.85

(4) The transferor's basis for the property must carry over to the transferee.88

(5) The transfer must be "forthwith completely liquidated" in pursuance of a plan under which the property is acquired; and

(6) "Immediately after the liquidation," 87 the shareholders of the transferor must own all such stock.

The several limitations of the new provision suggest that it was written to cover a specific situation then known to exist. In any event

32. These adjustments will be of little consequence. The new provisions apply only to the determination of daily invested capital after the exchange. Since the transferor must be "forth completely liquidated" (condition (5) below), adjustments to the transferor's invested capital will be for a brief period only.

33. Act, Section 219 (c); Code, Section 718 (c) (5).

34. Cf. Code, Section 112 (g) (1) (C). The phrase "substantially all" has not proved a satisfactory legislative tool in the past. See Pillar Rock Packing Co. v. Com'r., 90 F. (2d) 949 (C. A. 9th, 1937) (68% insufficient); Com'r. v. First National Bank of Altoona, 104 F. (2d) 865 (C. A. 3d, 1939) (86% sufficient); Western Industries Co. v. Helvering, 82 F. (2d) 461 (App. D. C., 1936); Gross v. Com'r., 88 F. (2d) 567 (C. A. 5th, 1937); Daily Telegram Co., 34 B. T. A. 101 (1936); American Foundation Co. v. U. S., 120 F. (2d) 807 (C. A. 9th, 1941) (value, not cost, the measure); Schuh Trading Co. v. Com'r., 95 F. (2d) 404 (C. A. 7th, 1938) (worthless assets disregarded); Milton Smith, 34 B. T. A. 702 (1936) (assets withheld to pay debts disregarded).

35. Cf. Code, Sections 112 (b) (5); 112 (g) (1) (C); U. S. v. Hendler, 303 U. S. 564 (1938); Helvering v. Southwest Consolidated Corp., 315 U. S. 194 (1942).

36. Code, Sections 112 (g) (1) (C), 113 (a) (7) (B). This would seem to follow as a matter of course without such a provision. The function or purpose of the phrase "for the purposes of this subsection" in the new Section 718 (c) (5) (B) is not readily apparent.

37. The phrase "immediately after" the transfer or exchange has also proved a serious legislative stumbling block in the past. See Code, Sections 112 (b) (5); 112 (g) (1) (D); 113 (a) (7) (A); Bassick v. Com'r., 85 F. (2d) 8 (C. A. 2d, 1936); cert. den. 290 U. S. 552 (1935); Hazeltine Corp. v. Com'r., 89 F. (2d) 513 (C. A. 3d, 1937); Com'r. v. Schumacher Wall Board Corp., 93 F. (2d) 79 (C. A. 9th, 1937); Case v. Com'r., 103 F. (2d) 283 (C. A. 9th, 1939); Heberlein Patent Corp. v. U. S., 105 F. (2d) 965 (C. A. 2d, 1939); Portland Oil Co. v. Com'mr., 109 F. (2d) 470 (C. A. 1st, 1940), cert. den. 310 U. S. 650 (1940); Briggs-Darby Construction Co. v. Com'r., 119 F. (2d) 89 (C. A. 5th, 1941); Handbird Holding Corporation, 32 B. T. A. 238 (1935); Columbia Oil & Gas Co., 41 B. T. A. 38 (1940), aff'd. 118 F. (2d) 459 (C. A. 5th, 1941); Wilgard Realty Co., 43 B. T. A. 557 (1941).
it does not approach an adequate treatment of the problem of reorganized deficit corporations. Even as to the "identity" type of reorganization, the area encompassed by the new provision is too restricted to cover many cases of practical identity. It completely fails, apparently, to cover the case of two or more transferors of assets to the new corporation, or the merger of existing corporations, even though proportionate interests are rigidly maintained. It covers only by implication the case of statutory merger of a predecessor and a new successor company, as a constructive transfer of assets for stock followed by a liquidating distribution and dissolution. And the limitation of the consideration "solely" to stock and assumed liabilities (or liabilities to which the property is subject) will exclude many reorganizations involving substantial identity merely because of new debt securities, stock warrants, liabilities assumed in the course of reorganization, and various elements in the transaction which may be in some way classed as "consideration" other than stock and assumed liabilities. Finally, protracted consideration will doubtlessly be required to settle the question whether the issuance of new debt securities in lieu of those outstanding at the time of reorganization represents an "assumption" of liabilities "of the transferor." 40

(c) Railroad Reorganizations.—A further limited attack on the problem of deficit reorganizations was made for the benefit of railroad and electric railway companies undergoing reorganization. These provisions have the effect of carrying the basis of the assets over from the transferor or predecessor corporation to the transferee or successor corporation in the case of a reorganization of companies of that type under court supervision pursuant to receivership and bankruptcy laws—whether or not the "reorganization" would qualify as such under section 112 (g) of the Code. 43 The indirect effect, therefore, is that in the application of section 760 of the Code, the equity invested capital of the new company turns on the basis of the assets

39. Ibid.
41. Act, Section 142 (b); Code, Section 113 (a) (20).
42. Act, Section 142 (c); Code, Section 113 (a) (21).
43. The "reorganization" definition in Section 112 (g) has become so technical as not to encompass many true business reorganizations under the bankruptcy laws. Cf. Helvering v. Southwest Consolidated Corp., 315 U. S. 194 (1942). Where the enterprise in fact continues in operation, and the issue (invested capital) is one of prior investment in the business, failure to meet the many technical pitfalls in the tax concept of "reorganization" should not be allowed to prevent a fair determination of the excess profits tax. If a "reorganization" under section 112 (g) did not occur, and this were retained as the test of a carry-over basis for invested capital purposes, the result would be to fix invested capital under Section 718 (a) at depressed property or security values at the conclusion of bankruptcy. See generally, statement of W. James MacIntosh, and supplementary memorandum, House Hearings, p. 1839 et seq.
in the hands of the old, and in effect will be the basis of the assets at that time, net of liabilities surviving reorganization.\textsuperscript{44}

