

THE YALE LAW JOURNAL

VOLUME 60

MARCH, 1951

NUMBER 3

GENERAL RELIEF PROVISIONS OF THE EXCESS PROFITS TAX ACT OF 1950

JOHN H. ALEXANDER†

This is as strange a maze as e'er man trod;
And there is in this business more than nature
Was ever conduct of . . .

The Tempest, Act V, Scene 1*

Now that the controversy over the adoption of an excess profits tax has been resolved by the passage of the Excess Profits Tax Act of 1950, the time has come for those who must live with it to examine with some curiosity their new roommate.¹ In view of the importance and difficulties attaching to the general relief provisions of the excess profits tax law of World War II, section 722 of the Internal Revenue Code, the treatment of general relief in the new law must claim a very fair share of such curiosity.² Before proceeding to the general relief pro-

† Member of the New York and New Jersey Bars.

* It is only through a desire to avoid any possibility of a suggestion that a need has been filled that there has been omitted the balance of the quotation:

“ . . . some oracle

Must rectify our knowledge.”

1. For a discussion of the conflicting views on the merits of an excess profits tax, see Rudick, *The Controversy over EPT*, 6 TAX L. REV. 121 (1951).

2. Section 722 has been the inspiration to a great many commentators. Bierman, *What is New in Excess Profits Taxes* in PROCEEDINGS OF NEW YORK UNIVERSITY SIXTH ANNUAL INSTITUTE ON FEDERAL TAXATION 1147 (1948); Bierman, *Section 722 in the Light of Recent Tax Court and Treasury Study* in PROCEEDINGS OF NEW YORK UNIVERSITY FIFTH ANNUAL INSTITUTE ON FEDERAL TAXATION 864 (1947); Bock, *Possibilities for Excess Profits Tax Relief under Sections 722(b)(1), 722(b)(2), 722(b)(3)*, 21 TAXES 443 (1943); Bryson, *The Excess Profits Tax Provisions of the Revenue Act of 1942*, 91 U. OF PA. L. REV. 533 (1943); Crampton, *Excess Profits Tax Relief for Pre-1940 Corporation*, 24 TAXES 231 (1946); Diamond, *Problems of Proof and Procedure under Section 722*, 24 TAXES 579 (1946); Grose-close, *Expanding Business and the Excess Profits Tax*, 18 TEMP. L. Q. 504 (1944); Hamel, *Administrative Problems Faced by the Excess Profits Tax Council* in PROCEEDINGS OF NEW YORK UNIVERSITY FIFTH ANNUAL INSTITUTE ON FEDERAL TAXATION 886 (1947); Maloney and Wood, *The Treasury Department's Bulletin on Section 722*, 23 TAXES 39 (1945); Merry, *Current Status of Excess Profits Tax Council Action on Section 722 Claims* in PROCEEDINGS OF NEW YORK UNIVERSITY SIXTH ANNUAL INSTITUTE ON FEDERAL TAXATION 1140 (1948); Miller, *Section 722—Another Year*, 2 TAX L. REV. 417 (1947); Polk, *Excess Profits Tax Relief*, 21 TAXES 432 (1943); Tarleau, *Currently Controversial Aspects of Section 722*, 1 TAX L. REV. 197 (1946); Tarleau, *Section 722: Safety Value of the Excess Profits Tax*, 10 LAW & CONTEMP. PROB. 43 (1943); *Transcript of Round Table on Section 722 with Members of Bureau*

visions, however, some consideration must be given to that from which relief is granted.

The new tax is imposed for each taxable year of a corporation ending after June 30, 1950, and beginning before July 1, 1953, at the rate of 30 per cent of the adjusted excess profits net income, subject to an overall limitation designed to limit the aggregate excess profits tax and the ordinary corporate income taxes to 62 per cent of the excess profits net income.³ The new law, like its predecessor, allows a credit based alternatively on earnings or invested capital.⁴ The general relief provisions are particularly designed to allow a substitute credit for the earnings, or average base period net income, credit. The general rule provided for the credit based on income is that it shall be the sum of 85 per cent of the average base period net income, and, in appropriate cases, 12 per cent of capital additions during and subsequent to the base period.⁵

The base period is, generally, the period beginning January 1, 1946, and ending December 31, 1949.⁶ The average base period net income

of Internal Revenue and Excess Profits Tax Council in PROCEEDINGS OF NEW YORK UNIVERSITY SIXTH ANNUAL INSTITUTE ON FEDERAL TAXATION 1176 (1948); *Round Table Discussion of Today's Problems under Section 722* in PROCEEDINGS OF NEW YORK UNIVERSITY FIFTH ANNUAL INSTITUTE ON FEDERAL TAXATION 896 (1947); Note, Cooper, *Relief under Section 722(b)(4)—Fesandie & Sperrle, Inc.*, 1 TAX L. REV. 457 (1946); Note, *Excess Profits Tax Relief under Section 722*, 62 HARV. L. REV. 679 (1949); Comment, *Excess Profits—General Relief under Section 722* I. R. C., 45 MICH. L. REV. 763 (1947). For a collection of other articles, see 3A CCH 1946 FED. TAX REP. 9141.

3. INT. REV. CODE § 430(a). In the case of taxable years beginning before July 1, 1950 and ending after June 30, 1950 the excess profits tax is proportionately reduced, depending on the number of days in the taxable year before and after June 30, 1950. *Id.* § 430 (b). The term "excess profits net income" is defined in § 433.

4. An important departure from the earlier law is the permission to compute invested capital by a net worth method as well as by the historical method. The former is based on determining equity capital by computing the adjusted basis for gain on sale or exchange of total assets and reducing by liabilities. INT. REV. CODE § 437. The historical method is based on determining invested capital by, among other things, ascertaining the amount of money and property, at unadjusted basis (subject to certain limitations) for determining loss, paid in for stock or as paid-in surplus, or as a contribution to capital. INT. REV. CODE §§ 437, 458. The historical method was employed in the earlier law. INT. REV. CODE § 718.

5. INT. REV. CODE § 435(a). The adjustments are:

"(B) if the average base period net income of the taxpayer is the amount determined under subsection (d) of this section or under section 442, 12 per centum of the amount of the base period capital addition, computed under subsection (f), and

"(C) 12 per centum of the net capital addition (as defined in subsection (g) (1)) for the taxable year,
minus 12 per centum of the net capital reduction (as defined in subsection (g) (2)) for the taxable year."

6. INT. REV. CODE § 435(b). In the case of a taxpayer whose first taxable year under Subchapter D, the excess profits tax law, was preceded by a taxable year which ended after December 31, 1949 and before April 1, 1950, and which began before January 1, 1950, the term "base period" means the period of 48 consecutive months ending with the close of such preceding tax year.

is to be computed under section 435(d), the general average method, section 435(e), the growth formula, or sections 442, 443, 444, 445, or 446, the general relief provisions, whichever results in the lesser tax.⁷ The general average method requires the computation of the excess profits net income for each month in the base period, attributing to no month less than zero, the elimination from the base period of twelve poor months by a formula, the aggregating of the excess profits net incomes of the remaining thirty-six months and the division by three of the amount so determined.⁸ The relief afforded by the elimination of a poor twelve months combined with the generally prosperous condition of American industry during the base period certainly influenced Congress in its consideration of relief allowances.⁹ Counter balancing considerations lay in the limited but possibly long continued nature of the emergency as compared with World War II. Taxpayers' representatives made a strong showing that base period prosperity was not uniform for all industry and that many meritorious cases would be ignored in the absence of relief provisions.¹⁰ The final result was an act which contained both general relief provisions and also many special relief provisions.

Among special relief provisions are the growth formula,¹¹ the

7. INT. REV. CODE § 435(c).

8. *Id.* § 435(d). The twelve months to be eliminated are the twelve consecutive months the elimination of which produces the highest average base period net income, or the twelve which remain after retaining in the base period the thirty-six consecutive months which produce the highest average base period net income. The excess profits net income for any month during any part of which the taxpayer was in existence shall be the excess profits net income for the taxable year in which such month falls divided by the number of full calendar months in such year, but in no case shall the excess profits net income be less than zero. The excess profits net income for any month during no part of which the taxpayer was in existence shall be zero.

9. See H. R. REP. No. 3142, 81st Cong., 2d Sess. 16 (1950); SEN. REP. No. 2679, 81st Cong., 2d Sess. 18 (1950). These reports mention also various other provisions which may be expected to reduce the need for relief.

10. The testimony of witnesses before the Senate Finance Committee is particularly interesting as they had had opportunity, to some extent at least, of relating their problems to the provisions of the House bill. *Hearings before Senate Finance Committee on H. R. 9827*, 81st Cong., 2d Sess. (1950).

11. INT. REV. CODE § 435(e). The growth formula is narrowly restricted as compared with the growth formula under section 713(f) relating to the World War II excess profits tax. It is allowed in only two general categories. Under the first category, the total payroll of the taxpayer in the last half of the base period must be at least 130 per cent of its total payroll for the first half of the base period, or its gross receipts in the last half of the base period at least 150 per cent of its gross receipts for the first half of the base period; relief is denied to a taxpayer which had total assets on the first day of the base period exceeding \$20,000,000. INT. REV. CODE § 435(e) (1) (A). The second category contains several limitations, one of which is that 40 per cent of the taxpayer's net sales for 1950 must be attributable to a product of a kind not generally available to the public prior to January 1, 1946, and another of which is that the amount of the taxpayer's net sales which is attributable to such product or class of similar products for 1946 is 5 per cent or less of the amount of net sales so attribut-

special treatment of regulated public utilities,¹² the exemption accorded a personal service corporation if the appropriate election is made,¹³ the exemption of income attributable to the mining of strategic minerals,¹⁴ the permission to capitalize advertising expenditures,¹⁵ the limited exemption of income from certain mining and timber operations and from natural gas properties,¹⁶ the relief for installment basis taxpayers and taxpayers with income from long-term contracts,¹⁷ and the special computation provided in the case of certain payments to the Federal Maritime Board.¹⁸ The most important special relief provisions of the earlier law were those contained in section 721 of the Internal Revenue Code, relating to abnormalities in income in the taxable period, a section which has presented difficulties of administration second only to those raised by section 722. The corresponding section of the new law clearly discloses its parentage, but omits from the specified classes of income certain important types included in section 721.¹⁹ Income resulting from research or development of patents, formulae or processes is not described in the new statute.²⁰ Claims for relief

able for 1949. INT. REV. CODE § 435(e)(1)(B). Television corporations might qualify in the second category, but it is doubtful that many others will.

