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Hearings of Joint Committee on Internal Revenue Taxation on the Administration of Section 722 of the Internal Revenue Code: February 6, 1946, Statement of Maurice Austin, Chairman of the Committee on Federal Taxation of the American Institute of Accountants

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American Institute of Accountants. Committee on Federal Taxation

United States. Congress. Joint Committee on Internal Revenue Taxation

HEARINGS OF
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION
ON THE ADMINISTRATION OF SECTION 722 OF
THE INTERNAL REVENUE CODE

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Statement of Maurice Austin, Chairman of the
Committee on Federal Taxation of the
American Institute of Accountants

To the Honorable Members of
the Joint Committee on Internal Revenue Taxation:

This statement is respectfully submitted on behalf of the Committee on Federal Taxation of the American Institute of Accountants.

The American Institute of Accountants is the only national organization of certified public accountants. Its members number in excess of 9,000. Public accountants, probably more than any other group, have a direct and intimate contact with the practical administration of the tax laws, including the section under consideration. This statement represents the carefully considered views of the Institute's Committee on Federal Taxation, which consists of members chosen for their ability, experience and reputation in the field of taxation, and is based not only upon the experiences of the members of that committee, but also upon the experiences of many others which, in one way or another, have been brought to the attention of the committee.

We wish to make it clear at the outset that this statement is not made in the spirit of criticism, but in a sincere endeavor to place before this Joint Committee pertinent facts, as we see them, regarding the administration of Section 722 of the Internal Revenue

Code, and constructive suggestions and recommendations for the improvement of such administration in the interest of both government and taxpayer. Representatives of the Bureau of Internal Revenue and of the Treasury Department will be the first to affirm that our past record demonstrates a sympathetic understanding of the Bureau's practical problems of administration and of active cooperation on our part in their solution.

We have recognized from the beginning that Section 722 placed upon the Bureau a heavy and unprecedented administrative burden which, by reason of its nature and the amounts involved, has assumed an importance out of all proportion to its place in the tax structure. As you know, the form of relief provided by Section 722 is available when, for certain specified reasons, neither invested capital nor actual prewar earnings furnish an adequate standard of normal pre-war earning power, so that determination of excess profits tax liability under the general formulas provided in the Code result in an excessive and discriminatory tax. To obtain relief in such cases it is necessary to establish what normal pre-war, i.e., base period, earnings would have been had certain conditions then existed which, in fact, did not exist. Many claims for such relief have been filed, involving large amounts. The details regarding this are set forth in the Bureau's statement, and, although the Bureau's figures on the amounts of refund claimed do not give effect to the substantial offset represented by the corresponding increase in income tax liability, the sums involved, though smaller than the eight billion dollars referred to in the Bureau's statement are nevertheless very substantial. We do not wonder,

therefore, that, faced with an elusive problem of this nature, involving so much money and so many taxpayers, the administrative officials are found to exercise extreme caution, to be wary of creating precedents with unforeseeable repercussions, and to proceed slowly before important points are determined by litigation.

We are not here primarily concerned with slowness of administration. We are much more concerned with sound and proper administration, than with speedy administration; and, while undue delay in administration may undoubtedly nullify, to a large extent, the rights granted by law, we should much prefer a slower, but sound, equitable and proper administration of these provisions, than a speedy one which merely succeeds in crowding the litigation calendars and transferring the delay from one point to another.

In its statement, the Bureau has given its reasons for slowness in progress of administration to date. With most of these reasons we agree. The section is difficult and involves entirely new problems. The number of claims and amounts involved are large. Many claims, perhaps a substantial proportion of the whole, are ill-founded or ill-prepared. Like all other employers, the Bureau has suffered serious wartime shortages, both in number and in qualificationsof personnel. The number of taxpaying returns to be processed has multiplied. Other pressing problems, referred to in the Bureau statement, have preoccupied Bureau attention and manpower. Many taxpayers naturally wishing to await clarification of a section of such unprecedented nature, and desirous of not being included among the guinea-pigs for

precedent-making litigation, have delayed filing or implementing their claims. Many taxpayers, faced with a deadline filing date on September 15, 1943 (subsequently extended by statutory amendment), filed so-called skeleton claims to protect their rights, without opportunity to explore fully what rights to relief they actually had. It is with a full understanding of these circumstances that we say that, for the immediate present, we are much more concerned with the kind of administration than with its speed.