The policy reflected in these provisions is sound, as values at the time of bankruptcy reorganization obviously are no fair measure of the invested capital of an enterprise that is continued by reorganization rather than liquidated. The principal weaknesses of the new provisions are that they fail to extend similar treatment—which is justified on precisely the same grounds—to (a) reorganizations affected by recapitalization rather than by transfer of assets to a new corporate vehicle, and (b) to reorganizations of industrial corporations under the bankruptcy laws.\textsuperscript{46}

\textit{(4) Intercorporate Liquidations}

Section 761 of the Code is the new provision, controlling the effect on invested capital of an "intercorporate liquidation," added by section 230 (a) of the Act. Section 230 (c) thereof prevents the application, in taxable years beginning after December 31, 1941, of sections 718 (a) (5) and 718 (b) (4) of the Code, relating to "gain" and "loss" on tax-free liquidations, and of section 718 (c) (4) relating to property paid in for stock on merger or consolidation.\textsuperscript{46}

Under the new provision an "intercorporate liquidation" contemplates the receipt by the taxpayers of property not only in a complete liquidation of another corporation which is tax-free under section 112 (b) (6) of the Code, or a corresponding provision of prior law, as was the case prior to the Act, but also the receipt of property to which "a provision of law is applicable prescribing the non-recognition of gain or loss in whole or in part upon such receipt (including a provision of the regulations applicable to a consolidated income or excess profits tax return but not including section 112 (b) (7), (9) or (10)

\textsuperscript{44} Complementary provisions relating to cancellation of indebtedness and the recognition of losses were also enacted. See Act, Section 142 (a); Code, Section 112 (b) (9); Act, Section 114 (b); Code, Section 23 (b) (10).

\textsuperscript{45} It appears that Treasury and Congressional experts and committee members agreed, when the Act was under consideration, that the policy of the railroad legislation should be extended to industrials in subsequent legislation as soon as it could be prepared. See statement of Senator Vandenberg, Cong. Rec. October 6, 1942, p. 8080, as follows:

"Mr. President, I simply wish to observe in passing that this relief is extended exclusively to railroad corporations. It is generally agreed in the Finance Committee, and, I think, in the staff of the Treasury Department, that similar relief is justly and legitimately due to other corporations generally. It simply has been a physical impossibility, according to the Treasury, to develop the total text to cover the situation as a whole in time for consideration in the pending bill. I should like, however, to make it plain that there is general agreement that the relief should be universally extended at the first available opportunity."

\textsuperscript{46} As to optional retroactivity of the new provision, see note 18 \textit{supra}.
or a corresponding provision of a prior revenue law)." 47 The writer has found no significance in the quoted subsection beyond the intercorporate liquidation during a consolidated return period, 48 since it is immediately followed by a limiting phrase—"but only if none of such property so received is a stock or a security in a corporation the stock or securities of which are specified in the law applicable to the receipt of such property as stock or securities permitted to be received (or which would be permitted to be received if they were the sole consideration) without the recognition of gain." The latter clause eliminates the application of the section to the constructive liquidation involved in a "reorganization" of the subsidiary under which the taxpayer, as the parent, exchanges its stock in the old subsidiary for stock in the successor or reorganized corporation.

The operative provisions of the section are a prime example of the complex technique in legislative draftsmanship of which we have seen so much in recent times. Two working concepts—the "plus adjustment" and the "minus adjustment"—are set up in sections 761 (b) (1) and (2), with a third provision, section 761 (b) (3), supplying the "rules" for arriving at such concepts under their individual definitions. In brief, the "plus adjustment" is the excess of money and the adjusted basis of property received by the taxpayer on the intercorporate liquidation over the adjusted basis of the shares surrendered therefor, net of liabilities assumed, liabilities to which the transferred property is subject, and "boot." The converse is the "minus adjustment." These formulas correspond to the "gain" and "loss" on tax-free liquidations under old sections 718 (a) (5) and 718 (b) (4) of the Code.

With the concepts of a "plus adjustment", and a "minus adjustment" thus tentatively defined, section 761 (c) lays down further "rules" which represent merely a further development of the meaning of such concepts for purposes of the section. These additional "rules" fall into two parts: (a) the rule where the liquidated stock has a "cost basis"; 49 and (b) the rule where the liquidated stock has "other than a cost basis." 50

47. Act, Section 230 (a); Code, Section 761 (a). Note that the section erroneously refers to a non-existent section 112 (b) (10) of the Code, which was never enacted either as a Code provision or as a counterpart under prior laws, and to Section 112 (b) (7) of the Code, which has never existed as a Code provision, although it was part of the Revenue Act of 1938. However, Section 112 (b) (9) is a bona fide reference to a new provision on railroad reorganizations. See pp. 541-542 supra.

48. Statutory mergers and consolidations, where the surviving corporation owned stock in the merged company, are separately covered in Section 761 (f), under which the property attributable to such stock is treated as having been liquidated on an intercorporate liquidation.

49. Act, Section 230 (a); Code, Section 761 (c) (1).

50. Act, Section 230 (a); Code, Section 761 (c) (2).
The rule as to stock having a cost basis in effect specifies an artificial basis to be attributed to the property transferred in liquidation of the shares held by the taxpayer, for purpose of computing the plus or minus adjustment. While such basis is elaborated upon at great length in the statute, the substance of it is to give to the net assets, for such purpose, the basis (adjusted cost) of the surrendered stock. Where the stock has "other than a cost basis," the normal carry-over basis of the assets is used in computing the plus or minus adjustment.

After these definitions are thus finally completed, sections 761 (d) and (e) prescribe the operative rule of the new provision. The plus adjustment or minus adjustment is to be made to the earnings and profits account of the taxpayer in the case of stock having a cost basis; and to the equity invested capital, as an additional element thereof under section 718 (a) or a reduction thereto under section 718 (b), in the case of stock having a basis other than a cost basis. Further, the assets are thereafter to retain the basis used in computing the plus or minus adjustment for all invested capital purposes.