12. INT. REV. CODE § 448. The credit in the case of specified regulated public utilities is the sum of the ordinary Federal income taxes plus six or seven per cent, depending on the type of utility, of the adjusted invested capital (specially computed in many cases) and the average borrowed capital, reduced by certain prescribed adjustments. With respect to this treatment the Senate Finance Committee said:

"Your committee believes that this is appropriate in view of the fact that the profits of these industries in the base period years were held down well below the profits earned by unregulated industries." SEN. REP. NO. 2679, 81st Cong., 2d Sess. 31 (1950). There was no corresponding provision in prior law.

13. The election is that the shareholders be subject to tax on undistributed Supplement S income. INT. REV. CODE § 449. The section follows section 725 relating to the earlier excess profits tax.

14. INT. REV. CODE § 450. The section is somewhat broader than section 731 granting similar exemption under the prior law.

15. INT. REV. CODE § 451. A similar election was granted under the World War II excess profits tax law by section 733.

16. INT. REV. CODE § 453. The provisions of the section were derived from section 735.

17. INT. REV. CODE § 455. Installment basis taxpayers may treat income from installment sales or installment sales obligations on the basis of the taxable period for which such income is accrued without treating any portion of such income as unrealized at the close of such period, in lieu of the basis provided by section 44(a). A taxpayer computing income from contracts the performance of which requires more than twelve months may elect to compute such income upon the percentage of completion method of accounting. These provisions of section 455 are modeled on, but vary considerably from, those contained in section 736 relating to the earlier excess profits tax.

18. INT. REV. CODE § 457. The section is patterned on section 726.

19. INT. REV. CODE § 456.

20. Section 721(a)(2) includes as a separate class of income:

"(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; * * *."

with respect to this class of income often were filed concurrently with claims for relief under the change of character of business provisions of section 722.²¹ There are other variations from the predecessor section but the difficult problem of determining how much of the abnormal income is attributable to other years, and to what years it is attributable, remains.²²

Although the above summary is not exhaustive, enough has been said to indicate that the special relief provisions are extensive and cover, on the whole, at least as much ground as the similar provisions of the earlier law.²³ The extent to which the general relief measures and their problems parallel section 722 and the extent to which new considerations may be involved can only be determined or, rather, at this early stage, suggested, by a study of these measures.

GENERAL STATEMENT

The basic concept of the general relief sections is that every corporation can be identified with a single industry by a formula type of test and that the ratio of industry earnings to industry assets represents an appropriate rate of return to apply to the assets of the taxpayer entitled to relief. This approach and the provisions designed to implement it raise the question whether, in attempting definiteness

Section 456(a)(2) treats as separate classes of income:

“(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

“(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; * * *.”

Both treat as separate classes:

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

* * * * *

“(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.”

Section 721(a)(2)(D) also includes a “change in the taxpayer's accounting period.”

The earlier law also covers income included in gross income of lessor of real estate by reason of the termination of the lease. INT. REV. CODE § 721 (a)(2)(E). Dividends from foreign corporations, except foreign personal holding companies, were another separate class. *Id.* § 721(a)(2)(F). Under the new excess profits tax law dividends from all corporations, except foreign personal holding companies, are excluded from excess profits net income (subject to the limitation relating to dividends in kind). INT. REV. CODE § 433(a)(1).

The new law provides that the classification of income of any class not specifically described shall be subject to regulation prescribed by the Secretary. INT. REV. CODE § 456(a). This provision is similar to that contained in the earlier law. INT. REV. CODE § 721(a).

21. In this connection see the limitations contained in section 721(f).

22. INT. REV. CODE § 456(b), (c), (d).

23. It should be borne in mind that the summary does not include numerous adjustments to normal tax net income in computing excess profits net income, most of which are of a relief nature. INT. REV. CODE § 433.

to minimize the administrative complexities which have beset the history of section 722, Congress has not ignored the usual relationship which should exist between damage and relief.

A man drives his auto negligently and as a result destroys another's car. The law allows relief to the owner of the second car, measured by the damage suffered. A seller fails to perform his obligation to deliver at a stated price certain goods. The law attempts to measure the buyer's damage and to allow him relief accordingly. An excess profits tax law is enacted allowing a norm for profits and taxing the "excess profits." The norm set is recognized as not an adequate standard in certain situations. Applying usual principles the relief should be to restate the "norm" in these situations by some means which will allow the affected taxpayers an adequate standard, thus reducing or eliminating the unduly high "excess profits." This was, of course, the section 722 approach. The new provisions give no assurance that in a particular case the relief granted will have any but a fortuitous relationship to the cause for granting relief. In reconstructing base period income no account is taken of the particular taxpayer's ability or inability to use its assets efficiently as compared with the industry as a whole. In all instances, except one, reconstructions are based on assigning the taxpayer to one industry group out of a possible sixty-four industry groups, which are intended to include the entire American economy.²⁴

If everything must be classified, perhaps it is not too extreme to classify the new method as the despair approach. To anyone having even the slightest contact with the widespread criticism of section 722 administration, the evidence of Congressional statements is hardly necessary for the purpose of locating the source of the despair.²⁵

24. The relief afforded to a depressed industry subgroup, the exception, is more narrowly treated. INT. REV. CODE § 446.

25. The Congressional committees in their reports did not review the administration problems of section 722 in detail. After referring to the "tailor made" nature of the reconstruction under that section and the consequent difficulties of determination of constructive average base period net income, the Ways and Means Committee said:

"These complex relief provisions of the World War II law have resulted in extended delay in the settlement of relief claims which discriminated against taxpayers who had neither the time nor the financial resources necessary for the establishment of their cases. Moreover, the determination of what the taxpayer's base period income would have been in the absence of the claimed abnormality was largely a matter of subjective judgment, and a great deal of complaint has arisen on this account. Hence this bill reduces to a minimum the amount of administrative discretion involved in the adjustment of the hardship cases which may be expected to arise under an excess profits tax." H.R. REP. NO. 3142, 81st Cong., 2d Sess. 16 (1950).

Similar language is contained in the Senate Finance Committee Report. SEN. REP. NO. 2679, 81st Cong., 2d Sess. 18 (1950). The most extensive review and criticism of section 722 and its administration are contained in *Hearings before the Joint Committee on Internal Revenue Taxation on Section 722 of the Internal Revenue Code*, Parts 1 and 2, 79th

Whether the alternative selected by Congress will result in a more contented taxpayer only time will tell. That the correlation of the reason for relief and the measure of relief granted must be in many, if not most, instances fortuitous will be indicated, it is believed, by a rather detailed review of the new provisions.

AREA IN WHICH RELIEF IS GRANTED

The general relief sections parallel rather closely the enumerated grounds for relief under section 722. The earlier section, although in language contemplating relief in any appropriate case, has been narrowly interpreted and the Treasury indicates great reluctance to go beyond the specified grounds.²⁶ The new act does not contain any blanket relief clause and, to qualify, the taxpayer must satisfy the enumerated requirements of the particular section. The general relief provisions are contained in sections 442, 443, 444, 445 and 446 of the Internal Revenue Code. Each section is designed to cover some part of the area covered by an enumerated ground for relief in section 722. Section 442 grants relief on the ground of interruption or diminution during or immediately prior to, a taxable year in the base period of production, output or operation due to "events unusual and peculiar in the experience of such taxpayer." This ground corresponds to section 722(b)(1). Section 442 also states as a ground for relief a depression in the business of the taxpayer because of "temporary economic circumstances unusual in the case of such taxpayer." Section 722(b)(2) which contained a similar ground, also included a depression in business due to similar circumstances in taxpayer's industry. There is no directly corresponding provision in the new law and section 446, relating to relief if the taxpayer is a member of a depressed industry subgroup, is primarily designed to replace the variant profits cycle and sporadic profits experience cases covered by section 722(b)(3).²⁷

Cong., 2d Sess. (1946). Although the possibility of legislative action was prevented by the acceptance of the proposal of the Commissioner of Internal Revenue for the creation of the board which has become the Excess Profits Tax Council, the criticism of administration has certainly not abated.

26. U. S. Treasury Department Bureau of Internal Revenue Bulletin on Section 722 of the Internal Revenue Code, Part VI (A) (November, 1944). For convenience, subsequent citations will refer to this document as the "Bulletin". Since its publication in 1944 various parts of the Bulletin have been modified by releases of the Excess Profits Tax Council.

27. SEN. REP. No. 2679, 81st Cong., 2d Sess. 23 (1950). It is possible, of course, that the depressed industry subgroup provision may take care of a case falling within the depressed industry category of section 722(b)(2). Pursuant to the provisions of section 446(h) of the Internal Revenue Code, the Secretary of the Treasury has now tentatively identified eight industry subgroups as "depressed industry subgroups" and has tentatively determined their "adjusted rates of return." T.D. 5829. These determinations and tentative adjusted rates of return have been incorporated in regulations issued since this paper was prepared. Reg. 130, § 446-2.

The treatment of "change in the character of the business" cases has been considerably restricted in the new provisions. Under section 722(b)(4), a change in the character of the business included a change in the operation or management of the business, a difference in the products or services furnished, a difference in the capacity for production or operation, a difference in the ratio of nonborrowed capital to total capital, and the acquisition after January 1, 1940, of all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished. The only survivors are a change in products or services, section 443, and an increase in capacity for production or operation, section 444.²⁸

Section 722(b)(4) also provided for relief if the taxpayer commenced business during, or immediately prior to, the base period and the average base period net income did not reflect the normal operation for the entire base period of the business. New corporation relief was also provided in section 722(c) which was broad enough to cover any corporation not entitled to use the excess profits credit based on income, provided the invested capital credit was inadequate for stated reasons. The entire problem of new corporation relief is covered for purposes of the new excess profits tax by section 445.

ABNORMALITIES DURING BASE PERIOD

Grounds for Relief

To secure relief under section 442 the taxpayer must have commenced business on or before the first day of its base period.²⁹ It must establish that for a taxable year within, or beginning or ending within, its base period there was an interruption or diminution of production, output or operation because of the occurrence, during or immediately prior to, such year of events unusual or peculiar in the taxpayer's experience or that the taxpayer's business was depressed because of temporary economic circumstances unusual in the case of the taxpayer. From this language it appears, and the balance of the section

28. The House bill also omitted the increase in capacity provision but the Senate included both this provision and one covering, in limited cases, a change in operations or management. In conference, the House accepted the increase in capacity relief, but the change in operations or management proposal was stricken. H. R. REP. No. 3231, 81st Cong., 2d Sess. 20, Amendment No. 131 (1950). The Ways and Means Committee reasons for dropping certain of the section 722(b)(4) grounds are set forth in its report. H. R. REP. No. 3142, 81st Cong., 2d Sess. 20 (1950).

