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COMMENTARY ON GENERAL RELIEF UNDER THE EXCESS PROFITS TAX ACT OF 1950*

Thomas N. Tarleau†

I. General Statement

Analysis of an excess profits tax involves inquiries which are essentially foreign to the concepts of ordinary income taxation. The question of excess profits arises only after taxable income has been defined and characterized, its recipients determined and the time of receipt established. The problem is to divide taxable income into two components, one representing the corporation's normal profits, which it is permitted to enjoy free of the penalty tax, and the balance which is deemed to be "profits due to the outbreak of hostilities and to large military expenditures." Under the Excess Profits Tax Act of 1950, as was the case under its World War II predecessor, the division is accomplished by the determination of a "credit" which stands for the "normal" component of the taxpayer's income. The taxpayer is given an election between two basic alternative methods of computing the credit. One method permits the corporation to earn a stated minimum return on invested capital without becoming subject to the excess profits rates. The second method, the one with which we are concerned here, is based on the taxpayer's average earnings for a "base period," 1946 through 1949.

The credit based on income is necessary to provide a fair measure of normal earnings for corporations whose ratio of profit to investment

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† Member, New York Bar.—Ed.
3 I.R.C., §710 et seq.
4 Senate Report, part III, §§4 and 5.
5 Ibid.
6 Id. at §5.
is more favorable than that enjoyed by industry generally, so that a continuation of such earnings in the excess profits tax years could not be considered the consequence of mobilization or war. The necessity for the general relief provisions arises when it is recognized that for some of those corporations base period average earnings do not reflect normal performance—the corporation may not have done business through the full span of the base period, it may have suffered abnormal physical or economic adversities, or it may have grown or changed the nature of its business to an extent which makes base period income unrepresentative of normal earnings for the changed entity. The general relief provisions are in the law to correct the effect on the earnings credit of such aberrations. They will be of practical interest to a large number of corporate taxpayers, especially because of the dynamic nature of economic conditions in the postwar years which make up the base period. For the technician, they possess an irresistible fascination because they are a testing ground of the underlying philosophy of the whole excess profits concept, a legislative crystallization of economic ideas which are unusually elusive and abstract. In the World War II law, Congress sought to solve the same problems in a fundamentally different way from that which it has recently chosen; the change invites curiosity and study; whether it merits admiration is a question to which it is hoped some of the answers may be suggested by this paper.

II. The Credit Based on Income

Before considering the relief provisions themselves, it will be necessary to summarize the features of the excess profits credit based on average earnings, the correction of which is the object of the relief sections.

In general, the credit is composed of the following amounts: (1) 83-85 per cent of the average base period net income;\(^7\) (2) 12 per cent of certain capital additions made during the last two years of the base period;\(^8\) (3) 12 per cent of the net increase or reduction in capital since the base period.\(^9\) The base period is the four years from January 1, 1946 to December 31, 1949, with variations to account for fiscal year taxpayers.\(^10\)

\(^7\) The percentage is 85% for 1950, 84% for 1951, and 83% for 1952 and later years. See section 602 of the Revenue Act of 1951, amending I.R.C., §435(a).

\(^8\) I.R.C., §435(a)(1)(B).

\(^9\) I.R.C., §435(a)(1)(C).

\(^10\) I.R.C., §435(a)(1)(b). In this paper it will be assumed that a calendar year taxpayer is discussed in each case.
The starting point for the determination of average base period net income, the chief component of the credit, is the corporation's normal tax net income for each of the base period years. This amount is adjusted, particularly to eliminate the effect of nonrecurrent items of income, and the result is the excess profits net income for each such year. For purposes of the formula, no base period year is deemed to have shown a deficit; where there was an actual deficit, excess profits net income is considered to have been zero. The poorest base period year is then eliminated; the excess profits net incomes of the remaining three years are added together, the sum is divided by three, and the result is average base period net income, 83-85 per cent of which is the first component of the credit.

The general relief provisions are primarily concerned with the reconstruction of average base period net income, where base period experience was affected by one of six abnormalities recognized by the statute. In appropriate circumstances, the treatment of capital additions in the computation of the credit is also affected in order to avoid duplicate allowances.

It should be noted that the elimination of the poorest base period year provides a substantial measure of tax reduction without reference to the relief provisions and it is expected that a large number of claims which would otherwise be made will be automatically satisfied by this element of the formula. Where an abnormality affected not more than a year of base period income, the corporation concerned would ordinarily not need to consider the relief provisions if the remaining 36 months of the base period showed enough income to justify election of the credit based on income in the first place. Similarly, the treatment of deficit years as having produced a zero result for purposes of the general average can be expected partially to alleviate the depressing effects on the earnings average of other base period abnormalities.

III. General Relief: Introduction

In the broadest sense, any provision of the statute which reduces the tax is a relief provision. We are concerned with the so-called "general relief provisions," designed to correct an excess profits credit which,
because of certain specified circumstances has been determined to be unrepresentative of the normal performance of the corporation. The law also contains numerous special relief provisions which, for various reasons, give tax benefits to corporations engaged in particular businesses.