Devious as this approach is, its basic philosophy is relatively simple. The stock of a subsidiary may be first acquired and its assets then taken over by liquidation, or the assets may be acquired directly in the first instance. In either case the consideration may be cash, thus resulting in a cost basis, or stock of the taxpayer, thus resulting in a carry-over basis. The objective of section 761 is to arrive at the same invested capital result, whether the assets are acquired directly, or indirectly by means of a stock acquisition followed by liquidation. This is the normal effect of the complex adjustments.

The Commissioner, with the approval of the Secretary, is specifically authorized to issue regulations as to the various determinations under the new provision, and to liquidations extending over a long period of time.

51. See Act, Section 230 (a); Code, Sections 761 (c) (1) (A)-(E). The difficult computations envisioned by this section will be apparent upon a glance.

52. Act, Section 230 (a); Code, Section 761 (c) (2). Query whether stock the basis of which is determined by reference to the basis of property previously held (which had a cost basis) is stock having "other than a cost basis." It should not be so treated, but Section 113 (a) of the Code treats basis so determined as an exception to the rule that the basis of property is cost. See Sections 113 (a), 113 (a) (6). Note that the consolidated returns regulations more carefully refer to basis carried over from a predecessor. Reg. 110, Sections 33.31 (b) (a) (iv) (F), 33.31 (b) (a) (iv) (G); 33.31 (b) (a) (v) (A).

53. This will require a separate computation of earnings and profits for excess profits tax purposes.

54. Act, Section 230 (a); Code, Section 761 (g).
II. General Relief

The “general relief” provisions of section 722 of the Code have been completely rewritten. The revised provisions are of primary importance to all prosperous corporations exposed to the high excess profits tax rate, in that they afford an opportunity for liquidation, in particular cases and on broad and equitable principles, of the many unfair applications of the otherwise specific and rigid excess profits tax. Liberalization is the key note of the changes made in the section.

All the former grounds for relief have been retained and broadened, and new grounds have been added. The benefits of the section have been extended to corporations which came into existence after January 1, 1940 and as a consequence were limited under prior law to the invested capital credit, for which no relief was provided. Former arbitrary limitations on the amount of relief have been eliminated. Finally, the new provisions have been made retroactive to cover all excess profits tax years.

To secure relief under section 722, the taxpayer must first establish that the tax computed without regard to the section is an “excessive and discriminatory” tax. This may be regarded as a requirement of eligibility. Having established eligibility, the taxpayer must then establish a “fair and just amount representing normal earnings to be used as a constructive average base period net income”—which use is the “relief” granted.

The phrases “excessive”, “discriminatory”, “fair”, “just”, and “normal” necessarily sacrifice precision and certainty. They do so, however, in the interest of achieving substantial justice in cases where the other statutory provisions are inadequate for the very reason that they are precise and certain. Moreover, the general pattern, legislative history, and fundamental philosophy of section 722 are not without their guidance as to its interpretation. There is, for example, one ultimate touchstone by which nearly all the language of 722 may be tested. That is the assumption that the years 1936 through 1939 represent a fair measure of normal profits of American business. Although the section does not expressly so provide, it is evident from the eligibility requirements laid down and Congress' general approach to the problem that if the taxpayer can show that for some reason recognized in the statute it failed to achieve such “normal” profits, the “relief” would at

55. “Special relief” prior to the Act.
56. See Act, Section 222.
57. See, for example, House Report, 143; Senate Report, 199. Relief may, of course, be founded on the ground that this assumption is erroneous in the case of particular industries. See, for example, Act, Section 222 (a); Code, Section 722 (b) (3).
least include an adjustment in credit to compensate for failure to attain such level.

(i) Corporations Using the Average Earnings Method

Under the new section 722 (b), a corporation entitled to use the income credit—i.e., one either in existence prior to January 1, 1940 or which comes into existence thereafter and qualifies for the income credit under Supplement A—will be eligible for relief if its average base period net income is an inadequate standard of normal earnings because of any one or more of the following circumstances:

(a) Normal production, output, or operation during any part of the base period was interrupted or diminished because of the occurrence, during or immediately prior to the base period, of events unusual and peculiar in the experience of such taxpayer.

This type of event or circumstance, which was also embodied in the former law, is primarily physical rather than economic in nature and would include, for example, fires, floods and strikes. It should be noted that the new provision is made applicable to cases where base period earnings are diminished by occurrences "immediately prior to" as well as "during" the base period, and under circumstances indicating a sufficiently direct causal connection, this phrase may include occurrences as much as several years before the beginning of the base period.

58. Section 722 (b) is headed "Taxpayers Using Average Earnings Method" and it in terms covers "a taxpayer entitled to use the excess profits credit based on income pursuant to Section 713" (italics inserted). Section 712 states that the credit of a taxpayer "shall be" the greater of the credits computed under 713 (income) and 714 (invested capital). The language of the two sections would, literally construed, make those corporations having base period experience whose credit based on income without benefit of relief is less than their credit based on invested capital eligible for relief only on the grounds for relief set forth in Section 722 (c), discussed below. However, it is clear that Congress intended no such restricted meaning of the word "entitled", and it is not to be expected that the Commissioner would attempt to assert such a position. The taxpayer is in a general sense entitled to the income credit, but such credit is less than the invested capital credit to which it is also entitled. In this connection, note that the Senate report (p. 35) points out that the relief provided for in Section 722 (b) "is granted to all taxpayers in existence during the base period, even though they computed their excess profits on the invested-capital basis." Moreover, the Act was intended to broaden relief, and prior law would have allowed such taxpayers relief on the grounds now stated in Section 722 (b).

The Committee reports in explaining the relief provisions extended to "invested capital" corporations by Section 722 (c), refer to the disadvantageous position under prior law of "corporations commencing business after January 1, 1940, as well as other corporations deprived of such credit" (based on income). The latter phrase is intended to refer to those foreign corporations engaged in trade or business within the United States, that are limited by Section 712 (b) to the invested capital method. See House Report, 146; Senate Report, 203.