29. Commencement of business on or prior to the first day of the base period is a common requirement of the general relief sections, except section 445, the new corporation section. INT. REV. CODE §§ 442(a), 443(a), 444(a), 446(a). As subsequently pointed out, however, commencement of business may be in certain circumstances constructive because of the attribution to the taxpayer of the position of a component corporation through the operation of the sections contained in Part II of Subchapter D, relating to the credit based on income in connection with certain exchanges.

supports the view, that the taxpayer must establish the causal connection between the unusual event and the interruption or diminution or between the depressed business and the unusual temporary economic circumstances.³⁰ This has been the rule, of course, under section 722(b) (1) and (2).³¹ Because of the similarity between the relief provisions, the considerations applicable to the World War II excess profits tax law in determining whether a particular event is unusual and caused an interruption, diminution or depression should be equally applicable to the new law.³²

Period Subject to Adjustment

To determine the period subject to adjustment, the first step is to ascertain the best thirty-six months period under the general method previously described.³³ The next step is to determine how many of the thirty-six months fall within taxable years the excess profits net income of which was adversely affected by reason of the abnormality. If not more than twelve months fall within such taxable years, the reconstruction is made under section 442(c); if more than twelve months are involved, the reconstruction is under section 442(d).

Twelve or Fewer Months Affected by Abnormalities

Reconstruction. Under section 442(c), the reconstruction involves the use of the thirty-six months period already determined and the computation of the excess profits net income for each month by the

30. In the instructions for the excess profits tax schedule to be attached to the return for a taxable year ending after June 30, 1950 and before December 31, 1951, the following statement is made:

"The interruption or diminution must be a direct result of events unusual and peculiar in the experience of the taxpayer, such events occurring in or immediately prior to such taxable year." Instructions for Schedule EP-5(B) (Form 1120.) 1950. See also Reg. 130, § 40.442-2.

31. For example, the Bulletin says, with respect to section 722(b)(1), that the taxpayer must establish:

"(1) That in one or more taxable years in its base period normal production, output, or operation was interrupted or diminished because of the occurrence of events unusual and peculiar in the experience of the taxpayer; and

"(2) That *because* of such interruption or diminution its *actual* average base period net income is an inadequate standard of normal earnings * * *." Bulletin, Part II (A).

32. Monarch Manufacturing Company, 15 T. C. No. 63 (1950); Trunz, Inc., 15 T. C. 99 (1950); Winter Paper Stock Company, Inc., 14 T. C. 1312 (1950); Acme Breweries, 14 T. C. 1034 (1950); El Campo Rice Milling Company, 13 T. C. 775 (1949); Dyer Engineers, Inc., 10 T. C. 1265 (1948); The Fish Net and Twine Company, 8 T. C. 96 (1947); The Monarch Cap Screw and Manufacturing Company, 5 T. C. 1220 (1945); E. P. C. 12, 1947-1 CUM. BULL. 80; Deutsch, *A Historical Analysis of Section 722(b)(2)*, 27 TAXES 127 (1949). The new regulations are general in their treatment of abnormalities. Reg. 130, § 442-2.

33. A deficit in excess profits net income is not eliminated, although it would be under section 435(d). INT. REV. CODE § 442(b).

general average method. A "substitute excess profits net income" is computed for each month falling within a taxable year affected by the abnormality and if the "substitute excess profits net income" for a particular month exceeds 110 per cent of the excess profits net income of that month the substitute figure is used. The aggregate of the amounts for the thirty-six months divided by three is the average base period net income computed under section 442.

Before considering the method used in determining the substitute excess profits net income for each month, one point might be noted. An alternative to the method employed might have been to use the entire base period for reconstruction purposes and determine the effect of the abnormality on the full period before discarding twelve months. It might be, for example, that in fact the best year in the base period would have been the discarded twelve months had it not been for the abnormality. The method employed of first discarding twelve months can be supported on the theory that, in effect, the act contemplates that all taxpayers are put on the same basis of a thirty-six months period and the reason for the relatively poor showing in the discarded twelve months will not be the subject of consideration in any case. The requirement that the substituted excess profits net income for a month must exceed 110 per cent of the excess profits net income otherwise computed is, in the language of the Senate Finance Committee, "to avoid burdening the administration of the tax with trivial claims."³⁴

Substitute Excess Profits Net Income. The general concept is simple. It is to substitute for a period affected by the abnormality a constructive income determined by applying to the taxpayer's assets the earnings ratio of the taxpayer's industry.³⁵ The determination of the taxpayer's assets will normally be made at the close of the

34. SEN. REP. No. 2679, 81st Cong., 2d Sess. 19 (1950).

35. INT. REV. CODE § 442(e). The formula is as follows:

(1) Ascertain the taxpayer's total assets for the earlier of (a) the last day of the taxable year in which such month falls and (b) the last day of its taxable year immediately preceding its first taxable year under Subchapter D. Multiply the total assets as of such day by the base period yearly rate of return, proclaimed by the Secretary of the Treasury, for the taxpayer's industry classification for the appropriate year.

(2) Reduce the resulting amount by the interest paid or incurred by the taxpayer for the twelve months beginning with the first day of the taxable year within which such month falls.

(3) Divide the result by twelve. This is the substitute excess profits net income for the month.

The appropriate year is—

in the case of a taxable year beginning in 1945 and ending in 1946—the year 1946;

in the case of a taxable year beginning in 1949 and ending in 1950—the year 1949;

and

in the case of any other taxable year—the year in which falls the greater number of days in such taxable year. INT. REV. CODE § 442(e); Reg. 130, § 40.442-3(b).

taxable year in which the particular month to be reconstructed falls. If the month to be reconstructed under the formula falls within a taxable year the last day of which is later than June 30, 1950, the total assets are to be taken as of the close of the preceding taxable year.³⁶ The interest paid or incurred by the taxpayer is eliminated because the industry ratio includes interest.³⁷

Before evaluating the reconstruction, it is necessary to consider the formulas employed in determining total assets, the industry classification of the taxpayer and the industry rate of return.

Taxpayer's Total Assets. For the purposes of section 442, the taxpayer's total assets are an amount equal to the adjusted basis, for gain purposes,³⁸ of the sum of the cash and the property (other than cash, inadmissible assets, and "loans to members of a controlled group"³⁹) held by the taxpayer in good faith for the purposes of the business.

The adjusted basis for determining gain, generally, is that prescribed under section 113, and permits the use of March 1, 1913 values.⁴⁰ The

36. The statement in the text is in accordance with the position taken in the regulations. Reg. 130, § 40.442-3(b). No explanation is given but the conclusion expressed seems to be necessarily drawn from the use in the statute of the last day of the taxable year immediately preceding "its first taxable year under this subchapter" if such day is earlier than the last day of the taxable year in which such month falls. The law does not define the meaning of the phrase "taxable year under this subchapter" but it would seem clearly to mean a taxable year subject to the excess profits tax imposed under Subchapter D, which could only be a taxable year ending after June 30, 1950. Calendar year corporations and those with fiscal years ending during the first three months of the calendar year cannot have a month to be reconstructed in any taxable year ending after June 30, 1950, as they use for the base period the forty-eight month period closing with a taxable year which terminates prior to June 30, 1950. INT. REV. CODE § 435(b). All other corporations use the period January 1, 1946 to December 31, 1949. *Ibid.* Such a corporation, for example one with a fiscal year ending September 30, might have a month to be reconstructed falling within the first excess profits tax taxable year, a year which would necessarily end after June 30, 1950 (INT. REV. CODE § 430(a)), and would then be required to use the formula with respect to assets held as of "the last day of its taxable year immediately preceding its first taxable year" under Subchapter D, instead of the later day, the last day of the taxable year in which the month falls.

37. INT. REV. CODE § 447(b). See SEN. REP. NO. 2679, 81st Cong., 2d Sess. 20 (1950).

38. The adjusted basis is to be determined under the rules of section 441. INT. REV. CODE § 442(f).

39. Loans to members of a controlled group are defined in section 435(f)(4).

40. There is an exception to the use of March 1, 1913 value in the case of "secret processes and formulae, good will, trademarks, trade brands, franchises, and other like property." INT. REV. CODE § 441(i); Reg. 130, § 40.442-3(d).

The regulations contain the following provision:

"In determining total assets, so much of the distributions to shareholders made during the first 60 days of any taxable year (other than the taxpayer's first taxable year ending after June 30, 1950) as does not exceed the accumulated earnings and profits at the beginning of the year shall be considered to have been made on the last day of the preceding taxable year." Reg. 130, § 40.442-3(d).

This indicated limitation is based on the provisions of section 441(e). It is by no means

committee reports do not explain the reason for using the adjusted basis for determining gain. It may be that Treasury experience shows that this is the figure which is most likely to give an appropriate comparison with the figures shown on the balance sheets attached to corporate tax returns which are to be used in determining industry ratios.⁴¹ In applying a ratio to it, the result should be a larger amount than if adjusted basis for determining loss were used (provided any property with a March 1, 1913 value is held) but smaller than if the unadjusted basis for determining gain were employed. The requirement that the assets be held by the taxpayer in good faith in connection with the business is similar to that in the provision dealing with the net worth method for determining equity capital.⁴²

Taxpayer's Industry Classification. For the purposes of the substitute excess profits net income provisions, the taxpayer's industry is the industry classification to which is attributable the largest amount of the taxpayer's gross receipts for the taxable year within which falls the last month for which a substitute excess profits net income is determined.⁴³

As previously stated, all industry is divided into sixty-four classifications.⁴⁴ The classification is made in accordance with specifications shown in the Standard Industrial Classification Manual for the major group or groups, the numbers of which appear opposite such classification. The enumerated list includes all but four of the major groups shown in the Manual but combines some of the major groups into a single classification.⁴⁵ The major group specifications are, of course,

clear, however, that section 441(e) should be applied to the "total asset" concept of section 442. If there is any reasonable doubt on the point it should be decided in favor of not reducing "total assets" by any such adjustment; the industry assets which determine the applicable rate of return are not reduced by distributions made after the end of the year. INT. REV. CODE § 447(a).

41. Adjusted basis for gain is, of course, used in determining depreciation. INT. REV. CODE § 114(a). The reason for using adjusted basis for gain may simply be that this is the basis used in determining equity capital by the net worth method. INT. REV. CODE § 437(c). The above described exception with respect to certain intangible property is here applicable. INT. REV. CODE § 441(i).