In explaining the narrower scope of the general relief provisions in the present law, as compared to those which were incorporated in the World War II law,\textsuperscript{18} Congress cited\textsuperscript{19} the following examples of tax reducing provisions which were thought to cut down very substantially the need for special treatment of the hardship cases covered by the general and special relief sections proper:

1. The former excess profits law granted a $10,000 specific exemption from taxable income. The present law gives a $25,000 minimum credit, which relieves many small corporations from liability for the new tax.\textsuperscript{20}

2. In computing the credit based on income, taxpayers may eliminate the worst year of their base periods in computing average base period net income.\textsuperscript{21}

3. Deficit years which go into the computation of average base period net income are treated as having produced no income or loss.\textsuperscript{22}

4. Under the World War II law, unused excess profits credits could be carried forward two years and carried back two years. The present law provides for a one year carry-back and a five year carry-forward.\textsuperscript{23}

5. The recent loss adjustment permits certain taxpayers using the credit based on investment the privilege of including in invested capital deficits incurred during the base period, or the 1940-1949 period, which were not used to offset income of other years.\textsuperscript{24}

6. The adjustment of average base period net income for certain capital additions which took place during the last two years of the base period.\textsuperscript{25}

7. The adjustment of average base period net income for net capital additions after the end of the base period.\textsuperscript{26}

\textsuperscript{18} I.R.C., §722.
\textsuperscript{19} Senate Report, part III, §9.
\textsuperscript{20} I.R.C., §431.
\textsuperscript{21} I.R.C., §435(d)(2).
\textsuperscript{22} Ibid.
\textsuperscript{23} I.R.C., §432.
\textsuperscript{24} I.R.C., §437(f).
\textsuperscript{25} I.R.C., §435(a)(1)(B).
\textsuperscript{26} I.R.C., §435(a)(1)(C).
(8) The ceiling limitation on combined normal and surtaxes and excess profits taxes.\textsuperscript{27}

One special relief provision which is expected to have wide application is the alternative method of computing the excess profits credit of regulated public utilities.\textsuperscript{28} These corporations are allowed a minimum credit which consists of 6 or 7 per cent of the total of invested capital,\textsuperscript{29} retained earnings, and borrowed capital, plus normal and surtaxes payable for the year whose credit is being determined, less the interest deduction for the year on borrowed capital. In general, the formula applies to railroads, electric companies, airlines, municipal transit corporations, and other public utilities whose rates are controlled by government commissions. The minimum credit is substantially equated with the rate of return allowed by such commissions. It was believed in enacting this provision, that it was undesirable to consider as excess profits for tax purposes, income which is normally limited to a fair rate of return by regulatory authorities.\textsuperscript{30} Furthermore, it was noted by the committees that these industries tended to lag behind business in general in being able to take advantage of the widespread prosperity which characterized the base period, because rate increases came more slowly than increases in the cost of operation.\textsuperscript{31}

Other special relief provisions give advantages to corporations engaged in the extraction of minerals of strategic importance, and make adjustments on equitable grounds in the tax liability of particular businesses.\textsuperscript{32}

\textsuperscript{27} Before amendment by the Revenue Act of 1951, the ceiling limitation on combined normal surtaxes and excess profits taxes was 62\% of a corporation's income. Section 121 of the Revenue Act of 1951 amended I.R.C., §430 to provide a new method for computing the ceiling tax based upon a percentage of excess profits net income. The percentage is 17\% for 1951 and 18\% for subsequent years. Section 501 of the Revenue Act of 1951 amends I.R.C., §430, to provide a lower ceiling tax applicable to the first five years of existence of corporations which began business after July 1, 1945.

\textsuperscript{28} I.R.C., §448.

\textsuperscript{29} Telephone, telegraph and air transport companies use 7\% of capital; electric energy, water, sewer, surface transportation companies, etc., use 6\%. I.R.C., §448(c).

\textsuperscript{30} Senate Report, Part IV, §1.

\textsuperscript{31} Ibid.

\textsuperscript{32} I.R.C., §449 (personal service corporations); I.R.C., §436(b) (corporations deriving most of their income from United States possessions); I.R.C., §453 (corporations deriving income from certain mining and timber operations and from natural gas properties); I.R.C., §433(a)(1)(P) (corporations receiving amounts from the United States for the encouraging of exploration, development or mining of strategic and critical minerals and metals); I.R.C., §450 (mining of strategic minerals); I.R.C., §457 (corporations completing contracts under Merchant Marine Act); See also I.R.C., §451 (capitalization of advertising and goodwill promotion expenditures).

Certain other special relief provisions were added by the Revenue Act of 1951: I.R.C., §459(a) (conversion to peacetime production—growth formula available to certain addi-
The general relief provisions are designed to correct the excess profits tax credit of the following classes of corporations:

(1) Corporations which suffered abnormal physical or economic adversities which substantially distorted their income during the base period.  
(2) Corporations which changed products or services during the base period making the resulting average earnings experience unrepresentative of normal income.  
(3) Corporations which substantially increased their capacity for production or operation during the base period.  
(4) Corporations which began business after the beginning of the base period (new corporations).  
(5) Members of certain industries which were generally depressed during the base period.  
(6) Corporations which grew during the base period at a substantially greater rate than industry in general.

The dominant motif of the general relief provisions of the new law is the effort which has been made to make their operation automatic as to both qualification for relief and the measure of correction afforded. The chosen technique is a radical shift from the policy which governed relief under the World War II law and much of the interest which has been focused upon the new relief sections is concerned with the consequences of the change.