59. Act, Section 222 (a); Code, Section 722 (b) (i).
60. Senate Report, 198; House Report, 143.
62. This new phrase is also employed in connection with changes in character of the business and its possible scope is further discussed here. See pp. 548-550 infra.
(b) The taxpayer's business was depressed in the base period because of temporary economic circumstances unusual in the case of such taxpayer, or because it was a member of an industry which was depressed by reason of temporary economic circumstances unusual in the case of such industry.63

This ground for relief is concerned with distortions of base period income by reason of temporary economic circumstances peculiar to the taxpayer's business or peculiar to the industry of which it is a member, and is not in conflict with the general rule that ordinary economic hazards to which business in general is subject, such as prevailing high costs of production, low demand, or low selling prices for the taxpayer's product, do not afford a basis for relief.64 For example, the earnings of an entire industry may have been severely depressed because of a price war carried on during the base period. On the other hand, although the industry's experience as a whole during the base period may have been normal, the taxpayer's earnings may have fallen off because of an economic disturbance limited to its particular business. For example, business may have depended on a single customer who may, for some reason, have been lost during the base period. The remainder of the base period may have been largely devoted to re-establishing a market for the product without attaining normal earnings for an appreciable time.65

(c) "The business of the taxpayer was depressed in the base period by reason of conditions generally prevailing in an industry of which the taxpayer was a member, subjecting such taxpayer to

"(A) a profits cycle differing materially in length and amplitude from the general business cycle, or

"(B) sporadic and intermittent periods of high production and profits, and such periods are inadequately represented in the base period." 66

This ground for relief calls for economic analysis to an even greater extent than the others contained in section 722 (b). The taxpayer seeking relief under clause (A) must establish that the business cycle of its industry is "materially" out of line with the general business cycle, and further that the consequence was to depress its earnings in the base period. This is said to require an analysis of the "entire economic history" of the industry,67 and presumably, for purposes of comparison, of industry in general. The prima facie measure of the

63. Act, Section 222 (a); Code, Section 722 (b) (2).
64. See House Report, 143; Senate Report, 199.
65. See House Report, 143; Senate Report, 199.
66. Act, Section 222 (a); Code, Section 722 (b) (3).
67. See House Report, 143; Senate Report, 199.
constructive credit seems to be the taxpayer’s earnings in a period which represents the same phase of the cycle of the industry of which it is a member as the years 1936 through 1939 represent in relation to the cycle for business generally.68 Certainly there will be room, however, for correction of those years to the extent that in the particular taxpayer’s case the earnings during such normal cycle were out of line with the rest of the industry.69 The machine-tool industry and the building industry are possible examples of industries entitled to relief under this provision.70

Taxpayers eligible for relief under clause (B) are members of industries having a high degree of irregularity in profits without any discernible cycle. The quantum of relief here will be a particularly difficult matter, as almost by definition there is no “normal” period, unless it be one which has both good and bad years in a proportion consistent with experience over a long period. This test is indicated in the House Report, in which the canning industry is cited as a case in which “ordinarily in one out of every four years the earnings were substantially above the average of the other three, and . . . it had no such high earnings in the base period . . . .”.71

(d) “The taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business.” 72

The term “change in the character of the business” by statutory definition, includes the following: 73

(i) A change in the operation or management of the business;
(ii) A difference in the products or services furnished;
(iii) A difference in the capacity for production or operation;
(iv) A difference in the ratio of nonborrowed capital to total capital; and
(v) The acquisition before January 1, 1940 of all or part of

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68. See House Report, 144; Senate Report, 199. Note, however, that examples in the House Reports suggest the use of a previous high phase, rather than something comparable to “moderate prosperity” in the industry. Thus the years 1926-1929 in the heavy machinery industry, referred to as the last period of “high earnings,” is mentioned. See p. 546 supra, third example.
69. Note that the example referred to in the preceding footnote is phrased in terms of a single taxpayer rather than the industry at large.
70. See House Report, 144; Senate Report, 199.
71. See pp. 22-23. Note that the largest four year period involving one good year is mentioned as the measure of normal earnings; and also that such period will yield a credit approximately equal to the average for the 14-year period examined.
72. Code, Section 222 (a); Act, Section 722 (b) (4).
73. Ibid.
the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished.\footnote{The acquisition before May 31, 1941, of substantially all the assets of a competitor in the dissemination of news through the public press qualifies by special provision.}

Of these specific types of change, only (i) is new to the statute; \footnote{All the former types of change in character of business have been retained except the case where "the taxpayer was in existence during only part of its base period." Note also that the statutory list is not necessarily all-inclusive, as the section merely provides that the term "includes" the specified changes.} but the practical effect of the other types has undoubtedly been broadened through numerous illustrations in the committee reports indicating a liberal approach to them, and by the relaxation of the section in general. Moreover, the Act eliminates the provision of old section \textsection{722} (b) (4), limiting the constructive average base period net income to the income constructed for the last year of the base period.

The rule of section \textsection{722} (b) (4) is that the change in the character of the business must have occurred during or immediately prior to the base period, and of section \textsection{722} in general that no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally, occurring or existing after December 31, 1939.\footnote{Act, Section 222 (a); Code, Section 722 (a).} As to pre-base period changes in the character of the business, in determining whether they occurred "immediately prior to the base period," no arbitrary temporal limitations control. The test is whether under normal conditions the effect of the change would not be manifested until sometime after the beginning of the base period and would be directly related to the change.\footnote{House Report, 144-145; Senate Report, 200.} The same principle would, of course, apply with respect to a commencement of business prior to the base period. The December 31, 1939 cut-off date is subject to two exceptions:

First, any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939 as a result of a course of action to which the taxpayer was committed prior to January 1, 1940, is deemed to be a change on December 31, 1939 in the character of the business. The term "commitment" is not limited to its ordinary contractual sense. It includes the expenditure of money or other changes in position clearly establishing the intent to increase capacity. The Committee Reports indicate, however, that a change of this character will not be taken into account in determining the constructive average base period net income for any excess profits tax year prior to that in which such change was completed.\footnote{House Report, 146; Senate Report, 202.} The term "completed" should be read as meaning sufficiently
completed to contribute to current income, for the legislative reports indicate that the extent to which the new facilities enter into the business of the corporation for the taxable year shall be considered to be the extent to which the character of the business was changed on December 31, 1939.\textsuperscript{79}

Second, it is provided that in the case of commencement or a change in the character of the business occurring during or immediately prior to the base period, if the business did not reach the earning level by the end of the base period which it would have reached if the business had been commenced or changed two years earlier, the commencement or change shall be deemed to have occurred at such earlier date. This is a “growth” provision, \textit{i.e.}, it is designed to include in the base period the results of growth that would have been available if the change had occurred earlier, thus reflecting normal earning capacity for the business in its changed condition.