We believe that the Bureau of Internal Revenue has honestly and sincerely tried to administer this section fairly, as it sees it. We also believe, at the same time, however, that under present conditions of organization and procedure, the very nature and history of the Bureau, its tradition and training, and its past relations with Congress, make it inevitable that in its administration of this section, the Bureau, despite its best intentions, should assume an adversary character, should apply the section narrowly and restrictively, and, where questions of interpretation of the section arise, should almost invariably, and in many cases, unnecessarily, select the interpretation unfavorable to claimants generally, - all resulting in unnecessarily forcing many meritorious claims to litigation. That this is the condition is the consensus of our experience, and, this condition, we cannot emphasize too strongly, we believe to be the product of circumstances and not of intention.

The features of present administration which have been most prolific of dissatisfaction may be classified generally as involving (1) Bureau attitude or approach to administration, (2) certain apparent

limitations of the present statute which, of course, the Bureau must administer as it finds it, and (3) unduly narrow interpretations by the Bureau of specific points involving application of the section. Of these the first is by far the most important. Accordingly, while recommendations with respect to all of these phases are set forth later herein, it seems appropriate to expand briefly at this point on the matter of general attitude or approach to administration.

At the present time it is the general experience that an application for relief is all too frequently (though not, of course, universally) approached by Bureau officials with a view to finding reasons, whether technical or real, for disallowing the claim, rather than in a real effort to determine to what extent, if any, it has merit. It is the all-too-common experience to receive a revenue agent's report recommending rejection of the claim with the mere statement, recited in stereotyped pattern, that the taxpayer has not established qualification for relief and has not established a constructive base period income representing normal earnings. This may occur after the agent has made an extensive examination and requested and received voluminous data or, as happens in many other cases, without even a conference with the taxpayer's representatives. To a large, although lesser, degree, a similar attitude prevails at higher field levels. This attitude is not confined to claims which obviously lack merit, although the probably large number of groundless claims is a contributory factor. We consider this condition to be the result of a belief current throughout the Bureau's field offices as to the attitude toward these claims of the Washington reviewing sections and policy-making officials. This general impression has been created, we believe,

by the nature and character of the regulations and bulletin issued by the Bureau, which appear to be primarily concerned with limitations, cautions and unacceptable claims, theories and procedures, as well as by the high percentage of complete or partial rejections by the review divisions in Washington of claims allowed in whole or in part in the field. The fact that rejections in the field are not subject to Washington review or criticism, while complete or partial allowances are subject to such review, is another factor.

We believe that this condition has been made inevitable by the following factors, among others:

(1) The Bureau of Internal Revenue is by nature, training and tradition, the watchdog of the Treasury, and inevitably assumes an adversary, rather than a judicial, position -- with the consequent natural tendency to develop reasons, technical or otherwise, for disallowing claims, instead of exerting efforts to determine the extent of their merit. This condition is accentuated by the procedure of having the relief claims processed by the same personnel and in the same manner as the ordinary run of tax issues, with respect to which an adversary attitude on the part of the Bureau has become accustomed procedure.

(2) Past experience with Congressional review of its activities have made the possibility of Congressional criticism an ever-present factor affecting Bureau policy and impelling it always to support its disposition of tax cases by a record so well documented as to be beyond all criticism. This condition is normally conducive to sound administration. In the present instance, however, by reason of the fact that the section deals with substantial refunds of taxes on profits realized during the war years, based upon factors not susceptible of precise mathematical determination, and involving essentially personal judgments regarding which men may easily differ, the concern about Congressional criticism has reached a stage of super-caution, which tends to resolve all doubts of interpretation against the taxpayer and to require a degree of proof which the nature of the subject does not permit.

(3) The Bureau, over its entire history, has generally dealt with matters which were capable of mathematical or quasi-mathematical demonstration. Such an approach to the administration of section 722 is utterly inappropriate and unworkable.