Under section 722 of the former law, corporations qualified for relief by showing that because of one or more recognized abnormalities, their base period experience was "an inadequate standard of normal earnings" and that as a consequence of the distortion, the resulting tax was excessive and discriminatory. The relief credit was computed

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33 I.R.C., §442.  
34 I.R.C., §443.  
35 I.R.C., §444.  
36 I.R.C., §445.  
37 I.R.C., §446.  
38 I.R.C., §435(e).  
according to a hypothetical reconstruction of the corporation's base period profits record as it would have been but for the specified abnormality. Each claim for relief was a separate problem in finance, accounting, and economics. The volume of relevant data affecting each determination tended, because of the nature of the inquiry, to be enormous. However, the fundamental objective of the statutory provisions was relatively clear and simple: an informed business judgment of the effect of the recognized abnormality upon the taxpayer's base period income. For the moment it is sufficient to say that the experience in administration of section 722 led Congress to abandon it for the new method. The general statements describing abnormalities which characterized the old law have been reduced to a great extent in the new general relief provisions to numerical rules. For example, where under the old law it was necessary to show that increase in the taxpayer's capacity for operation or production during the base period made the income of that period an inadequate standard upon which to base the tax, under section 444 of the present law, qualification is achieved by demonstrating that the increase itself was of a specified size.

Furthermore, not every kind of hardship case for which relief was available under section 722 is covered by the new law. The essential difference between the old law and the new in the matter of qualification is not, however, in the number of recognized abnormalities but in the technique of qualification. Under section 722 each claimant actually had to show hardship resulting from a recognized abnormality in order to qualify; under the new law Congress has generally determined that relief is justified whenever certain happenings have had a designated quantitative effect on one or more aspects of the taxpayer's economy in the base period. Rigid formulas have taken the place of the somewhat elastic statements of principle which governed qualification under section 722. The substitution is much more than a technical alteration in the interest of speed and efficiency: it goes to the underlying philosophy of the relief provisions. By their very nature, the hardship cases do not fit a pattern. This was recognized in section 722 which, as a "safety valve," was intended to invoke informed business judgments to achieve fair and reasonable tax results adapted to the facts of each case. The narrow formulations of the present law inevitably will bar relief in some deserving cases and give benefits which

41 Senate Report, part III, §9.
42 I.R.C., §722(b)(4).
The philosophy of section 722 has been even more emphatically rejected in the present law in connection with the measure of relief. Under the former law, the taxpayer's abnormal base period experience was reconstructed with the purpose of determining an excess profits tax credit which represented a fair measure of normal earnings for the particular taxpayer. The corporation qualified under the present general relief provisions uses in computation of its credit an average base period net income based upon the performance of its industry during the base period. Relief is measured by multiplying the taxpayer's assets by an "industry rate of return" determined according to formula. The object is no longer a credit based upon what is normal for the taxpayer, but one supposedly based upon what is normal for an industry.  

IV. Industry Rates of Return

A. General: Industry Classification. With industry rates of return as the key to the operation of the relief formulas, we may begin our detailed consideration of the general relief provisions with section 447, which tells us what an "industry" is and how the crucial "industry rates of return" are computed.

Section 447(c) sets forth 64 major industry groups, into one of which every business corporation is to be placed. The system of classification is founded upon the specifications shown in the Standard Industrial Classification Manual prepared by the Division of Statistical Standards, Bureau of the Budget, for use by federal agencies, heretofore principally in connection with statistical compilations. The 64 categories are a consolidation of 397 industrial groups which in turn embrace more than 1,000 industries which the Manual classifies.

The Secretary of the Treasury is directed to determine and proclaim rates of return for each of the 64 major groups. These are computed

Corporations which were reorganized during or after the base period present special problems in connection with allowance and the computation of the excess profits credit based on income. These are dealt with in Part II of the excess profits tax law, I.R.C., §§461-465. Part II also covers the application of the general relief provisions to corporations which have been parties to transactions therein described such as tax-free exchanges covered by section 112 of the code, and include corporate "split-ups" and the acquisition of the property of partnerships. Part II problems have not been treated in this paper but their existence and the special rules provided for their solution should be noted in connection with cases involving reorganizations.

I.R.C., §447 also deals with the procedure in relief cases, as to which, see below, pp. 403-405.

I.R.C., §447(a).
by dividing the sum of the aggregate net incomes\textsuperscript{46} and the aggregate interest deductions shown on the income tax returns filed by members of the group during the base period, by the aggregate total assets of such corporations at the close of the years for which such returns were filed. Assets are based upon the balance sheets which the corporations filed with their returns. For each group, by the method stated, a base period yearly rate of return is computed for each year of the base period, and a base period rate of return is computed by averaging the yearly rates.\textsuperscript{47}

The relatively small number of major groups under section 447, when compared with the immense variety of American industrial enterprise, provides grounds for a principal objection to the scheme of relief under the new law. Even assuming the wisdom of a policy which equates relief with the average tax position of members of the relieved taxpayer’s industry, relief based on section 447 is not consistent with that policy because the crudeness of classification may make relief depend upon the performance of industries that are economically different.