In determining such growth, consideration is to be given to the business experience of the taxpayer and to its prospects at the end of the base period. However, events occurring or existing after December 31, 1939 are to be disregarded.\textsuperscript{80} Accordingly, the provision does not permit an automatic adoption, as of the end of the base period of the earnings level actually reached at the end of the second year following the change, since such level may be reached at a time subsequent to the base period. In the latter case, the effect of post-base period conditions will have to be eliminated.

\textbf{(e) Any other factor, consistent in principle with the foregoing, which prevented the base period earnings from representing an adequate standard of normal earnings.}\textsuperscript{81}

This ground for relief is intended to cover taxpayers who fulfill the spirit but not the letter of the more specific grounds set forth above, and will function principally as a deterrent to narrow construction of provisions intended to receive broad and liberal treatment. The Senate Report illustrates this provision by citing the example of a corporation organized shortly before the beginning of the base period to carry on a kind of business that requires a long period of preparation before the realization of earnings.\textsuperscript{82}

\textsuperscript{79} Ibid.
\textsuperscript{80} See House Report, 145; Senate Report, 200-201.
\textsuperscript{81} Act, Section 222 (a); Code, Section 722 (b) (5).
\textsuperscript{82} See pp. 202-203. The example given is a distillery organized in 1935 without reserve stocks. This example sheds little real light on the possible scope of the catch-all provision since a taxpayer of that type would qualify under Section 722 (b) (4) as a case of commencement of business.
(2) Corporations Organized after December 31, 1939

Section 722 (c) extends relief to corporations organized subsequent to December 31, 1939, which, except for section 722, would be forced to rely exclusively on the invested capital credit. The tax in the case of such corporations is considered to be excessive and discriminatory if the invested capital credit is an inadequate standard for determining excess profits for any one or more of the following reasons:

(a) The business of the taxpayer is of a class in which intangible assets, not includable in invested capital under section 718, make important contributions to income;

(b) The business of the taxpayer is of a class in which capital is not an important income-producing factor; or

(c) The invested capital of the taxpayer is abnormally low.

If the taxpayer qualifies for relief under one of these tests, it is entitled to use the average earnings or income method of computing its credit, despite the absence of actual earnings during the base period. A constructive credit equal to a fair and just amount representing normal profits is used as average base period net income. This does not necessarily imply a mere correction of invested capital by including the intangibles otherwise not includable, or building it up to a point where it is no longer "abnormally low." The quest is "normal profits", and if they exceed or are less than the allowable return on a normal invested capital, they presumably will nevertheless prevail as the measure. Here typical experience in the industry during the base or other "normal" period will be of vital importance.

The statutory language setting forth these three grounds of relief is, of course, quite general. Again, however, the committee reports supply a measure of guidance. A typical example of "intangible assets not includable in invested capital" would be contacts developed with customers. The second ground for relief covers taxpayers engaged in a kind of business, such as that of a fashion consultant, in which capital is not nearly so important a factor in producing income as skill, reputation, personnel, etc. The third ground for relief of new corporations—where the invested capital is abnormally low as compared with other corporations in the same line of business—would include a

83. 722 (c) is not limited to newly organized corporations but covers any taxpayer "not entitled to use the excess profits credit based on income pursuant to Section 713." Thus foreign corporations excluded from the income credit by Section 712 (b) would also be eligible for relief under this subsection. See note 58 supra.

84. The section expressly avoids duplication of credit and capital additions and reductions under Sections 713 (g) and 743, by dating the latter from the date after which they are not reflected in the constructed credit.

85. See House Report, 147; Senate Report, 203.
corporation whose principal capital asset is a leased plant not acquired for stock or as paid in surplus or capital.

(3) Procedure under Section 722

Consistently with the substantive changes which make relief available to many more corporations, the Act has made relief procedurally more attractive. The former minimum and maximum limits on the amount of relief that may be claimed have been removed.66

It is also now possible for a taxpayer partially to defer payment of the tax while its relief application is pending.67 The deferment applies to 33% of the amount of the reduction in tax applied for, and is granted only in cases where the adjusted excess profits net income, computed without relief, is in excess of 50% of normal tax net income.68 Although the new section 722 is retroactive to all excess profits years,69 the deferment provision, contained in section 710 (a) (5), applies only to taxable years beginning after December 31, 1941.90

If a determination under section 722 results in a reduction of tax in excess of the amount deferred, the difference is treated as an overpayment, while a determination of a tax greater than that paid is treated as a deficiency;91 and interest accrues accordingly to the taxpayer or the government. Such overpayments or deficiencies will, of course, be partially offset by a corresponding increase or decrease in the amount of income subjected to normal and surtax.92

86. Under prior law, Section 722 (c) stated as pre-requisites to relief: (1) that the tax without relief exceed 6% of normal tax net income (without deduction of the excess profits tax); and (2) that the relief applied for decrease the tax by more than 10%. The House bill reduced the latter requirement to 5% but otherwise retained the former limitations to prevent a flood of claims. See House Report, 148. The Senate eliminated these provisions (see Senate Report, 204) and the House managers receded in conference. See Conference Report, 62. In addition, Section 722 (d) of prior law fixed two limits on the amount of the reduction obtainable by relief: (1) relief could not reduce the tax below 6% of normal-tax net income; and (2) after the tax was computed with relief, it was increased by 10% of the tax computed without relief.