The problem is analogous to that involved in the renegotiation of war contracts and calls for a similar approach toward its solution. While the inappropriateness of mathematical solution of section 722 cases is recognized in the Bureau statement, it is difficult for personnel, trained in the matters which normally confront the Bureau, to deal with Section 722 cases by the radically different method of deriving a "fair and just" figure for normal prewar earnings by applying to the pertinent facts a considered judgment of what is reasonable under all of the circumstances.

Other problems coming under this general heading of administration may be referred to briefly as follows:

(a) The present procedure of processing section 722 claims together with all other matters affecting a corporation's tax liability, has made possible an unfortunate practice in many field offices of insisting upon the withdrawal of section 722 relief claims as a condition for the settlement or dropping of other totally unrelated issues. This frequently happens at a time when the merits of section 722 claims have not been explored, and, in some cases, in fact, even before a section 722 claim has been filed. While the inclusion of a section 722 claim in a general settlement may be entirely proper where its merits have been weighed and taken into account in the settlement, this procedure seems to be utterly unfair and out of place where that is not the situation.

(b) The manpower shortages have so far made it not possible for the Bureau to have these claims processed in the field by a sufficient number of personnel adequately trained for this purpose. This, of course, is a product of wartime conditions and presumably will be remedied as rapidly as conditions permit.

(c) The proof called for in many section 722 cases requires figures of sales, costs and earnings of other corporations, usually competitors. In the very nature of things, these figures, while available to the Bureau, are not available to the taxpayer except in those relatively few cases where trade associations have secured such data. This places claimants at a serious disadvantage in the handling of their claims.

While there is the right of review by an impartial body, the Tax Court of the United States, there are several reasons why this remedy is a far from adequate means of dealing with the situation which the present conditions of administration are bound to create. The Tax Court is burdened with proceedings involving many types of tax issues, of which Section 722 is presumably only a minor part, in addition to which it is charged with the duty of hearing appeals in renegotiation cases. The number of Section 722 cases which, under present conditions of administration, will reach the Tax Court will clog its calendars for years. The procedure of the Court is formal and is subject to formal rules of evidence. Facts not submitted for the Commissioner's review may not be proved in a Section 722 proceeding in the Tax Court. This type of procedure is singularly inappropriate for the types of issues involved in Section 722 proceedings, involving, as they do, intimate details of operating conditions, manufacturing costs, demand and general economic data, particularly in the cycle and depressed industry cases. We would view the matter differently if procedure for processing claims within the Bureau were designed or in fact operated to apprise the claimant, through responsible Bureau officials, of the alleged deficiencies of his claim or proof in support thereof, so as to enable him to supply appropriate supporting data if he can. Under present actual conditions of Bureau procedure, the claimant seldom learns authoritatively what shortcomings of proof the Bureau alleges in his case, with corresponding lack of opportunity to develop a complete factual case before formal trial in the Tax Court, when it is often too late. The attitude of Bureau representatives in most instances is to assert

inadequacy of proof or merit without real effort to specify the shortcomings, relying upon the taxpayer's burden of proof to support their position.

An orderly and fair administration of a section such as this demands that there be some forum in which claimants may have their claims heard under an informal procedure in which factual controversies, if any, can be resolved informally, the positions of both sides defined, and the opportunity to remedy factual deficiencies in the light of the positions thus taken, and in which such claims will be passed upon by officials with a responsibility which will support the proper exercise of the type of personal judgment required by these cases, and which will not be trammelled by tradition and training and past relations with Congressional Committees, which interfere with the use of an approach to these cases more appropriate than that which is suitable in the ordinary run of tax issues.

We submit the following recommendations:

I. An independent advisory board should be established to hear Section 722 cases, upon the application of claimants, under informal procedures, and to make recommendations for disposition, which shall be prima facie correct in any subsequent proceeding in the Tax Court.