In this connection it is interesting to consider the concept of “an industry” as it was developed by the Bureau of Internal Revenue under section 722. Under section 722 (b)(3) claims for relief depended, for one thing, upon a showing by the taxpayer that “the circumstances claimed as depressing its business also prevailed generally in the industry of which the taxpayer was a member.”\textsuperscript{48} The Bureau’s bulletin on section 722 stated, “In most general terms an ‘industry’ comprises a group of business concerns sufficiently homogeneous in nature of production or operation, type of product or service furnished, and type of customers, so as to be subject to roughly the same external economic circumstances affecting their prices, volume and profits. Stated otherwise, an industry will generally consist of all of the producers which compete with each other in selling essentially the same products or services in the same market. General economic conditions external to the industry itself will be expected to affect the different competitors similarly if they are selling the same products in the same market, and it is the similarity of external conditions in the marketing processes which forms the basis of the concept of an industry for purposes of determining when an indus-

\textsuperscript{46} Computed without regard for net operating loss deductions provided in section 23(c).

\textsuperscript{47} I.R.C., §447(b).

\textsuperscript{48} Bureau of Internal Revenue, Bulletin on Section 722 of the Internal Revenue Code (hereinafter called the “Bulletin”) part I, ¶(F).
try is depressed." It would seem that substantially similar criteria should be applicable for the purpose of determining the average rates of return under section 447 for the industry of which the taxpayer is a member. But, for instance, under section 447 a single classification is provided for "wholesale trade." Is there the slightest justification for assuming that wholesale distributors of ladies dresses, nuts and bolts, groceries, and antiques were subject to common market conditions during the base period, that they competed with one another, or that they sold substantially the same products in the same markets? The answer is clearly "No." Numerous other industry groups set forth in section 447(c) reveal equivalent possibilities of variety, e.g., personal services; miscellaneous business services; miscellaneous retail stores; miscellaneous manufacturing industries; etc. Many of the 64 major groups are so broad as to comprehend a wide range of products some of which may have only a tenuous economic relation to others included in the industry group. The achievement of even a minimum of realistic results would appear to have required a refinement of the industry classifications which would have substantially enlarged the number of categories so as to decrease the variety within each of them.

B. Industry Classification by Gross Receipts. Section 447 tells the Secretary of the Treasury, rather than the taxpayer, what to do. The relief sections themselves govern the application of the rates determined under section 447 to the computation of the applicant corporation's reconstructed average base period net income. Given the rates by section 447, each corporation must establish its proper classification in one of the industry groups in order to determine the earnings index which it is to use.

With certain variations, industry classification is based upon a gross receipts test in each case. Under sections 442, 443, 444 and 445, the taxpayer's industry classification is the one of the 64 groups set forth in section 447(c) to which is attributable the largest amount of the taxpayer's "gross receipts" for a stated period. Gross receipts are defined for this purpose in section 435(e)(5), as

\[(A) \text{the total amount received or accrued during the period from the disposition of inventoried property, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's business; plus}\]

49 Ibid.
50 I.R.C., §447(c).
51 The provision for depressed industry subgroups, I.R.C., §446, follows the pattern of the sections enumerated, with certain variations discussed in connection with the general treatment of §446.
(B) the gross income attributable to the taxpayer's business, excluding the following:

(1) Gross income from the disposition of property of all kinds;
(2) Gross income from the discharge of indebtedness;
(3) Dividends; and
(4) Income attributable to the recovery of bad debts.

For most corporations, gross receipts for this purpose will correspond roughly with gross receipts from the business regularly carried on.

Characterization based on gross receipts is one major cause of the undesirable gulf between the cause and consequences of relief under the present law. Some aspects of the problem are best illustrated in connection with the operation of the specific relief provisions themselves and will be discussed later. But one major infirmity of the new scheme lies in the lack of correlation between gross receipts and profits. In the case of corporations which produce more than one product, that disparity may produce absurd results if the product to which is attributable the larger share of gross receipts accounts for the smaller portion of profit. Since average base period net income is being reconstructed, it would have been logical to base industry classification on the principal source of the taxpayer's net income. To have done so would have caused no particular difficulty to single product corporations, and it would have cured to some extent the "grab-bag" operation of the present method as it applies to numerous multiple product businesses. The problem of attributing portions of the net income of a corporation to particular sources is admittedly not free of difficulty, but it is one which is posed elsewhere in the code and in the relief provisions themselves.\(^{52}\)

The gross receipts test is therefore justified by neither reason nor practical necessity.

C. The Base to Which the Industry Rates Are Applied. The industry rate of return, determined under section 447 and the test of gross receipts, is, under sections 442, 443, 444 and 445, applied to the taxpayer's "total assets" as of a moment established by the particular relief formula under which average base period net income is being substituted. Total assets for this purpose are defined in section 442(f) as an amount equal to the sum of cash and the property held by the taxpayer in good faith for the purposes of the business.\(^{53}\) Property is to be

\(^{52}\) See pp. 386-388 below.

\(^{53}\) There is excluded from the "total assets" base certain loans to related corporations described in §435(f)(4), securities which are wholly or partially tax exempt under
included in an amount equal to its adjusted basis for determining gain upon sale or exchange.\textsuperscript{54}

There are obvious disparities between the asset bases used by particular corporations when applying the industry rates of return, and the industry-wide bases used in computing the rates. The taxpayer, in making his claim, must exclude inadmissible assets, principally the stock of other corporations, from the asset base, but these are included in the industry base, as well as loans to members of controlled groups and property not held in good faith for the purposes of the business. To have required the Commissioner of Internal Revenue to analyze thousands of past income tax return balance sheets to exclude these items would undoubtedly have been impractical, but the failure to do so clearly tends to depress the industry rates of return below what they would have been had the asset base been computed as the taxpayer’s total assets are figured.\textsuperscript{55} Perhaps some arbitrary general upward adjustment in the industry rates would have provided an equitable and practical solution of this deficiency.