42. INT. REV. CODE § 437(c). The good faith limitation was inserted by the Senate. The Finance Committee explained it in the following statement:

"Your committee has also added a provision which excludes from invested capital the assets which are not held in good faith for the purposes of the business. The purpose of this limitation is to disallow in computing invested capital those assets which are not required in the business and which have the principal effect of reducing excess profits tax." SEN. REP. NO. 2679, 81st Cong., 2d Sess. 9 (1950).

43. INT. REV. CODE § 442(g).

44. INT. REV. CODE § 447(c).

45. The Standard Industrial Manual, which was prepared by the Division of Statistical Standards of the Bureau of the Budget, consists of two volumes, Volume I, Manufacturing Industries, Parts 1 and 2, and Volume II, Nonmanufacturing Industries. The only major group classifications omitted from section 447 are Major Group 66, Combinations of Real

broad or they would be hardly adequate to encompass all industry, including service and other non-manufacturing industries.⁴⁶

The first step in determining the taxpayer's industry classification would seem to involve an analysis of taxpayer's gross receipts for the year so that it can be determined to which major group the largest amount is attributable. Gross receipts are defined to mean the sum of

(A) The total amount received or accrued from the disposition of stock in trade or other inventorable property or property held primarily for sale to customers in the ordinary course of trade or business, and

(B) Gross income attributable to a trade or business regularly carried on by the taxpayer, excluding—

- (i) Gross income derived from the disposition of property.
- (ii) Gross income derived from the discharge of debt.
- (iii) Dividends on stocks of corporations.
- (iv) Income attributable to the recovery of bad debts.⁴⁷

This is indeed a rough and ready method of analyzing a taxpayer's business. The first general category is based on gross receipts although gross income would normally be determined by deducting the cost of goods sold.⁴⁸ From the standpoint of a business operation the gross income from a high profit margin article may be far more important than relatively large receipts from a low profit margin article. Having

Estate, Insurance, Loans, Law Offices, Major Group 88, Private Householders, Major Group 90, Government, and Major Group 99, Nonclassifiable Establishments.

In view of the use made of the classifications of the Manual, its introductory sentences are of particular interest.

"The Standard Industrial Classification was developed for use in connection with the collection, tabulation, and presentation of data supplied by establishments. An establishment is generally defined as a single physical location where business is conducted or where services or industrial operation are performed; for example, a factory, mill, store, mine, or farm. Where a single physical location comprises two or more units which maintain separate pay roll and inventory records and which are engaged in distinct or separate activities for which different industry classifications are provided in the Standard Industrial Classification, each such unit shall be treated as a separate establishment. An establishment is not necessarily identical with the business concern or firm which may consist of one or more establishments. It is also to be distinguished from organizational subunits, departments, or divisions within an establishment."

46. An indication of the breadth of some classifications is gained from considering Major Group 20, Food and Kindred Products. There are eight groups comprising this major group and each group has a number of industries. For example, one group, Beverage Industries, has five industry subdivisions, including one for Wines, which has been tentatively determined to be a depressed industry subgroup. Reg. 130, § 40.446-2. Although the major group tentative base period rate of return is 14.6 per cent. (Reg. 130, § 40.447-2), the tentative adjusted rate of return for Wines is only 7.8 per cent (Reg. 130, § 40.446-2), indicating, obviously, that the effect of this industry was to pull down the average of the major group and that the operating results within major groups vary greatly among industries.

47. The definition of gross receipts is in section 435(e)(5) to which section 442(i) refers.

48. Reg. 111, Sec. 29.22(a)-5.

used gross receipts in the case of the sale of stock in trade it would seem that a gross receipts test should be applied for the balance of the business operations. Perhaps it was thought that a broad category of gross receipts from other operations would sweep in items which would have no bearing on gross income. What constitutes "gross income" is not clear, but this problem is more acute in the case of the relief provisions relating to new products and will be considered there.

Base Period Yearly Rate of Return. The Secretary of the Treasury is required to determine and proclaim for each industry classification a rate of return (to the nearest thousandth) for each of the years 1946 through 1949. The yearly rate of return for each industry classification is to be computed by dividing the sum of the aggregate net income and the aggregate interest deduction shown on the income tax returns filed by the corporations in such classification submitting balance sheets, by the aggregate total assets for which such returns were filed.⁴⁹ Tentative rates of return, which were required to be determined and proclaimed not later than March 1, 1951,⁵⁰ have now been released.⁵¹

It will be noted that the total assets are simply according to balance sheets. It is immaterial whether a balance sheet carries assets at adjusted basis for gain, adjusted basis for loss, or some entirely different book basis. No elimination of inadmissible assets is required and no review of the correctness of the net income reported is apparently contemplated. It is apparently believed that on an industry wide basis any deviations will have little effect on ultimate earnings ratios. The premise seems somewhat questionable.

Comments on Method. The steps already discussed complete those necessary for determining average base period net income in the ordinary case where section 442 applies and twelve or fewer months are affected by the abnormality, although they do not cover the effect of Part II transactions, which are discussed subsequently. Certain of the adjustments in arriving at the final credit are somewhat different than in the case of the usual method and these are summarized in a note.⁵²

49. The net income is to be computed without regard to the operating loss deduction. INT. REV. CODE § 447(a). The last two sentences of the subsection (a) are:

"Such aggregate net income, interest deduction and total assets for each such year shall include the amounts reported on the income tax returns for the calendar year and the amounts reported on returns for other taxable years the greater part of which falls in such calendar year. The determinations by the Secretary required under this section shall be made on the basis of returns regularly used by the Treasury Department in compiling published statistics from income tax returns, computing all rates of return after giving effect to renegotiation of contracts in accordance with renegotiation statistics published in the statistics compiled with respect to industry classification."

50. INT. REV. CODE § 447(d).

51. T.D. 5829; Reg. 130, § 40.447.2. Action taken on the basis of such rates is subject to redetermination on determination and proclamation of final rates. INT. REV. CODE § 447(d).

52. In determining the excess profits credit there is allowed only 85 per cent of the

The main merit and weakness of the method are clear at this time. Its merit is that it prescribes a means of ascertaining with reasonable ease and certainty a substitute income basis in case the statutory requirements are met. It is probable that the difficulty of establishing the existence of abnormalities and their causal connection with a reduction in income is not unduly burdensome or the cause for reasonable complaint. At least the problem here is no different than under section 722(b)(1) and (2) which has not been the ground for widespread objection. The merit is no minor one. But neither is the main fault—the complete lack of correlation between the ground for relief and the relief, if any, allowed. To illustrate:

A corporation manufactures two products, small electric motors and electric clocks. The electric motor business is long established and accounts for the "larger part of the gross receipts"; the manufacture of the electric clocks is a growing part of the business and results in substantial income. The taxpayer is on a calendar year basis of accounting. During 1946 there is a destruction by fire of that part of the property which is used for the manufacture of electric clocks. This results in depressing earnings for part of 1946 and most of 1947. Under the thirty-six month rule 1947 is eliminated and relief is sought under section 442(c) with respect to 1946. As the larger part of gross receipts is derived from the electric motor manufacturing business the corporation's industry classification is in Major Group 36, relating to electrical machinery, equipment, and supplies. Reconstruction, therefore, must be based on the index for this group, although the abnormality occurred in the part of its business which would be classified in Major Group 38 and 39, relating to professional, scientific and controlling instruments, photographic and optical goods, watches and clocks, and miscellaneous manufacturing industries. There have been determined for Group 36 a tentative base period yearly rate of return

average base period net income whether computed by the general method or under one of the general relief sections. INT. REV. CODE § 435(a)(1). Under the general average method of section 435(d), the taxpayer is normally allowed an additional credit of 12 per cent of the amount of the base period capital addition. If the average base period net income is computed under section 442, the base period capital addition is allowed to a limited extent. If there is included a substitute excess profits net income for any month either for the first taxable year under Subchapter D or for the immediately preceding year, the base period capital addition is zero. If there is included a substitute excess profits net income for any part of the earlier of the two taxable years immediately preceding the taxpayer's first taxable year under Subchapter D, the base period capital addition shall be the excess of the yearly base period capital for the first taxable year under Subchapter D over the immediately preceding taxable year. INT. REV. CODE § 435 (a)(1) and (f) (3). The allowance of the credit with respect to the net capital addition for the taxable year is the same as under the general average method. INT. REV. CODE § 435(a)(1). If the abnormality affects more than twelve months and the reconstruction is under section 442(d) (discussed subsequently) the base period capital addition is zero. INT. REV. CODE § 435(f)(3).

for 1946 of 4.2 per cent and for Group 38 and 39, 11.9 per cent.⁵³ On a reasonable method of reconstruction the taxpayer should be entitled to use the latter rate, but, under the method employed, the 4.2 per cent rate is the measure.

A slight variation in the facts indicates a further oddity in the method employed. Assume that the fire had taken place in that part of the property devoted to the manufacture of the motors. Since the taxpayer could not manufacture motors for part of 1946, the larger part of its gross receipts for that year would be derived from the electric clock business and the taxpayer would then be entitled to use the index for Major Group 38 and 39 although it had sustained no abnormality in its electric clock business and normally would be classified in Major Group 36.

A further basic weakness in the method is the use of the same percentage for all taxpayers assigned to a particular industry. If the taxpayer is efficient, the percentage is unduly low. The House bill did make an attempt to relate the taxpayer's relative efficiency to the relief granted, but this portion of the bill was replaced by the provision in the final Act.⁵⁴ Conversely, if the taxpayer is highly inefficient and simply a marginal manufacturer the reconstruction might be unduly generous.

If American industry were based upon one product per corporation and if the method employed made some attempt to relate the extent of the relief to the taxpayer's relative efficiency in its particular industry, the principal vice of the reconstruction would be gone. American industry, however, is not based upon any such concept and, indeed, the classification employed in the Manual recognizes this fact.⁵⁵ The extremely wide fluctuations in rates of return within a major group classification constitute a very troublesome feature of the system used in the general relief sections. The tentative base period rates of return among major groups vary from .2 per cent for Major

53. Reg. 130, § 40.447-2.

54. The provisions in the House bill relating to abnormalities in the base period were contained in section 442 of that bill. H. R. 9827, 81st Cong., 2d Sess. (1950); H. R. REP. No. 3142, 81st Cong., 2d Sess. 17 (1950). The method employed and the reason given for the rejection are stated in the Finance Committee Report as follows:

"The House bill used a somewhat different formula which allowed the taxpayer to substitute for the actual income of the year or years of the abnormality an amount which bore the same relation to the taxpayer's earnings in its 'normal' years during the base period as an earnings index for the taxpayer's industry in that year bore to the aggregate of the industry indexes in the taxpayer's normal years. The House formula could not be applied unless one of the taxpayer's base period years was free of abnormality. Moreover, the substituted amounts might be inappropriate if the year to year changes in the taxpayer's earnings during the base period were not similar to the changes in the index of the taxpayer's industry. Finally, the system of indexes used under the House bill was somewhat complex."