It is visualized that upon failure of agreement after exhaustion of procedures available within the Bureau, a tentative notice of disallowance would be issued by the Commissioner, within thirty days of which the taxpayer would have the right to apply for hearing before the advisory board. The Commissioner would be required to refer to the Board all facts before him relating to the claim, including such general economic facts as the Commissioner has considered in arriving at his conclusions, and to define his position with respect to the claim. Both sides would be entitled to submit additional facts from time to time during the course of the proceeding and would be required to furnish, to the extent possible, such data as the Board might deem necessary. Proceedings before the Board would be informal and not subject to formal rules of evidence. The Board member or members would indicate in what respects they tentatively agreed or disagreed with the contentions of the parties and the adequacy of their proof. The hearings would be held in one or more sessions, with such reasonable adjournments for submission of additional data, as may best promote a just determination.

The Board would be established as an independent agency, outside the Treasury Department, consisting of a number of members on a full-time basis, sufficient to hold regional sittings if the Board would deem that expedient, and should be adequately financed and staffed with its own experts.

The Board, if it could not bring about an agreement between the parties, would render a report, setting forth findings and conclusions of fact, whether or not the applicant qualifies for relief and on what grounds, a determination of constructive base period net income, and a statement of the facts and conclusions upon which such determination is based.

Such report would be advisory, but, in any subsequent proceeding in the Tax Court, such report, both as to facts and conclusions, would be prima facie correct, and the burden of proof would be on the party expressing disagreement with such report, in whole or in part. To the extent not controverted in the pleadings and refuted by proof, the report of the Board would be binding on the Tax Court. Under these conditions, proof before the Tax Court would properly be limited to facts submitted to the Board.

We believe that this procedure would create a forum much more suitable than any now existing for the proper disposition of these claims. We do not feel that such a Board would be "softer" or any readier to grant refunds unjustifiably, or insensitive to Congressional review, nor should it be. We are convinced, however, that under such a procedure claims would get the kind of hearing appropriate to their nature, which the present procedure does not afford, and that it would tend, to a substantial degree, to prevent an accumulation of Section 722 cases from clogging the calendars of the already overworked Tax Court.

II. The last sentence of Section 722(a) should be deleted, with retroactive effect.

This sentence requires that, with certain exceptions, in determining constructive average base period net income, no regard shall be had to events or conditions occurring or existing after December 31, 1939. Probably no single provision has done as much as this one to nullify merited relief. Taxpayers commencing business toward the end of 1939, or later, or undergoing a change in management or other change in character of the business toward the end of 1939, generally find it impossible for lack of experience, to establish constructive earnings on the basis of their new operating conditions. The two-year push-back rule becomes almost impossible to apply in many cases. In computing costs under new operating conditions giving effect to the pushback rule, the taxpayer is forbidden, for example, to determine its typical factory payroll by reference to its fully developed operating conditions in 1941, which would be the best source of such data.

It is recognized, of course, that post-1939 figures, involving war years as they do, must be used with caution. In some cases, they would be so affected by war economy conditions as to be entirely useless as evidence from which to help draw inferences as to normal pre-1940 figures. In other cases, comparison with industry statistics will suggest simple procedures for eliminating post-1939 factors from the figures. In still other cases, no adjustment will be necessary. Where, for example, post-1939 data are resorted to for the purpose of determining the number of machine operators required in a given department under given conditions, war economy conditions are a totally irrelevant factor, and there is no sound reason for denying use of such figures.

It is not suggested by any means that post-1939 figures be given anything approaching determinative weight. It is suggested merely that they be admissible as evidence, to be given such weight and used in such manner as may seem proper to the administrative agencies and the Tax Court, consistent with the purposes of the section. Surely sound administration can be trusted to use properly, and not to misuse, such data, particularly if appropriate cautions be expressed by the Congressional Committees.

The present prohibition against use of post-1939 data was prompted by a fear that it would not be possible to extract therefrom the "contaminating" influence of the war economy. Although this is a formidable difficulty, we believe that its proportions have been exaggerated, and that the problem can be safely dealt with administratively. In an effort to protect the administrative agencies and Tax Court against themselves, this provision has tied them in a strait jacket, which completely nullifies merited relief in many cases, and has created a situation in which the taxpayer, while unable to use post-1939 to support his case, frequently finds such data used to refute his claim. This is done not only by the Bureau, but by the Tax Court as well (as in the Monarch Cap Screw and Manufacturing Co. case.) Even the Bureau bulletin does the same thing by providing that where a pre-1940 change in capacity which qualifies for relief is abandoned after 1939, constructive base period income based on such change in capacity will not be allowed.