V. Commencing Business

The moment when a corporation “commenced business” is of critical importance to the application of several of the general relief provisions because notwithstanding that it suffered one or all of the qualifying abnormalities heretofore noted, a corporation which commenced business after the beginning of its base period is treated as a “new corporation” and is afforded only the relief given by section 445 for such corporations.

The code does not define the term “commenced business.” The regulations state that it has a meaning different from “in existence,” but they do not require actual operations: “If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have commenced business.”\textsuperscript{56} For example, the regulation establishes that the acquisition

\textsuperscript{54} Such basis is computed under the special rules provided in §441. I.R.C., §442(f).
\textsuperscript{55} Cf. I.R.C., §442(f).
\textsuperscript{56} U. S. Treas. Reg. 130, §40.445-1(a)(2).
of operating assets necessary to the kind of business to be carried on may
be a commencement of business, whereas mere organizational activity
is not. In the ordinary case, the regulations tell us, a corporation com-
mences business when it begins "the operations for which it was organ-
ized."

The regulations do not specifically cover the case of a corporation
which was dormant at the beginning of the base period and later revived
and commenced operations. It seems likely, however, that a corporation
which was merely a shell, an organization without function, on January
1, 1946 would be remitted to section 445 for relief as a new corpora-
tion, even though it had done business at some earlier time.\footnote{57}

VI. Physical and Economic Abnormalities During the Base Period

A. Qualification under Section 442. Section 442 is concerned with
correcting the effects upon the excess profits tax credit of particular
physical and economic adversities suffered by taxpayers during the
base period. Corporations which commenced business on or before the
first day of their base period are eligible for section 442 relief if during
one or more base period years: (1) normal production, output, or opera-
tion was interrupted or diminished because of the occurrence, either
immediately prior to, or during such taxable year, of events unusual
and peculiar in the experience of such taxpayer,\footnote{58} or (2) the business of
the taxpayer was depressed because of temporary economic circum-
stances unusual in the case of such taxpayer.\footnote{59}

The qualifying abnormalities are taken from section 722 of the
World War II law.\footnote{60} There is a further important qualification stated
in the relief formula itself; in order to be eligible for relief under sec-
tion 442, the substituted excess profits net income ascertained by the
application of the appropriate industry rate of return to the corporation's
assets must be 110 per cent or more of the actual excess profits net in-
come for the period affected by the abnormality.\footnote{61}

Section 442(a)(1) is primarily concerned with physical events:
floods, fires, storms and similar manifestations. The requirement that
they must have occurred "immediately prior to" the affected year has
been construed under section 722 to imply a direct causal connection
rather than strict proximity in time and there appears to be no reason

\footnote{57} Cf. Eveready Loan Corp., 2 T.C. 1035 (1943).
\footnote{58} I.R.C., §442(a)(1).
\footnote{59} I.R.C., §442(a)(2).
\footnote{60} I.R.C., §§722(b)(1) and 722(b)(2).
\footnote{61} I.R.C., §442(c)(3) and §442(d). This limitation is primarily to avoid small claims.
for a contrary interpretation in the present law. Similarly, "production, output or operation" should retain its former meaning which covered services as well as the supply of tangible goods. It may be noted that in determining whether an event was "unusual and peculiar," the standard is the taxpayer's own experience, so that if the event occurs regularly each year in the taxpayer's business it cannot qualify. For example, recurrent strikes or floods are characteristic of some businesses although the same happenings tend to be unusual in others.

The reference in section 442(a)(1) to "normal" production, output or operation may, however, be expected to cause a certain amount of difficulty in its present context. In qualifying for relief under section 722, a corporation had to demonstrate that its base period experience, because of one or more recognized abnormalities, was "an inadequate standard of normal earnings." The relief credit was, as noted above, a reconstruction of normal earnings for the period. The underlying assumption was the existence of a discoverable norm for the particular taxpayer and the fundamental problem of section 722 claims was the determination of the norm. The use of the word "normal" in the context of section 722 was, in a sense, a duplication. The old regulations in defining the word stated: "Normal production output or operation means the level . . . which would have been reached by the business of the taxpayer had the unusual and peculiar events not occurred." With the use of industry rates of return in the present law, no effort is to be made to ascertain the normal earnings of the particular taxpayer for the measurement of relief: the reference in every case is to a mandatory general standard. However, the new regulations state: "Normal production, output, or operation means the level . . . customary for the taxpayer, determined on the basis of the actual experience of the taxpayer up to the time the unusual and peculiar event occurred."