SEN. REP. NO. 2679, 81st Cong., 2d Sess. 19 (1950).

The point is further discussed in the Conference Report on the bill. H. R. REP. No. 3231, 81st Cong., 2d Sess. 20, Amendment No. 129 (1950).

55. See note 45 *supra*.

Group 45, transportation by air, to 25 per cent for Major Group 55, automotive dealers and gasoline service stations.⁵⁶ Industries within some major groups probably fluctuated almost as widely. For example, even after applying the depressed industry subgroup provisions to the wine industry, its tentative adjusted rate of return is only 7.8 per cent compared to the tentative base period rate of return of 14.6 per cent for its major group, food and kindred products.⁵⁷

The subject should not be left without mention of the difficulty which must inevitably attach to the determination by the Treasury Department of index ratios from income tax return data. A very important part of the manufacturing industry is surely carried on by large corporations. To make an accurate allocation of assets employed in particular industries to the net earnings from those assets would seem to be very difficult in many cases. In certain industries the most efficient producers are the large corporations and their operations, where identifiable, substantially affect industry ratios. If not identifiable, an important element may be missing in some industries.

Effect of Certain Exchanges under Part II. The provisions of Part II (Sections 461-465) relate to the excess profits credit based on income where exchanges have been involved, and include a number of rules with respect to the effect of such exchanges on section 442(c) and the other general relief provisions. In view of the highly complicated nature of Part II provisions, any detailed discussion of their effect on the general relief sections is not possible within the confines of this paper. Only a few general comments will be made.

The general purpose of Part II is to give a successor corporation, the "acquiring corporation," benefits of the base period experience of a predecessor, the "component corporation." "Acquiring corporation" and "component corporation" are defined in terms familiar to those who have dealt with the intricacies of Supplement A of the excess profits tax law of World War II. In general, an acquiring corporation is a corporation which has acquired properties of another corporation, or partnership, in connection with certain types of exchanges which would be ordinarily tax free under the provisions of section 112.⁵⁸ A provision, not found in Supplement A, section 461 (a) (1) (E), which is broad enough to cover tax free split-ups, has been included.⁵⁹ In such

56. Reg. 130, § 40.447-2.

57. *Id.* §§ 40.446-2 and 40.447.2.

58. INT. REV. CODE § 461. For a discussion of the Supplement A definitions, see Reg. 112, § 35.740-2. The regulations issued under the new law, Regulations 130, do not contain provisions dealing with Part II.

59. With respect to the new category the Finance Committee said, in part, it covered "those corporate reorganizations under section 112(g)(1)(D) which are commonly known as split-ups, where the assets of the corporation are split up among two or more new corpora-

a case, the base period experience has to be apportioned.⁶⁰ One important rule that must be borne in mind in connection with determinations under Part II is that, for purposes, among other things, of the general relief provisions, an acquiring corporation is generally deemed to have commenced business on the earliest date on which it or any of its components commenced business.⁶¹

The average base period net income under section 442(c) may be determined by computing the excess profits net income either with or without reference to Part II. In the case of the other general relief provisions, average base period net income shall be determined subject to the rules provided in Part II. The excess profits net income of the acquiring corporation, computed with reference to Part II, is the excess profits net income for each month of the acquiring corporation's base period, and for the additional period ending June 30, 1950, increased or decreased, as the case may be, by the addition or reduction resulting from including the excess profits net income for that month of all component corporations in the manner provided.⁶²

There is a separate subsection in section 462 of Part II setting forth the special rules to be applied in each of the related general relief sections and the appropriate subsection must be considered if an acquiring

tions followed by the liquidation of the corporation originally transferring the assets." SEN. REP. No. 2679, 81st Cong., 2d Sess. 37 (1950). As indicated in the Senate Finance Committee report section 461(a)(1)(E) covers more than split-ups.

60. INT. REV. CODE § 462(i).

61. INT. REV. CODE § 461(d). Subsection (d) also provides that, except for the limited purpose indicated in the text, a component corporation, other than one described in section 461(a)(1)(E), shall be deemed not to have been in existence or to have commenced business prior to the day after the section 461(a) transaction for purposes of determining the applicability of section 435(e) and the general relief provisions to such corporation after such transaction.

62. INT. REV. CODE § 462(a). The manner is provided in section 462(b), which, in general, provides for the recomputation of the excess profits net income for each month. The computation is made for the acquiring corporation and for each component under the general average method prescribed in section 435(d)(1) (without regard, however, to the provision that in no event shall excess profits net income for any corporation for any month be less than zero). If the acquiring corporation was in existence itself or constructively at the beginning of its base period, but for any month of the base period the acquiring corporation or any component was not in existence, there is allowed an excess profits net income for that month of 1% of the equity capital at the earlier of two dates, reduced by the inadmissible asset formula. Special provision has been inserted to avoid the equity capital reflecting money or property having been paid in by the acquiring corporation or a component. Finally, for every month of the acquiring corporation's base period and for each month thereafter for the period ending June 30, 1950 there shall be added to the excess profits net income of the acquiring corporation for that month, determined as above indicated, the excess profits net income of each component corporation for that month so determined. The excess profits net income of the acquiring corporation for any month so recomputed shall in no event be less than zero.

corporation transaction is involved.⁶³ There are also certain other Part II provisions which may have a bearing in a particular case.⁶⁴

More than Twelve Months Affected by Abnormalities

Reconstruction, if more than twelve months are affected by abnormalities, eliminates the use of actual base period net income entirely. The method requires the determination of the average amount of the taxpayer's total assets for the base period, the application to such amount of the base period rate of return for the taxpayer's industry classification and elimination of the average annual interest paid or incurred by the taxpayer.⁶⁵ The average base period net income so computed is not available unless it exceeds 110 per cent of the average base period net income determined under the general average method. The taxpayer's industry classification is determined by reference to the last taxable year within or beginning within its base period, and is, as in section 442(c) cases, the industry classification to which is attributable the largest amount of the taxpayer's gross receipts for such taxable year.⁶⁶ The base period rate of return is to be determined and proclaimed by the Secretary of the Treasury for each industry classification.⁶⁷ Tentative rates of return are provided for⁶⁸ and have already been determined and proclaimed.⁶⁹ The base period rate of return is to be obtained by aggregating net income and interest deduction and dividing the aggregate by the sum of the total assets for the four years 1946 to 1949, and the ascertainment of such items for an industry classification is to be based on data appearing on corporate tax returns.⁷⁰ It should be noted that although the general average method discards twelve months from the base period, the base period rate of return uses all four years.

CHANGE IN PRODUCTS OR SERVICES

The qualification provisions of section 443, relating to a change in products or services, are relatively strict and require careful con-

63. The related subsections are as follows:

Section 442, base period abnormalities—section 462(d).

Section 443, change in products or services—section 462(e).

Section 444, increase in capacity—section 462(f).

Section 445, new corporations—section 462(g).

Section 446, depressed industry subgroups—section 462(i).

64. See section 463(a)(13) and (14) relating to net capital additions and reductions in certain changes in products or services and new corporation cases.

65. INT. REV. CODE § 442(d). The method is, of course, worked out by formulas in the law.

66. INT. REV. CODE § 442(g).

67. *Id.* § 447(b).

68. INT. REV. CODE § 447(d).

69. T. D. 5829; Reg. 130, § 40.447-2.

70. INT. REV. CODE § 447(b).

sideration. The relief granted follows the form used under section 442(d), that is, an average base period net income determined by multiplying assets by the base period rate of return for the taxpayer's industry classification and eliminating the interest paid or incurred by the taxpayer for the appropriate period.

The section is applicable with respect to a taxpayer which commenced business on or before the first day of its base period and which establishes with respect to any taxable year that

(1) During so much of its three immediately preceding years as falls within the thirty-six month period ending on the last day of its base period, there was a substantial change in the products or services furnished by the taxpayer,

(2) More than 40 per cent of its gross income or 33 per cent of its net income for such taxable year (i.e., the taxable year with respect to which the taxpayer establishes the conditions) is attributable to one or more new products or services, and

(3) Its average monthly excess profits net income (determined under section 443(e)) for such taxable year exceeds 125 per cent of its average monthly excess profits net income (similarly determined) for the taxable years ending within its base period and prior to the taxable year in which occurred the first change to which gross income is attributed for the purpose of the subsection.

If these elements are so established, then, in computing its excess profits credit for taxable years under Subchapter D which end on or after the earliest taxable year with respect to which the requirements of paragraphs (1), (2) and (3) are satisfied, its average base period net income under section 443 shall be the amount computed by the method above described.⁷¹

For purposes of convenience, these various requirements are discussed under appropriate headings.

Relief Requirements

Time Limitations on Year of Change and Year of Qualification. Certain time rules may be stated:

(a) For a change in products or services to be a qualifying change it must occur within some part of the thirty-six months ending with the close of the base period, which will most frequently be December 31, 1949.⁷²

(b) The first taxable year with respect to which the requirements could be met would be the taxable year following the taxable year of change.

71. INT. REV. CODE § 443(a).

72. For base period, see INT. REV. CODE § 435(b).

(c) No taxable year subsequent to the third taxable year succeeding the taxable year of change can meet the requirements.

(d) It is not important to identify any possible qualifying taxable year (i. e., a year meeting the requirements) except the earliest.

An illustration may serve to clarify some of these points. If a corporation is on the calendar year basis of accounting, the base period ended on December 31, 1949. As the qualifying change cannot occur other than during some part of the thirty-six months ending with December 31, 1949, the first year in which a qualifying change could occur would be 1947. No taxable year prior to 1948, then, could be a taxable year meeting the statutory requirements. The last taxable year in which a qualifying change might occur would be 1949. As the third taxable year succeeding 1949 would be 1952, the last taxable year which could be a taxable year meeting the requirements would be 1952.

These time limitations do not seem unduly restrictive although some questions might be raised. For example, if Congress was willing to permit relief if a qualifying change occurred in 1947 and the requirements were first met in 1950, why should relief be denied if the change occurred in 1946 and the requirements could be met in 1949? It does not seem sufficient to say that the benefits in the second case will be partly reflected in the base period. They would also be reflected before the end of the base period if the year of change were 1947 and the requirements were met in 1948 or 1949.