87. Act, Section 222 (b); Code, Section 710 (a) (5).

88. Computed without the credit provided in Code, Section 26 (e) (relating to adjusted excess profits net income).

89. Act, Section 222 (e).

90. Act, Section 201.

91. See House Report, 149; Senate Report, 205.

92. Changes in adjusted excess profits net income as a result of the relief provisions must surely be reflected in the Section 26 (e) credit. As sometimes happens, however, Section 722 was treated as an isolated problem by the draftsmen. Neither 26 (e) nor any of the (usual) multiple cross-references radiating therefrom refers to Section 722. 26 (e) refers to 710 (b), which refers to 711 and 712, which in turn refer to 713 and 714.
Applications for relief must ordinarily be filed within six months after "the date prescribed by law" for the filing of the return; but applications relating to taxable years beginning before January 1, 1942, must be filed on or before September 15, 1943. In addition, even after these periods for claiming full relief have expired, a claim for relief may be raised as an offset against a deficiency in excess profits tax, but relief will be limited to the amount of the deficiency. When a credit based on a constructive base period net income has once been determined, the Commissioner is given power by regulation to waive the application in future years.

As under prior law, relief claims disallowed by the Commissioner are referred exclusively to the Tax Court. The Act, however, adds an amendment providing for specialization within the court itself. Determinations by any division of the Court are to be reviewed not by the entire Court, but by a special division thereof constituted by the Presiding Judge and consisting of at least three judges. The decisions of the special division are deemed decisions of the court.

(4) The Place of Section 722 in the Excess Profits Tax Law

There remains to be seen how a constructed credit under section 722 fits into the excess profits scheme: in general, to see to what extent a constructed credit is a complete substitute for a credit otherwise computed; and in particular to see how section 722 ties in with other provisions of the law in the nature of relief measures such as, for example, the unused credit adjustment, the "75%" provision, "normal growth." Supplement A, the 80% limitation, the foreign tax...
credit,104 credit adjustments on account of capital changes,105 and income abnormality adjustments under section 721. The relationship between some of these provisions and 722 is made explicit in the statute, but in others it is left to inference and construction.

No interpretative problem is presented by the provision of section 710 (a) (1) (B) which limits the excess profits tax to an amount which, when added to the normal tax and surtax, equals 80% of surtax net income.106 The 80% rule will, however, cut down the number of section 722 claims by eliminating many applications for small adjustments, since the constructed credit would first have to outrun the benefits derived from the 80% rule before section 722 relief would reduce tax liability for the year.107

The statute deals explicitly with the relationship between section 722 relief and the benefits of the foreign tax credit, capital additions and reductions, income abnormalities, and Supplement A. In determining whether the tax computed without section 722 relief is excessive and discriminatory, the foreign tax credit is not to be taken into consideration.108 As indicated above, the capital additions reflected in the constructed credit of an invested capital corporation may not be further reflected through the adjustments for capital changes since the base period.109 Section 721 (f) of the Code expressly provides that if a credit under section 722 is partially attributable to research and development factors of the type listed in section 721 (a) (2) (C), abnormal income resulting from such factors in an excess profits year may be reallocated only among excess profits years.110

With respect to Supplement A taxpayers, the Act clearly eliminates any doubt as to whether they might also have the benefit of section 722, by providing that the business of the absorbed corporations shall be treated as part of the business of the taxpayer "for the period for which the income of . . . (the absorbed corporations) is included in the computation of the average base period net income of the taxpayer." 111 This will permit a reconstruction of the base period earnings of the absorbed corporations as well as those of the taxpayer proper. The term "period" in the statute, quoted above, refers to the current taxable period, and not to the base period. It will be seen, upon a moment's consideration, that all circumstances surrounding the entire

104. Code, Section 729 (c).
105. Code, Section 713 (g).
106. Computed without regard to the Section 26 (e) credit.
107. This will ease the administrative burden. Compare note 86 supra.
108. Act, Section 222 (a); Code, Section 722 (e) (1).
109. See note 84 supra.
110. See Act, Section 222 (a); see also p. 417 of the first installment of this article.
111. Act, Section 222 (a); Code, Section 722 (e).
base period of the absorbed corporation may be taken into account, and not merely those confined to the portion of the base period the income of which is brought into the Supplement A computation.

On November 16, 1942, the Commissioner published I. T. 3585, holding that both Supplement A and section 722 are not available to the taxpayer.\textsuperscript{112} This ruling is in direct conflict with the revised provisions of section 722 outlined above, even though released several weeks after the effective date of the Act. There is reason to believe, however, that the ruling was made without consideration of the new provisions, and it may therefore probably be disregarded. The ruling should be revoked, however, in order to eliminate unnecessary confusion.

An important problem, to which at this writing no official solution has been forthcoming, is the relationship between section 722 and the unused credit carry-over and carry-back adjustments provided for in section 710 (c).\textsuperscript{113} The principal questions here presented are whether: (a) carry-overs and carry-backs are to be taken into account in determining whether a tax is "excessive and discriminatory"; (b) an unused constructed credit may be established; and (c) if the latter is the case, and relief is not needed in the year in which the unused credit will be developed, the application for reconstruction of the credit may be made for the year to which it is desired to carry over the unused credit.

With regard to the first question, the only clue in the statutory language is the general requirement of section 722 (a) that a taxpayer, to be entitled to relief, must establish that "the tax computed under this subchapter (without the benefit of this section) results in an excessive and discriminatory tax . . . ." It is certainly clear that the tax "computed under this subchapter" must take into account unused credit adjustments applicable to the year in question.

The next step is not so clear. What constitutes an "excessive and discriminatory" tax? May a very small tax be considered "excessive" on the ground that if the taxpayer were not subjected to a base period aberration, there would be a much larger credit resulting in no tax at all and perhaps in an unused credit adjustment to be carried forward or backward? In such circumstances, it would seem that any tax is excessive. When it is further noted that the statutory phrase is "excessive and discriminatory," it may be concluded that Congress intended that the requirement is met whenever an otherwise eligible taxpayer is placed in a tax position less favorable than taxpayers having "normal" base period experience.