Taken literally the quoted rule would require an applicant under section 442(a)(1) to show what its level of operation would have been but for the abnormality, and, in addition, to show that level to be normal. The difficulties arising out of this interpretation are obvious. It may inject into the new law the necessity for a hypothetical reconstruction of normal income which was supposed to have been elimi-
inated by the use of industry rates of return. It suggests that a taxpayer hit by a strike during an unusually prosperous base period year would be disqualified from section 442 relief if the affected level of operation was not normal, even though the level caused by the abnormality afforded income substantially below the industry average. In the case of a taxpayer operating at a low level during the base period, relief might be denied even though the industry rate of return would carry such taxpayer significantly above the income level it would have reached but for the abnormality. In any event, the regulation represents a substantial limitation of the automatic operation of this relief provision. The amendment of the former rule, despite the identical language of the two statutes, suggests that the Commissioner proposes to press the implied limitation for what it is worth. It may very well be that the reintroduction of economic analysis and judgment factors through the regulations may operate to correct some of the absurdities caused by the use of industry rates of return; it nevertheless appears to be unwarranted both as a matter of statutory construction and for its effect of offsetting the speed and certainty of section 442 determinations which the newly chosen pattern of relief was intended to achieve.

A similar limitation of the automatic operation of section 442 is apparently intended by the provision of the regulations which state that:

"Not every interruption or diminution of normal production, output, or operation in the base period may furnish the basis for the application of section 442(a)(1). The interruption or diminution must be significant and not trivial." 67

This rule has been taken over from the regulations under section 722. 68 It is apparent that without such a requirement a producer which normally operates at a level of efficiency far below its industry average might be given very substantial relief under section 442 on account of very minor abnormalities. It may be noted, however, that the quoted regulation is but a small ray of light in a fairly dark jungle, because it does not cure the disparities between injury and relief which inhere to the industry rate of return method as applied to cases of substantial abnormalities. And it is unfortunate that no way was found to state the requirement under the new law in more precise terms. While it is undoubtedly a desirable rule, its form in the regulations constitutes an invitation to controversy and litigation.

Section 442(a)(2) is primarily intended to cover abnormal business conditions as opposed to the physical effects of nature and chance

67 Id. at subsection (a)(2).
upon the taxpayer's operations. It corresponds in part to section 722(b)(2) of the prior law, which, however, gave as an additional qualifying cause of depression, the taxpayer's membership in an industry depressed by "temporary" causes. To a limited extent this relief is provided by section 446 for depressed industry subgroups. The unusual nature of the base period from an economic point of view should produce a substantial volume of claims in the area covered by section 442(a)(2). Such things as reconversion, international disputes, inflation, material shortages and government controls all can be expected to come into play. It may be noted that under the former law, it was the government's view that depressing effects of management decisions were not covered, and it is to be expected that the same position will be taken in connection with section 442(a)(2).69

The condition of section 442(a)(2) that the depressing economic circumstance be of a "temporary" nature deserves some special attention. It operates to exclude from relief under this section corporations whose adversities were the result of long-term factors which operated to depress the business. As an example of a qualified event, the regulations cite the situation of a corporation whose total output had been sold to a single purchaser which during the base period switched over to another source, leaving its supplier with the necessity of finding new markets.70 An instance of an economic circumstance having permanent effect might be the appearance of a cheap synthetic substitute for the taxpayer's product. Many cases will, however, not be clearcut. But the area of controversy may be limited by the availability of section 722 experience for the interpretation of the language of section 422(a)(2),71 and by the fact that determinations of whether base period economic conditions reflected long-term trends will necessarily be made with the advantage of at least some hindsight.

The gross receipts test for industry classification72 raises one of its most vexing problems in connection with section 442(a): the extent to which purely fortuitous circumstances predominate in measuring the

70 U.S. Treas. Reg. 130, §40.442-2(b)(2).
72 I.R.C., §442(g).
relief granted. For example, consider the situation of a corporation which produces two products, each of which, if produced alone, would result in a different industry classification. A flood halts the output of product A, but since the largest amount of the corporation's gross receipts are attributable to product B, relief is based upon the experience of corporations which produced B in the base period. The possibility that reconstruction based on sections 442 and 447 will remedy the injury caused to the corporation's income by the flood becomes purely a matter of chance, even apart from the validity of the average as a measure of normalcy; and if, in the above example, the sale of the A product resulted in a high margin of profit as compared to the B product which determined the industry classification, the distance between remedy and injury is increased even more. If the high profit margin applied to the product giving the larger share of gross receipts which was unaffected by the abnormality, the taxpayer would get the benefit of the absurdity of the statute, but the result would be no less wrong. And it should be noted that in the case of corporations with multiple products the incidence of the chance result is increased by the gross receipts test itself, because the abnormality will in every case where one part of the business is affected increase the preponderance of gross receipts of the unaffected part of the business and thereby tend to give relief on the basis of an industry other than the one affected by the abnormality.

B. **Substituting Average Base Period Net Income under Section 442.** To begin with, if the qualifying abnormality affected the income of only the taxpayer's poorest base period year, there would be no application of section 442 because that year would be automatically eliminated from the computation of average base period net income. If the abnormality affected any of the remaining 36 months after the elimination, reconstruction proceeds under one of two basic formulas, depending upon the period affected by the abnormality.