"Substantial Change" in Products or Services. What constitutes a "substantial change" under section 443? Is the change simply to be measured by the gross income or net income criteria set by paragraph (2)?⁷³ Consideration of the point indicates that paragraph (2) is not a gloss on paragraph (1). An automobile manufacturer brings out a new model embodying rather minor changes from previous models and thereafter practically all the income of the manufacturer will be attributable to the new model. Although the terms of paragraph (2) would be met, it cannot be seriously contended that there has been a "substantial change" in products satisfying the requirements of paragraph (1). Section 722(b) (4) did not use the modifying word "substantial," but the Treasury Department has construed the section to require that the change be substantial.⁷⁴ It seems that the problems

73. The Finance Committee seems so to suggest:

"To qualify for relief under the 'new product' provision the change in products or services must have been 'substantial' in the sense that by the end of the third year (or earlier) following the year in which the products or services were introduced, the gross income from such products must aggregate to more than 40 percent of the taxpayer's gross income in that year." SEN. REP. No. 2679, 81st Cong., 2d Sess. 21 (1950).

The Senate bill substituted for the net income test used in the House bill the gross income test but in conference the bill was changed to use both tests as alternatives. H.R. REP. No. 3231, 81st Cong., 2d Sess. 20, Amendment No. 130 (1950).

74. Reg. 112, § 35.722-3(d); E. P. C. 32, 1948-1 CUM. BULL. 94; E. P. C. 12, 1947-1 CUM. BULL. 80; E. P. C. 5, 1946-2 CUM. BULL. 122.

under the two sections are the same and that law developed with respect to section 722 on this point should serve as authority for the new provision.⁷⁵

Gross Income and Net Income Tests. The tests of paragraph (2) are to be made with respect to income "attributable to one or more of the new products or services." It would seem to follow that results from several new products or services may be combined in applying the tests. This is the interpretation of the Senate Finance Committee.⁷⁶

One of the first problems which crosses the mind is the application of the percentage tests if consolidated returns for the excess profits tax year are filed. Must the new product or service earn 40 per cent of the gross income or 33 per cent of the net income of the affiliated group? Although the excess profits tax act is silent on the point, it may well be that if consolidated excess profits tax returns are filed not only must the test of paragraph (2) be applied for the combined group, but also that other general relief provisions must be considered on an affiliated basis. There is little to guide the taxpayer except the general theory of consolidated returns. Perhaps the position of the Treasury Department with respect to abnormalities under section 721 is some indication of the course which may be followed in the regulations under the new law. The regulation under the prior law said:

"Whether or not an abnormality exists shall be determined in the light of the aggregate business and of the collective experience during the four previous taxable years of the several members of the group."⁷⁷

If such a rule is applied, there can be little chance for a large corporate group of affiliated corporations to meet the requirements of section 443. The point is emphasized by testimony introduced on behalf of Armour & Co. at the Senate hearings. The testimony was that Armour & Co. had developed a new miracle drug acthar (ACTH)

75. The Committee on Ways and Means said:

"The concept of what constitutes a change in product or service was developed under the prior excess profits tax law, and it is believed that the experience thereunder was generally satisfactory." H. R. REP. No. 3142, 81st Cong., 2d Sess. 19 (1950).

In this connection, see Acme Breweries, 14 T. C. 1034 (1950); Stonhard Company, 13 T. C. 790 (1949); Lamar Creamery Company, Inc., 8 T. C. 928 (1947). The regulations under the Excess Profits Tax Act of 1950 are not very detailed on the point of what constitutes a "substantial" change. Reg. 130, § 40.443-2(a).

76. "It is intended that, where a taxpayer establishes that it has made several substantial changes in products or services during the last 36 months of its base period, the aggregate effect of such changes may be considered in determining whether the eligibility requirements of the section are met. The gross income and net income tests can be met in a particular year by considering all such substantial changes which were made during the three preceding years." SEN. REP. No. 2679, 81st Cong., 2d Sess. 22 (1950). The regulations are in accord. Reg. 130, § 40.443-2(b).

77. Reg. 110, Sec. 33.30(a).

used in the treatment of arthritis and other diseases.⁷⁸ The drug was not marketed commercially until 1950 and it was testified that there was no hope of qualifying under the net income requirement of section 443 as the entire pharmaceutical division of Armour & Co. could not qualify for that test.⁷⁹ On the other hand, a wonder drug developed under similar circumstances by an independent corporation, or at least one not included in a consolidated return, might well afford the basis for relief.⁸⁰

The requirements of a section raise the question as to the method to be used by the taxpayer in determining whether, for a particular year, 40 per cent of its gross income "is attributable to one or more of the new products or services."⁸¹ The concept of "gross income" is, of course, used throughout the Internal Revenue Code.⁸² Although generally the classification of items of gross income is not of particular importance, in some instances it may be of vital moment.⁸³ The new product provision surely adds to the latter list. For the purpose of determining gross income from the sale of new products probably there is applicable the general rule that gross income from sales is represented by the amount of sales less the cost of goods sold.⁸⁴ The question of gross income from new services may raise problems on which there is little authority. Generally, gross income from services would seem to resemble more nearly the gross receipts from service operations than in the case of gross income from sales.⁸⁵

The identification of "net income" from new products or services for the purpose of the net income test may also raise considerable diffi-

78. *Hearings before Senate Finance Committee on H. R. 9827*, 81st Cong., 2d Sess. 739 (1950).

79. The alternative gross income test was not then in the bill but obviously that test would be of no help in such a case.

80. The record does not show whether acthar was in fact developed by a separate corporation although the testimony rather indicates the contrary.

81. Although this problem and the problem of determining the percentage of net income attributable to a new product or service bear some resemblance to questions arising under the abnormal income provisions of section 721, the resemblance is not too close. Under section 721 the problem is more one of comparison with other years and of the determination of the proper method of attributing the abnormal income to other years.

82. The general definition in section 22 is not very helpful for present purposes.

83. The identification and classification of items of gross income may be very important for the purposes of the provisions dealing with personal holding companies (INT. REV. CODE § 502), foreign personal holding companies (*id.* § 332), the determination of the domestic or foreign source of income (*id.* § 119), the determination of the question whether a corporation is an "affiliate" for the allowance of an ordinary loss for worthlessness of its securities (*id.* § 23(g)) and the related bad debt problem (*id.* § 23(k)), and the determination of certain depletion problems (*id.* § 114(b)(3), (4); see Reg. 111, § 29.23(m)-1 to 19).

84. Reg. 111, § 29.22(a)-5.

85. See, for example, *Frederick Smith Enterprise Company v. Commissioner*, 167 F. 2d 356 (6th Cir. 1948); *Noteman v. Welch*, 108 F. 2d 206 (1st Cir. 1939); *W. H. Bechtel Co.*, 42 B. T. A. 927 (1940). See also *Mim*, 2915, I-1 CUM. BULL. 233 (1922).

culty. One analogy that comes to mind is the problem of allocating net income within and without the United States.⁸⁶ Under these provisions once the source of the gross income is determined, it is necessary to determine the distribution of deductions to the sources. The general rule is to allocate to each type of income those expenses, losses and other deductions which can be directly related to the particular income and to apportion the remaining deductions ratably.⁸⁷

In short, the determination of the question whether the paragraph (2) requirements have been met may be highly difficult and complex in a particular case and conceivably may lead to considerable dispute and litigation.

Average Monthly Excess Profits Net Income Requirement. In order to determine whether the test of paragraph (3) is met, the taxpayer must ascertain the average monthly base period net income for the taxable year with respect to which it is claimed that the requirements of section 443 are met. Similarly, there must be determined the average monthly base period net income for the taxable years ending within the base period and prior to the first taxable year in which occurred the first change to which gross income is attributed for the purpose of section 443(a). In the case of any taxable year involved in the computation which is not in the base period, the excess profits net income is computed by making the same adjustments as in the case of a base period year.⁸⁸ This has the effect, of course, of putting the years on a comparable basis. The earlier period for which the comparison is made may include more than one taxable year. In this case, the aggregate of the excess profits net income for such taxable years is found, there is subtracted the aggregate amounts of deficits in excess profits net income for all taxable years in such period, and the result is divided by the number of months in the period.⁸⁹

If after these computations the average base period net income for the taxable year in respect of which it is claimed that the requirements were met exceeds 125 per cent of the average for the earlier period, the requirements of paragraph (3) are met.

Reconstruction

The method of determining the average base period net income has been briefly described and since it closely resembles reconstruction under section 442(d), it will not be reviewed in detail. If the qualifying

86. INT. REV. CODE § 119. Another analogy might be the "net income . . . from the property" in connection with percentage depletion. Reg. 111, § 29.23(m)-1(g).

87. INT. REV. CODE § 119(b), (d) and (e); Reg. 111, Sec. 29.119-10. For rulings indicating the Commissioner's approach to the problem, see G. C. M. 26013, 1949-2 CUM. BULL. 76; G. C. M. 7592, IX-1 CUM. BULL. 213 (1930); I. T. 3034, XV-2 CUM. BULL. 136 (1936).

88. INT. REV. CODE § 443(e).

89. The average monthly excess profits net income shall in no case be less than zero.

tests are met the reconstruction is made by multiplying the taxpayer's total assets, determined as under section 442, by the base period rate of return for the taxpayer's industry classification. The day as of which the total assets are determined is the later of (a) the last day of the taxpayer's taxable year immediately preceding its first taxable year under Subchapter D (that is, the end of the last taxable year ending prior to July 1, 1950), or (b) the last day of the taxable year in which the taxpayer first meets the requirements of section 443(a). There is subtracted the taxpayer's interest deduction for the twelve months ending with whichever date is used.⁹⁰

Under the formula employed, the industry index may be for an entirely different industry than that in which the new product or service was developed. Again, there is no attempt to relate the quantum of relief to the relative efficiency of the taxpayer in the industry. Whether the reconstruction will give any relief to the particular taxpayer may even depend on its relative inefficiency. If, for example, the new product is in the same industry as the other products of the taxpayer and on the whole the taxpayer has earned at the average industry rate, the reconstruction will be of no benefit. On the other hand, if it has earned much less than the industry rate, even though the low earnings were due to poor results from old products, the higher industry rate of return will be allowed.

INCREASE IN CAPACITY FOR PRODUCTION OR OPERATION

Under the provisions of section 444, relief based on an increase in capacity requires a showing that additions to or replacements of "facilities" have been made with certain results. "Facilities" are defined to mean real property and tangible personal property, held by the taxpayer in good faith for the purposes of the business. The increase in capacity, as defined in the section, must occur during the thirty-six month period ending on the last day of the taxpayer's base period. Benefits are restricted to a taxpayer which commences business on or before the first day of its base period. Reconstruction follows the formula of sections 442(d) and 443.