\textsuperscript{112} I. R. B. No. 46, p. 3.
\textsuperscript{113} See p. 400 of the first installment of this article.
If this view is correct, it supplies an *a fortiori* answer to the second question, *i. e.*, whether a credit larger than that needed in a current year may be constructed for carry-over and carry-back purposes. The underlying purpose of Congress in enacting section 722 was to ensure that a taxpayer with an abnormality affecting its credit should have its credit reconstructed so as to counteract the abnormality. Congress also has provided unused credit benefits available to taxpayers with normal credits. It would seem, therefore, that the only solution consistent with Congressional purpose is to permit the construction of a credit for carry-over and carry-back purposes, even with respects to years in which the tax computed without section 722 is zero.

The Commissioner might assert the contrary position, basing his argument on a literal reading of the first clause of section 722 (a), which states generally that relief may be granted "In any case in which the taxpayer establishes that the tax computed . . . (without the benefit of this section) results in an excessive and discriminatory tax . . . ." It might be argued that this language requires, as a prerequisite to the reconstruction of a credit for any year, that there be at the minimum *some* excess profits tax liability *in that year* without the benefit of relief; and further, that such tax be excessive and discriminatory. Leaving aside the fact that the quoted language is in the nature of a preamble intended merely to state a general objective, such an argument may be met on the literal level as follows: First, the language in question does not specify to what year the "tax" relates. Second, the unused credit adjustment is an element of the tax for the current year, and if that adjustment is less favorable to the taxpayer because of base period abnormalities, the tax in the current year may be excessive and discriminatory. This would require constructing a "fair and just" amount, to be substituted as a credit, which would reflect the benefit of a proper carry-over whether through a reconstruction of the current year's credit alone, or through reconstructing prior years and applying the carry-over thus produced.

The third question, whether application must be made for the year in which the unused credit will be developed, finds an answer in the foregoing analysis. Even though another year, from which the unused credit is carried back or carried forward, is involved, the relief is in fact granted for the current year in which tax is otherwise incurred. This current year is, sensibly, the year for which application alone should be required, and such year is the year to which the application logically "relates", within section 722 (d), even though the carry-over adjustment is involved. This construction has practical merit. Unless it is followed, numerous applications for years in which no tax is due would
have to be filed merely as a matter of protection in case of excess profits in a future year to which the constructed unused credit would be carried. The Commissioner could still insist, of course, that the credits for the various years involved should not be identical where valid differences exist.

The "normal growth" and "75\%" principles have a legitimate place in the use of section 722. These principles will not have automatic application under the statute, since the section 722 credit is to be used "in lieu of" the credit otherwise computed. However, their approval by Congress stamps them as "fair and just", and other things being equal, the flexibility in the constructed credit allows ample room for their application in a proper case. In many cases the basic section 722 adjustment will merely take the form of the correction of one or more years to counteract, for example, a strike or other interruption. The correction of the year affected by the interruption will merely place the earnings of the taxpayer on a par with others who were not so unfortunate. If the 75\% or normal growth principle is not then available to such taxpayer (assuming the earnings as corrected would qualify for the application of such formulas), section 722 will not have eliminated discrimination. On the other hand, where the circumstances are such that the section 722 credit is not constructed on a "year by year" basis, the determination of a flat credit may be assumed to cover all equitable considerations such as those underlying the 75\% and normal growth rules.

III. INCONSISTENCIES

Section 734 of the Code, dealing with adjustments where a position is taken in an excess profits tax year that is inconsistent with a position previously taken with respect to the same item for income tax purposes, has been revised by several amendments,\textsuperscript{114} most of which are favorable to the taxpayer and all of which are retroactive to all excess profits tax years.\textsuperscript{115} It will be recalled that section 734 in practical effect, through adjustment of excess profits tax liability, collects additional income tax (or refunds overpaid income tax, in either case with interest), with respect to a closed prior year resulting from correcting the treatment of an item affecting the excess profits credit erroneously treated in such prior year in a manner inconsistent with proper treatment as determined in connection with the excess profits tax liability in the current year.

\textsuperscript{114} Act, Section 227 (a); Code, Section 734.
\textsuperscript{115} Act, Section 227 (b); Code, Section 734.
Section 734, before the 1942 amendments, called for an adjustment in cases of inconsistency with a position previously adopted either by the taxpayer or its "predecessor"—thus making the taxpayer responsible for the tax sins (whether or not with malice prepense) of its antecedents. However, it did not define the term "predecessor", and the regulations attempted to fill this gap with a definition which carried a vague and complex threat of extremely broad application. The Act has supplied a definition which limits the term to include only the following: (a) a "component" of the taxpayer within the meaning of section 740; 116 (b) a person who on April 1, 1941, 117 or at any time thereafter, "controlled" the taxpayer; 118 and (c) any "predecessor" of a "predecessor". 119 The new definition will afford substantial protection to the taxpayer in limiting the adjustment to cases where there is real basis for the identity of interest that the section assumes. This limitation of the definition does not, however, preclude the application in other circumstances of such established judicial doctrines as estoppel, recoupment, and set-off. 120

Section 734 (b) (3) contains a new provision imposing upon the Commissioner, in cases where income tax liability in the prior year or years would be increased, and upon the taxpayer where such liability would be decreased, the burden of proof in establishing that an inconsistent position has been taken. The taxpayer must nevertheless correctly and fully disclose the pertinent facts in his possession to the Commissioner, since fraud and negligence penalties are not waived by the new provision. 121 However, the ascertainment of historical facts as to the prior treatment of an item is frequently a difficult matter, and the new provision should give much practical comfort to the taxpayer who prefers to abide by prior treatment.

The third amendment, contained in section 734 (c) (4), is a relief provision applicable to the case where the tax reduction in the prior year, and interest thereon, flowing from the correction is more than

116. Code, Section 734 (a) (4) (A). Such a component would be a "predecessor" regardless of whether the taxpayer uses or is eligible for Supplement A. See Senate Report, 212. It would also include an individual or partnership which may qualify as a "component" under Section 740.

117. The date of the original enactment of Section 734. See Excess Profits Tax Amendments of 1941, Section 11.

118. Code, Section 734 (a) (4) (B). The definition of "control", i. e., holding 80% of voting power and of outstanding stock, is that contained in Section 112 (h) of the Code. The statute is not clear whether the loss of control after April 1, 1941, will cease to make the taxpayer responsible for the earlier action of the erstwhile "predecessor." On equitable grounds, this should be the consequence.