III. <u>This Joint Committee should make a clear and unequivocal statement, endorsed by the Ways and Means and Finance committees, as to its interpretation of the points set forth in IV, below.</u>

As already stated, fear of Congressional criticism has caused the Bureau, in our opinion, to adopt unduly narrow interpretations as to the proper method of applying the section. We believe that a clear interpretative statement by this Joint Committee, endorsed as above indicated, could and would be followed by the Bureau and by the Tax Court without cause for concern about subsequent criticism for adopting the interpretations thus stated, and would be a tremendously important factor in facilitating disposition of pending claims and avoiding needless litigation. We recognize the unprecedented nature of this suggestion. Practically speaking, however, such a statement would differ but little from similar interpretations contained in the conventional type of Congressional Committee report. The situation is extraordinary and calls for a like remedy. The alternative is years of litigation. It is in recognition of the unusual nature of our suggestion that, although the disputed points of interpretation are numerous, we have confined the present suggestion to a relatively small number of points which have been a large source of difficulty.

IV. <u>It is suggested that the Joint Committee state its views on at least the following disputed points of interpretation</u>:

A. Concept of "normal earnings"

Section 722(a) refers to the establishment in these cases of a "fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period." The Bureau apparently has interpreted this to mean that it is necessary to establish what the arithmetical average of the taxpayer's base period earnings would have been under normal conditions of operations, giving effect not only to correction of the various abnormalities or commencement or change in character of the business which qualified the taxpayer for relief, but also giving effect to the elimination of other, unrelated, conditions believed to be not "normal," and without necessarily giving effect to the methods of computation of average base period net income provided by Section 713 in the case of all taxpayers.

We believe, on the other hand, that what was intended by the quoted language was a figure representing the average base period net income to which the taxpayer would have been entitled under Section 713 had the depressant abnormalities not existed or had the taxpayer throughout the base period enjoyed the earnings level which it had attained actually or constructively by the end of the base period in cases of commencement or change in character of the business.

We believe that our view of the situation necessarily follows from the preposition that the main purpose of Section 722 was to eliminate discrimination between taxpayers similarly situated, as

is evidenced by the provision that this relief be granted where the tax computed in the ordinary way is "excessive and discriminatory," and that this objective can be accomplished only if the computation of the taxpayer's average base period income be modified to take account of the conditions which create the discrimination, without denying to the claimant the benefit of other factors, conditions, and methods of computation, the benefits of which are available to the large number of "other taxpayers similarly situated."

This point is basic and underlies a number of the disputes now prevailing between the Bureau and taxpayers. One of the important applications of the point involved is set forth in B, below.

We consider it to be clearly discriminatory, for example, if a taxpayer which has suffered a disturbing event qualifying it for relief should be required to exclude from its base period income the effect of conditions affecting taxpayers generally during the base period, even though in an abstract sense not "normal" (whether the European war or any other general condition), while the vast majority of other taxpayers not suffering such disturbing events are allowed to benefit from the increased base period earnings due to the very same conditions.

B. Application of the growth formula and 75% rule in Section 722 cases

The Bureau's position is that in reconstructing normal base period earnings the subnormality of one or more years in the base period will have been taken into account and that there is no

room for application of Section 713(e)(1), which provides that, in averaging the income of the base period years, the lowest year shall be raised to 75% of the average of the other three, in effect providing that the average base period net income shall be no less than 93-3/4% of the average of the three best years. (It is to be noted that the 75% rule is an automatic rule not dependent on a showing of subnormality for any base period year.)

The Bureau also takes the position that application of the growth formula contained in Section 713(f) to Section 722 cases must depend on the circumstances. In practice, use of the growth formula in such cases is virtually never allowed.

The Bureau's position seems to be that the 75% rule and growth formula are in themselves relief measures and are in effect superseded and included when reconstructed base period earnings are established under Section 722.