If no more than 12 of the remaining 36 months fall within taxable years the income of which was depressed by the abnormality, reconstruction is governed by section 442(c). The taxpayer computes a substitute excess profits net income for each of the affected months by applying the industry yearly rate of return for the year in which each such month falls to its total assets as of the last day of such year, reducing the amount so computed by the interest deduction for the year, and

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73 I.R.C., §442(b).
74 I.R.C., §442(e)(2). Gross receipts for the year being reconstructed determines industry classification. I.R.C., §442(g).
dividing the result by 12. It should be noted that where the income of a single month is depressed by an abnormality, the excess profits net income of at least 12 months will be “affected” for the purposes of the formula described above, because the computation of the excess profits net income of any month is the average of the excess profits net incomes of the 12 months of the year in which the month falls. Therefore, the income of at least one year will be reconstructed under section 442(c) in each case. The substituted excess profits net income for such year is averaged with the actual earnings of the two remaining years to give the average base period net income used in computing the credit. Taxpayers computing under section 442(c) may claim the benefit of base period capital additions if the reconstructed year is 1946 or 1947, and may claim 1949 base period capital additions where the reconstructed year is 1948.

If the abnormality affects more than one of the remaining three base period years after the elimination of the poorest year, substitute average base period net income is computed under section 442(d), in which case the taxpayer’s average total assets on the last days of the four base period years are multiplied by the appropriate industry base period rate of return, the average annual base period interest deduction being eliminated. Taxpayers using section 442(d) do not use base period capital additions in the computation of the credit.

Substituted excess profits net income may be used under section 442(c) only if it exceeded 110 per cent of the amount of actual excess profits net income for the year. Substituted average base period net income may be used under section 442(d) only if it exceeded 110 per cent of the actual average base period net income.

As noted above, even if a flood interfered with only two months’ production, the abnormality, for purposes of the formula, affects the full year and, in turn, the industry rate of return will apply to the full year. This appears to be an undesirable loss of actual base period experience and adds to the artificiality introduced by the use of industry rates of return. The loss is aggravated in the case of corporations which

76 I.R.C., §442(e)(1).
76 I.R.C., §442(b)(1).
77 I.R.C., §442(c)(4) and (5).
78 I.R.C., §435(f)(3)(B) and (C).
79 Industry classification is determined according to the gross receipts of the last base period year. I.R.C., §442(g).
81 I.R.C., §§442(c) and 442(d).
compute average base period net income under the formula for abnormalities which affect more than 12 months. Such corporations use none of their own actual earnings experience in the base period in computing the credit, except as such earnings are incidentally reflected in retained assets to which the industry rate applies. The artificiality is enormously increased. For example, consider the case of an interruption of production which occurred in December and January falling within the 36 months remaining after the elimination of the poorest year. Because of the averaging noted above, 24 months are automatically affected. In such a case 34 months of physically unaffected base period experience are discarded in computing average base period net income.

There may be very substantial problems in determining what months are "affected" by abnormalities for the purposes of section 442. A strike may last three, six or ten months, but even after the workers have come back on the job, the corporation may not be able to attain full production for several months thereafter. In the case of depressing economic circumstances covered by section 442(a)(2), the difficulty of determining when the corporation recovered is even more severe. The factual problems will be complicated by the existence of economic factors affecting business which have nothing to do with the qualifying abnormality. For instance, consider the situation of the manufacturer which sold its whole output to one customer which switched to foreign sources of supply. Suppose that while the manufacturer is trying to develop new outlets for its product, the market for that product becomes generally depressed because of an industry recession. In such a case it will be very difficult to fix the time when the depressing effect of the loss of the customer is no longer felt. Neither the statute nor its legislative history are helpful on this point. A reasonable solution requires an analysis of the taxpayer's base period experience of exactly the kind made under section 722. It seems likely that in many cases the formulas of section 442 will operate automatically only after base period income has been "reconstructed" in quite the manner sought to be avoided where the choice between substitution under sections 442(c) or 442(d) is subject to dispute of the kind described. 82

Section 509 of the Revenue Act of 1951 provides a third alternative method for computing relief under section 442. It adds a new subsection (h) to section 442, which permits certain taxpayers, after selecting the 36 base period months which result in the highest excess profits net income or the smallest deficit in such income, to eliminate from the

82 See note, 64 Harv. L. Rev. 1143, 1148, n. 45 (1951).
36-month period the 12 months having the lowest excess profits net income or the greatest deficit, and to use a substituted excess profits net income computed under section 442(e) for such 12 months. This alternative is available only if the aggregate of the excess profits net incomes for each of the 12 months for which a substituted excess profits net income is to be computed is less than 35 per cent of one half the aggregate of the excess profits net income for each of the 24 months which remain after selecting the 12 months to be adjusted. Furthermore, the taxpayer’s normal production, output or operation must have been interrupted or diminished because of the occurrence (within 12 months preceding the beginning of the 12-month period to be adjusted) of events which are unusual and peculiar in the experience of the taxpayer. As the Conference Committee Report points out, the diminution of excess profits net income in the “third best year” subject to adjustment under section 442(h) need not have been caused by the interruption of production which is a qualification for the relief given. This may ease the problem of qualifying for section 442 relief in certain cases.

Corporations which qualify under section 442(h) may also qualify under sections 442(c) or (d). Where there is overlapping, section 442(a) expressly provides for relief under the subsection which results in the lower tax.

VII. New Products or Services Introduced During the Base Period

Corporations which commenced business before the beginning of the base period and which substantially changed products or services during the last three years of the base period are allowed to use a substitute average base period net income under the provisions of section 443. In order to qualify for relief, the product change must have been substantial in two senses, one having to do with the difference in the character of the taxpayer’s business resulting from the change, and the other concerned with the effect of the change upon the amount and sources of the taxpayer’s income.