To secure relief, one of three tests must be met. The first is that as a result of additions to or replacements of facilities the capacity for production or operation on the last day of the base period was 200 per cent or more of such capacity on the day prior to the beginning of the thirty-six month period. The second test may be met by satisfying two conditions, (i) that as a result of additions to or replace-

90. INT. REV. CODE § 443(b). The taxpayer is not, of course, entitled to any credit on account of a base period capital addition and obtains the benefit of a net capital addition only for the period subsequent to the taxable year when the requirements of section 443 are first met. See INT. REV. CODE §§ 435(a), 443(d); Reg. 130, § 40.443-3(b).

ments of facilities the capacity on the last day of the base period was 150 per cent or more of the capacity on the day prior to the beginning of the thirty-six month period, and (ii) that the adjusted basis for determining gain upon sale or exchange of the total facilities on the last day of the base period was 150 per cent or more of such adjusted basis of total facilities on the day prior to the beginning of the thirty-six month period. The third test is met if the unadjusted basis for determining gain upon sale or exchange of total facilities on the last day of the base period was 200 per cent or more of such unadjusted basis of the total facilities on the day prior to the beginning of the thirty-six month period.

The theory of allowing relief for an increase in capacity is, of course, derived from section 722(b)(4). The relief there, however, is not based upon specific tests but upon the usual broad grounds of section 722.⁹¹ The administrative difficulties which have been encountered in determining the grounds for relief and the extent to which relief should be allowed have resulted in the more particularized provisions of section 444.

Increase in Capacity by 200 Per Cent or More

Under the first test the increase in capacity must be the result of the additions or replacements. The concept of additions and replacements would not seem to be too troublesome. It is apparently contemplated that a physical addition to or replacement of facilities will be involved. The identification of additions or replacements should not present an unduly complicated problem.⁹² Other problems under the test may be more difficult. Thus, it may not be easy to establish that the entire increase in capacity was the result of additions or replacements. What constitutes "capacity" has proved troublesome under section 722. An aircraft factory shifts from producing two-engine planes to four-engine planes and at the end of the base period can make as many four-engine planes as it could two-engine planes at the beginning of the base period. What is the measure of its increase in capacity?⁹³ The whole problem may be more im-

91. For section 722 authorities on increase in capacity, see *Wisconsin Farmer Company*, 14 T. C. 1021 (1950); *Suburban Transportation System*, 14 T. C. 823 (1950); *Stonhard Company*, 13 T. C. 790 (1949); *Irwin B. Schwabe Company, Inc.*, 12 T. C. 606 (1949); *National Grinding Wheel Company*, 8 T. C. 1278 (1947); *East Texas Motor Freight Lines*, 7 T. C. 579 (1946); E. P. C. 27, 1948-1 CUM. BULL. 89; E. P. C. 26, 1948-1 CUM. BULL. 88; E. P. C. 19, 1947-2 CUM. BULL. 132; G. C. M. 24329, 1944 CUM. BULL. 408; G. C. M. 24013, 1943 CUM. BULL. 794.

92. Bulletin, Part V(I)(C)(3)(a), (b) and (c).

93. The regulations contain the following:

"In determining capacity for production or operation, the unit of measurement customary for the output of the particular kind of business shall be used, such as tons, gallons,

portant under section 444 even than it was under section 722. The section does not limit the manner in which facilities are to be added or replaced so that it would seem that most methods of acquiring or replacing facilities should be acceptable.⁹⁴

Whether the requirement under the first test that the increase in capacity must be 200 per cent is reasonable seems largely a matter of informed judgment. Many corporations increased their capacity during the base period so that some increase in capacity might be deemed almost a normal operation during the base period. Obviously any standard is arbitrary and the use of such a substantial figure as 200 per cent must have been chosen to reduce the claims for relief in this area to a relatively small number. Indeed, the House bill contained no provision for relief based on increase in capacity.⁹⁵

Combined Increase of Capacity and of Investment in Facilities

Under the second test there must have been at the end of the base period a capacity of 150 per cent of the capacity prior to the beginning of the thirty-six month period and the adjusted basis for determining gain of facilities at the end of the base period must have been 150 per cent of the adjusted basis of total facilities prior to the beginning of the thirty-six month period. It is not entirely clear why any test except actual increase in capacity is used.⁹⁶ It may be that proof of increase of capacity of 200 per cent, required in the first test, due to additions to or replacement of facilities would not be easy to meet in certain deserving cases, and that it was felt that the second test should also be available. Considerations with respect to the first of the alternative conditions of this test are generally similar to those with respect to the first test. The second condition requires a comparison of the adjusted basis for gain between the two dates. The use of basis for gain,

barrels, yards, or dozens. In those businesses having no customary unit of measurement, an acceptable alternative might be expressed in terms of the principal raw material utilized. Dollar amounts may be used only if there is no other practical measurement for such output and then only if the taxpayer can establish that no distortion in the comparison results. The same unit of measurement must be used in computing capacity for the last day of the base period as is used in computing capacity for the last day of the twelfth month of the base period, except that the capacity for the last day of the base period must not include any increase not due to replacements or additions to facilities." Reg. 130, § 40.444-2(b)(2).

94. See, however, the provisions with respect to Part II transactions. INT. REV. CODE § 462(f).

95. The Senate Finance Committee said:

"There was no equivalent provision in the House bill, but numerous witnesses who appeared before the committee pointed out the need for an adjustment based on substantial changes in capacity and stressed the discrimination which would result if an alternative basis were provided in the new product cases while no adjustment was made for substantial changes in capacity." SEN. REP. No. 2679, 81st Cong., 2d Sess. 23 (1950).

96. The Committee reports do not help on this question.

of course, contemplates the allowance of March 1, 1913 values if in excess of cost.⁹⁷

For the ordinary business corporation the principal difference between unadjusted and adjusted basis will be the reduction in the latter case of the basis by the depreciation allowed or allowable.⁹⁸ It is probable that a generalization cannot be made as to the effect of the use of a comparison between adjusted bases. On the one hand the same property held at both dates will have a lower basis at the later date by reason of the depreciation and to this extent will require a greater investment in other facilities to offset the loss of basis on assets held at both times. On the other hand, if the buildings and machinery were written down by depreciation allowances to a relatively low figure at the first date but are still useful in the business the test of an increase in investment may be met by a relatively small expenditure. This point might be of particular importance if the taxpayer had the benefit of accelerated amortization under section 124. As this adjustment was discontinued in 1945, the full adjustment allowed by that section will have been reflected before the beginning of the thirty-six month period.⁹⁹ Furthermore, since the amortization period under the new amortization section does not begin until 1950, no result from its application will be reflected in the figure at the later date.¹⁰⁰

Increase in Unadjusted Basis of Facilities by 200 Per Cent or More

Under the third possible test the taxpayer may qualify by establishing that the unadjusted basis for determining gain upon sale or exchange of total facilities was, on the last day of its base period, at least double the unadjusted basis of its total facilities on the day prior to the beginning of the thirty-six month period. This test would seem to involve in most cases a very large additional investment in facilities and if the operation were substantial at the outset it is unlikely that a corporation would be able to qualify as easily as under one of the other tests.

DEPRESSED INDUSTRY SUBGROUPS

As in the sections already discussed the relief under section 446 is granted to a taxpayer which commenced business before the first day

97. INT. REV. CODE § 113(a)(14). The use of March 1, 1913 values probably will tend to reduce the chance of meeting the condition. During the base period the taxpayer will not normally be acquiring property with a basis determined by March 1, 1913 values. The lower the basis of the facilities at the beginning of the base period the less difficult will it be to meet the condition.

98. INT. REV. CODE § 113(b).

99. The discontinuance was by Presidential proclamation of September 29, 1945. Proclamation 2669, 10 FED. REG. 12475 (1945).

100. INT. REV. CODE § 124A.

of the base period. The relief granted follows the general form used under section 442(d). The theory here is somewhat different, however, as it contemplates that the entire subgroup should be reconstructed. The section treats as the norm four-fifths of the rate of the return for the industry subgroup for the eleven year period, 1938 through 1948. The taxpayer's average total assets for the base period are multiplied by this rate of return and there is subtracted an appropriate part of the interest deduction. The key to the application of the section is the determination of whether the taxpayer belongs to a depressed industry subgroup.

Determination of Depressed Industry Subgroup

The Secretary is required to determine and proclaim as a depressed industry subgroup any industry subgroup having a rate of return for the period 1946 through 1948 which is less than 63 per cent of its rate of return for the period 1938 through 1948.¹⁰¹ Tentative determinations are contemplated¹⁰² and have been made.¹⁰³

Industry Subgroups. Industry subgroups shall be generally in accord with the industry subgroups regularly used by the Treasury Department in compiling published statistics from income tax returns but with such combinations of subgroups as the Secretary determines are necessary to provide reasonably comparable data over the period 1938 through 1948.¹⁰⁴

Identification of Members of Industry Subgroups. A taxpayer is a member of an industry subgroup if more than 50 per cent of its gross receipts for the taxable years beginning with or within its base period is attributable to such industry subgroup.¹⁰⁵ Gross receipts are to be determined by the tests already discussed. This is, of course, a very rough test for the purpose of identification of the members of a subgroup as well as for other purposes. Thus, if the taxpayer derives its income from two sources, one a service operation with large gross receipts but little profit, and the other the sale of a quality product resulting in relatively small receipts but high profits, a depression of the industry subgroup in which the latter product is placed will afford no basis for relief. The taxpayer with diversified products or services will find it difficult to establish any right to relief under section 446. Suppose, for example, that a taxpayer has three products, each of which falls into a different industry subgroup and that in no case do

101. INT. REV. CODE § 446(c).

102. *Id.* § 446(h).

103. T.D. 5829; Reg. 130, § 446-2.

104. INT. REV. CODE § 446(f). In the tentative determinations, the Secretary has made combinations. In the case of Industry Subgroup 8, transportation by air, he has, in fact, taken the entire major group classification. T.D. 5829; Reg. 130, § 446-2.

105. INT. REV. CODE § 446(g).

the total sales from a product equal 50 per cent of the taxpayer's gross receipts. Apparently the taxpayer would not be a member of any industry subgroup and would be entitled to no relief even if all three products fell into depressed industry subgroups.

Rates of Return for Industry Subgroups. In view of the definition of a depressed industry subgroup, the section prescribes the method of determining the rate of return for an industry subgroup for the three year period 1946 through 1948 and for the eleven year period 1938 through 1948. The formula for the first period calls for the determination of the sum of the aggregate net income (computed without regard to net operating loss deductions) for the three years and the aggregate interest deduction for such years shown on the income tax returns filed by the corporations in such industry subgroups submitting balance sheets. This sum is then divided by the aggregate assets for such years of such corporations as of the close of the taxable years for which such returns were filed.¹⁰⁶ To determine the rate of return for the period 1938 through 1948 similar procedure is to be followed.