We believe that one of the prime purposes of Section 722 was to eliminate discrimination between taxpayers similarly situated (note that the section applies where the tax is excessive and discriminatory); and that this purpose is not accomplished, where reconstruction is made separately for each base period year, if, after reconstruction of the income of each base period year to eliminate abnormalities or give effect to change in character of the business, etc., the average is not computed under the same rules (i.e., 75% rule and growth formula) applicable to every other corporation. Thus:

Example:

The taxpayer had a fire in 1939 which reduced its earnings; its competitor did not. The figures of both companies would be alike were it not for the fire. The actual and reconstructed figures are as follows:

	Taxpayer		
	Actual figures	Reconstructed	Competitor
1936	$150,000	$150,000	$150,000
1937	180,000	180,000	180,000
1938	60,000	60,000	60,000
1939	150,000	200,000	200,000
Average base period net income:			
Actual - giving effect to the 75% rule. . .	150,000	-	165,625 ~~196,875~~
Reconstructed:			
Per Bureau - not giving effect to 75% rule .		147,500	-
Giving effect to 75% rule		165,625 ~~196,875~~	-

In this case the Bureau would grant no relief although the claimant's base period earnings have been adversely affected by the abnormal fire occurrence, in the absence of which its average base period net income would have been $165,625 ~~$196,875~~ instead of $150,000.

C. Application of the two-year pushback rule.

The pushback rule gives the claimant the benefit of two additional assumed years of development in establishing the level for reconstructing normal pre-war earnings, where the business was commenced or a change in character of the business occurred during or immediately before the base period and the business of the claimant did not reach normal earning level by the end of the base period. The Bureau's position in applying this rule is that account may be taken only of those changes which actually occurred before the end of the base period and that no account may be taken of changes which did not actually occur during the base period but which would in normal course occur during an additional two year development period. Thus, if production of a new product is started in the base period, the Bureau's computation of the effect of two years' additional development with this product would be limited to the taxpayer's productive capacity actually existing or subject to commitment at the end of the base period, and would not take into account the fact that expansion of sales of the new product would in normal course lead to expansion of capacity, particularly where additional capacity means merely rental or relatively inexpensive purchase of additional machines. Another illustration is afforded by change in management cases. Changes in management frequently bring about changes in method of operation, new products, increases in capacity. The Bureau limits the reconstruction in such cases to the changes actually put into effect or committed for (in case of capacity changes) by the end of the base period and does not take into account the further changes which the

changed management would normally be expected to put into effect during an additional two-year development period. This point may also affect businesses newly commenced.

We believe that under the pushback rule the taxpayer is entitled to take into account all changes which would reasonably be expected to be put into effect during a two year additional development period as a result of the changes actually affected during the base period.

D. Nature of commitment to a course of action resulting in a post-1939 change in capacity.

It is provided in Section 722(b)(4) that the taxpayer may take into account a change in capacity for operation or production occurring after December 31, 1939, as a result of a course of action to which the taxpayer was committed prior to 1940. It was clearly indicated in the Congressional Committee reports at the time of the enactment of this section that a legally binding commitment was not contemplated. The Treasury regulations and bulletin do not, it is true, stipulate the necessity of a legally binding commitment, but do require either that, or some overt action, withdrawal from which would work a substantial detriment to the taxpayer. Usually this means either a legal commitment or the expenditure of sums in partial carrying out of the course of action, which would be lost in whole or in substantial part if the course of action were abandoned. In practice, a legally binding commitment is almost invariably insisted upon. One form of this difficulty appears in cases where the taxpayer has acquired or obligated itself to purchase certain pieces of equipment

constituting parts of a larger unit, with no legally binding obligation to purchase the balance of the pieces of equipment in the unit. Sometimes there is an option to purchase the remaining pieces, and in other cases there is no such option. But, in the cases which we have in mind, the logic of the situation is clear that the taxpayer would not have purchased or obligated itself to buy the first pieces of equipment, if it did not ultimately intend to acquire the balance. This type of case almost universally meets with difficulty of acceptance.

We believe that a commitment within the meaning of Section 722(b)(4) is sufficiently established by the production of evidence of an unequivocal decision made prior to 1940 to embark upon the course of action, whether or not a legally binding obligation was incurred and whether or not the taxpayer can comply with the detriment test stipulated in the Bureau bulletin.

Respectfully submitted,

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