119. I. e., "any persons in an unbroken series ending with the taxpayer if subparagraph (A) or (B) would apply to the relationship between the parties." Code, Section 734 (a) (4) (C).

120. See Senate Report, 213.

121. Id., 214.
sufficient to wipe out the current excess profits tax. In such case, the unused portion of the adjustment may be successively applied against excess profits tax in subsequent years until exhausted. If unused adjustments arise in several years, they are to be applied chronologically until all are consumed.¹²²

The fourth change consists of the addition of the last two sentences of revised section 734 (d), for the purpose of clarifying an ambiguity as to the computation of the net adjustment. It is now clear that interest on the adjustment of prior income tax liability is computed to the due date of the return for the excess profits tax year with respect to which the section is applied.¹²₈ Moreover, where several adjustments are involved, the interest is computed on each separately before the net adjustment is determined.

Finally, a new section 734 (e) is added, relating to the taxability and deductibility of interest included in the adjustment. The portion of the net adjustment representing interest will be deducted for tax purposes, in the case where the adjustment increases excess profits tax, and included in income in the case where the adjustment decreases excess profits tax, in the year in which the excess profits tax is payable. This rule applies even to taxpayers on the accrual basis. Where a carry-over is involved, a portion of the interest income also carries over. The statute supplies no clue as to how the adjustment should be apportioned between tax and interest for carry-over purposes, but this problem will probably be clarified by regulation.

The Senate Report contains its own bit of “legislation” on this section. It expressly ratifies previous Treasury regulations¹²⁴ to the effect that—

(a) A previous adjustment under Section 3801 (the income tax “inconsistency” provision) shall be taken into account in applying section 734;

(b) No adjustment under section 734 is authorized if an adjustment under the section has been made in a previous excess profits tax year with respect to the same item because of a similar position;

¹²² Id., 213. It may be doubted whether new Section 734 (c) (4) will frequently come into operation. The adjustment under Section 734 is not authorized if the party maintaining the inconsistent position is the party who would derive a pecuniary benefit from the adjustment. See Senate Report, 211; Section 734 (b) (2). This being the case, the situation contemplated in Section 734 (c) (4) is one where the Commissioner is maintaining the inconsistency, and he is unlikely to do so where the excess profits tax is more than eliminated.

¹²₃ l. e., to the fifteenth day of the third month following the close of such year. This rule was previously stated in the regulations. Additional interest is not provided for in the case where part of the adjustment is carried over under Section 734 (c) (4) and thus not beneficially used until a later year.

¹²₄ See Senate Report, 212; see also Conference Report, 64-65.
(c) Inconsistency, in order to effect a correction of previous erroneous treatment, is not required of the taxpayer, and may not be insisted upon by the Commissioner unless excess profits tax would thereby be reduced; and

(d) A taxpayer which has taken an inconsistent position may, upon notice to the Commissioner in writing, withdraw from such position.

IV. MISCELLANEOUS PROVISIONS

The few remaining miscellaneous excess profits tax amendments will be disposed of briefly. Basic changes in the determination of excess profits of certain insurance companies appear in section 205 of the Act: Their scope is so limited as not to warrant protracted analysis here. Foreign corporations not engaged in a trade or business in the United States are now exempt from excess profits tax, even though they have "an office or place of business" therein; and sections 712 (b) and 724, relating to the excess profits credits of foreign corporations, are amended accordingly. An exempt corporation loses its exemption if it is a member of an affiliated group for which a consolidated return is filed; and the investment company exemption has been changed to cover all such companies which fall within Supplement Q. Finally, prior provisions requiring the computation of both the income and invested capital credits, or the disclaimer of one of them, have been retroactively repealed.

V. CONCLUSION

To the reader who has struggled through the foregoing discussion, several conclusions must be obvious: Tremendous effort has been invested in the new legislation. It fairly bristles with provisions which betray the loss of sleep involved in turning out such a tax bill. Despite

125. Act, Section 212 (b); Code, Section 727 (f).
126. Act, Section 212 (a). These amendments apply only to excess profits taxable years beginning after December 31, 1941.
127. Act, Sections 223 (a) and (b); Code, Sections 725 (b), 727.
128. See Act, Section 170 (a); Code, Sections 361, 362. This supplement prescribes special income tax treatment for regulated investment companies. The House Report, p. 150, and the Senate Report, p. 210, indicate that the requirement under Supplement Q that 90% or more of the net income (excluding capital gains) be distributed as dividends, is to be disregarded in applying the excess profits tax exemption. In the final draft of Section 727 (c), however, by obvious error the cross-reference to the provision which is to be disregarded is Section 361 (b) (4) of the Code. The latter requires an election to be taxed under Supplement Q, and the literal effect of the two provisions is that an investment company, otherwise eligible, which does not elect Supplement Q, is nevertheless exempt from excess profits tax.
129. Act, Section 224. Disclaimers in prior years are no longer binding, and refund claims may thus develop. Where one computation is submitted, the return is to be audited on that basis, although a shift by the taxpayer is not precluded within the period of limitations. See Senate Report, 210; Conference Report, 64.
130. Section 730 of the Code, relating to consolidated returns, does not apply to taxable years beginning after December 31, 1941. Act, Section 255 (a). The provisions relating to consolidated returns have been transferred to Section 141, which also covers consolidated returns for income tax purposes.
this effort, however, the legislative scheme is at odds with itself, in that as taxes are increased and the number of heavy taxpayers expanded, the convolutions of the statute sought to be understood by them become more rather than less intricate. For each man-hour spent in the preparation of the Act, countless will be spent in determining its meaning. The construction of a towering statutory Frankenstein, controllable, if at all, only at the extreme cost of widespread specialization, is making alarming progress. The threat that the system will ultimately "fall of its own weight" no longer is entirely an idle one. Despite these reservations, however, the excess profits tax provisions of the Act must be judged a long step towards the ultimate ironing out of the many legislative difficulties inherent in such a tax.