The problem of classification of corporate returns by industry subgroups is obviously going to be on very rough bases, due to the diversification of products of many taxpayers. The problems are generally similar to those already mentioned in connection with industry classification in general but are probably somewhat more acute.

Reconstruction

The average base period net income determined under section 446 is computed by multiplying the taxpayer's average total assets during the base period by the adjusted rate of return for the taxpayer's industry subgroup and eliminating the average interest deduction of the taxpayer.¹⁰⁷ The adjusted rate of return is a rate equal to four-fifths of the rate of return for the industry subgroup for the eleven year period 1938 through 1948.¹⁰⁸ In some ways the theory of the relief

106. INT. REV. CODE § 446(d)(1). For the purpose of the computation, the income tax returns for a particular year shall be the income tax returns for that calendar year and the returns for other taxable years the greater part of which falls in such calendar year. *Ibid.* The determinations by the Secretary of the Treasury under section 446 are to be made on the basis of returns regularly used by the Treasury in compiling published statistics from returns. Rates of return are to be determined after giving effect to renegotiation of contracts in accordance with industry statistics published in the statistics compiled with respect to industry subgroups. INT. REV. CODE § 446(i).

107. INT. REV. CODE § 446(b).

108. As previously noted, the Secretary has made tentative determinations of depressed industry subgroups and their adjusted rates of return. Only eight subgroups are classified as depressed. The tentative adjusted rates of return vary from 1.5 per cent in the case of telegraphic communications, wire and radio, to 16.8 per cent in the case of the manufacture of metal-working machinery, including machine tools. T.D. 5829; Reg. 130, § 40.446-2.

under section 446 seems more reasonable than in the other general relief provisions. The question as to whether the identification of an industry subgroup is depressed where its rate of return is 63 per cent of the rate of return for the years 1938 through 1948 is debatable, of course. Any figure selected would necessarily be arbitrary. By using the eleven year period selected the depressed years are offset by the generally prosperous years of World War II together with several reasonably normal prior years. After reducing the average base period net income to 85 per cent thereof for the purposes of the credit, the effect is to consider a credit based upon 68 per cent of the rate of return for the eleven year period as a reasonable standard.

The method used does not take into account differences in operating efficiency between taxpayers and gives marginal taxpayers the same rate of return on their assets as the most efficient taxpayers. Of course, it may well be that even in a depressed industry subgroup the efficient taxpayers will have earned a rate of return on their assets exceeding that allowed by the relief provisions. Nevertheless, once the concept is adopted of a depressed industry subgroup it does not seem sound to contemplate relief for the entire group without reference to relative efficiency among members of the group.

NEW CORPORATIONS

A taxpayer which commenced business after the first day of its base period is entitled to relief under section 445. Such a taxpayer is ineligible for relief, however, if on or after December 1, 1950 and prior to the end of its third taxable year it acquires any properties in any of certain described transactions, except to the extent that Part II may make available relief in certain instances. The transactions enumerated are transactions where the taxpayer takes over the basis of the transferring corporation and certain other intercorporate transactions where more than a 50 per cent interest, as defined in the statute, in both the taxpayer and the other corporation to the transaction were in the same owners.¹⁰⁹ Unlike section 722, no qualifying factors have to be shown to entitle a new corporation to relief.¹¹⁰

109. INT. REV. CODE § 445(g). The provisions are technical and, among other things, employ the constructive ownership rules of section 503 relating to personal holding companies.

110. Section 722(b)(4) and (c) contemplated the allowance of relief to new corporations. The former applied if the taxpayer commenced business either during or immediately prior to the base period and the average base period net income did not reflect the normal income of the operation for the entire base period of the business. Section 722(c) allowed relief to a corporation not entitled to use the excess profits credit based on income if the invested capital credit was an inadequate standard for specified reasons. Under section 722(c) the possibility of relief, without reference to section 722(b)(4), was given to corporations of the following classifications:

“(1) Domestic corporations coming into existence after December 31, 1939 which are not acquiring corporations under section 740(a); and

In determining the average base period net income of a new corporation under section 445, two different rules are used, one for the purpose of determining the credit for any of the first three taxable years which is a taxable year under Subchapter D, and the other for determining the excess profits credit for other taxable years under Subchapter D. Under the first rule, the amount of the total assets for such taxable year held by the taxpayer in good faith for the purposes of the business is multiplied by the base period rate of return for the taxpayer's industry classification and there is subtracted the interest deduction for the twelve months ending with the last day of such taxable year.¹¹¹ For the purpose of the computation the total assets for any taxable year are the total assets, defined as previously described, for the last day of the taxpayer's taxable year immediately preceding its first taxable year under Subchapter D and the net capital addition, minus the net capital reduction.¹¹² Where taxable years other than the first three are involved, the computation is made by multiplying the taxpayer's total assets (defined as previously described in connection with section 442) as of (1) the last day of the taxable year immediately preceding the first taxable year under Subchapter D, or (2) the last day of its third taxable year, whichever day is later, by the base period rate of return for the taxpayer's industry classification.¹¹³ The identification of the taxpayer with an industry classification is in accordance with the usual gross receipts test.¹¹⁴

The effect of the provision is to give a new corporation the same rate of return on its assets as was realized by the base period rate of return of the industry in which the taxpayer is classified. In the instance of a new corporation the difficulty of assigning it to an industry would probably not be as great as in connection with some of the

"(2) Domestic corporations coming into existence prior to January 1, 1940, but which (a) never engaged in business prior to that date and (b) are not acquiring corporations under section 740(a); and

"(3) Foreign corporations required to use an excess profits credit based on invested capital under . . . section 712(b)." Bulletin, Part VII(A).

111. INT. REV. CODE § 445(b)(1). The first three years for this purpose are the taxable year of the taxpayer in which it commenced business and the next two succeeding taxable years.

112. Since under this computation the total assets include the net capital addition and net capital reduction, the general provision relating to the adjustment for net capital addition or net capital reduction is not applicable. INT. REV. CODE § 445(e)(1).

113. The section requires that the net capital addition and net capital reduction provisions be read, for the purposes of the computation, so that the comparison will be between the capital in the year of calculation and "the first day of the taxpayer's first taxable year under this subchapter or the day following the close of the taxpayer's third taxable year, whichever day is later," instead of between the year of calculation and "the first day of the taxpayer's first taxable year under this subchapter." INT. REV. CODE § 445(e)(2).

114. INT. REV. CODE § 445(d).

other relief provisions. On the whole the relief seems to permit a favorable basis of reconstruction for a new corporation.

APPLICATION FOR BENEFITS OF GENERAL RELIEF PROVISIONS

The excess profits tax is to be determined without regard to the general relief provisions unless an application for the benefits of the appropriate section setting forth the grounds for the application of the section, in such detail and in such manner as the Secretary of the Treasury may prescribe, is filed by the taxpayer.¹¹⁵ The application may be filed with the return of the taxpayer for the taxable year, or, generally, within the period of time prescribed for filing refund claims,¹¹⁶ or after such time if it is filed within the period of limitations for the assessment of a deficiency in tax for the taxable year, but in such case the application for relief may not reduce the tax by an amount greater than the deficiency determined without regard to the application of the relief section.¹¹⁷ These rules are subject to the exception that if a petition is filed with the Tax Court for the redetermination of tax for the taxable year, the application shall be effective only if filed not later than the date on which such petition is filed. The general relief sections shall not be applied upon the basis of any grounds other than those set forth in the application filed within the prescribed period.

The new provisions, broadly speaking, treat the general relief provisions as a standard matter. They contemplate that the taxpayer may compute under the appropriate relief section, and take advantage of the resulting credit, on its return. In this case the application is part of the return and the grounds upon the basis of which the application is made are to be set forth in detail in an accompanying statement.¹¹⁸ Probably a failure to file complete information with the return in such case is at worst a technical default, subject to later cure. If the tax is paid without use of the relief provisions, then the application for relief is treated similarly to a refund claim.¹¹⁹ The procedure

115. INT. REV. CODE § 447(e). There is a cross reference to this subsection in each of the general relief sections.

116. INT. REV. CODE § 447(e)(B). The provision expressly refers to section 322 and provides that the application of the particular general relief section shall be subject to the limitations as to the amount of credit or refund prescribed in section 322. Reference is made to the extension of time allowed by section 447(d) and section 446(h) relating to the express extension in those subsections of the time where action is taken on the basis of tentative rates and tentative determinations of depressed industry subgroups. The period of limitations does not begin to run with respect to any overpayment or deficiency caused by the Secretary's redetermination prior to such time as final determinations are made by the Secretary.

117. INT. REV. CODE § 447(e)(C). A reference is also made here to the possible extension of the period of limitations for the assessment of a deficiency by reason of the provisions of sections 447(d) and 446(h).

118. Reg. 130, § 40.447-3.

119. The regulations state that if the application is not filed with the original return,

under the new law is surely a great improvement over the procedure involved in section 722 claims.

CONCLUSIONS

From the standpoint of abstract logic and justice the new general relief provisions are probably not as soundly based as those contained in the excess profits tax law of World War II. It has not been entirely the fault of administration that section 722 has proved such a disappointment to so many taxpayers. A substantial percentage of relief claimants under that section probably had no real claim for special treatment. In the light of section 722 experience, however, a new approach was in order. Whether the new provisions will work satisfactorily can only be determined after a reasonable period of experience. At this stage it does seem reasonable to anticipate that a principal ground for complaint lies in the lack of a relationship between the grounds for relief and the relief, if any, granted. Of course, if the result in a particular instance is to reduce the taxpayer's tax it may not be of particular interest to that taxpayer whether the reduction should have been based upon some other method or that a more reasonable method would have produced no reduction. This, however, is hardly a sound basis for supporting a tax provision.

The broad industry classification employed does not seem a sound means for determining the taxpayer's position. Even in cases where a taxpayer may be properly placed in a particular industry, the lack of any attempt to relate that taxpayer's relative efficiency in its industry group is hard to justify logically.

By adopting the method used in the new excess profits tax law, Congress may have avoided many of the pitfalls of section 722, but it may have raised many other difficult problems. It may well be, however, that by avoiding even the appearance of a wide open relief provision, Congress will have minimized the risk of the widespread criticism which has attended section 722.

"it shall be filed with, and as a part of, an amended return, or, if made in connection with a claim for credit or refund, it shall be filed with, and as a part of, the claim for credit or refund." Reg. 130, § 40.447-3.