The exclusion of changes which occurred in the first year of the base period is technically convenient in that it permits the tests of substantiability to incorporate comparisons with at least one base period year which was not affected by the change in the character of the business. On the other hand, deserving taxpayers may be denied relief in cases where the effect of a 1946 change was not realized soon enough in the subsequent three years to make average base period earnings equal to the equivalent of the taxpayer’s industry’s base period rate of return, the benefit of which is available under the formula of section 443 to
corporations which made the qualified change in one or more of the last three base period years.

A. Qualified Changes under Section 443. Under the pressure of competition, the public taste for novelty, and the demands of advancing technology, most American businesses are characterized by continuous modifications and improvements in the kind and quality of their output. The clothing industry changes styles with the seasons; automobile manufacturers introduce new models annually; everything from soap to scooters is more commonly called "new" than "old reliable." Section 443 is concerned, however, with a different kind of product change. The requirement that the change must have been "substantial" means in the first place that normal, routine development of old lines is excluded. Rather, as was the case under the provision of section 722, from which section 443 is derived, the change must amount in essence to a real shift in the character of the taxpayer's business. For example: a meat packer begins to manufacture drugs from waste products; a pharmacy adds a lunch counter; a newspaper buys a radio station. As usual, borderline cases will continue to be difficult. Consider, for instance, the situation of a railroad which introduced a fleet of trucks to draw traffic from off-line territories or a soap maker which changed to the production of synthetic detergents. Fortunately, the experience under section 722 will be available. The regulations are also helpful in invoking "the trade custom or practice" in classifying the new products or services as being of a different class from those formerly offered. If the common-sense position of the regulations is carried out in practice, undesirable technicality can be avoided without sacrifice of the real object of the requirement of substantial change.

84 See BULLETIN, Part V(I)(C)(2), concerning §722(b)(4). See also U.S. Treas. Reg. 112, §35.722-3(d). See also Lamar Creamery, 8 T.C. 928 (1947); Stonhard Co., 13 T.C. 790 (1949); Suburban Transp. System, 14 T.C. 823 (1950). The present law does not have the full reach of §722(b)(4), which gave relief to account for changes in the character of the taxpayer's business, including in addition to change of output, (a) changes in operation or management, (b) a difference in the ratio of nonborrowed capital to total capital, and (c) the acquisition by the taxpayer of a competitor's assets with the consequence that the competition of such competitor was eliminated or diminished. Furthermore, §722(b)(4) provided for corporations which commenced business during the base period, a situation now covered by §445. Furthermore, §722(b)(5) of the former law was a "catch-all" provision which allowed reconstruction in the case of abnormalities not otherwise enumerated in §722, where the taxpayer could show that as a result of such "other factor" affecting base period experience, such experience constituted an inadequate standard by which to measure normal earnings.
86 See note 84 above.
88 See BULLETIN, Part V(I)(C)(2)(a), et seq.
Under section 722(b)(4) a qualifying difference in products and services furnished could be elimination of an old line as well as an addition of a new one. However, it is clear under the present law that a change in products or services for purposes of section 443 must have been an addition to the corporation's output. Both the committee reports and the provisions of the statute refer to the "new" products and services. It should also be noted that section 443 covers the addition of several new products or services during the base period.

B. Effect of the New Line on Income. The qualifying change of products or services under section 443 must also meet the following tests of substantiality:

1. By the end of the third year (or earlier) following the year in which the change took place, the gross income from the new line must aggregate to 40 per cent or more of the taxpayer's gross income for such qualifying year or the net income which is attributable to the new line must equal 33 per cent of the taxpayer's net income for the qualifying year;

2. The corporation must also show that its average monthly excess profits tax net income for the qualifying year (that is, the first year in which it meets either the gross or net income test described in 1), computed in the same way as base period excess profits net income is computed, exceeds by more than 25 per cent the average monthly excess profits net income of those taxable years which end within the base period and which precede the year in which the change occurred.

Thus, the change in products or services may have occurred in any one of the years 1947 through 1949. By the third year after the year of change, the new product must meet the standards of importance in the taxpayer's business described in (1) above and must have resulted

88 BULLETIN, Part V(I)(C)(2).
89 Senate Report, Part III, §9(ii).
90 I.R.C., §443(a)(2).
91 Senate Report, Part III, §9(ii). The report indicates that where the corporation has made several substantial changes during the last three years of the base period, the aggregate effect of such changes is to be considered in the determination of qualification.
92 I.R.C., §443(a)(2).
93 I.R.C., §443(a)(3). For the purposes of the 25% test, the excess profits net income for the qualifying year is computed by making the adjustments provided for in §443(b) I.R.C. for computing average base period net income. These adjustments eliminate from the computation net operating loss deductions, gains or losses from capital transactions, and certain other items which are primarily of a nonrecurrent nature; in making the comparison the average monthly excess profits net income for any period is not considered to be less than zero. Sec. 443(e) also describes a special method for averaging where the compared period includes two or more taxable years.
in the income increase described in (2) above. Qualification can, of course, occur in any of the three years subsequent to that in which the change occurred, including years during the base period. Since only the last three years of the base period can entertain qualified changes, 1946 is always available as the standard of comparison for the income increase requirement stated in (2) above. While changes occurring in the first year of the base period cannot qualify under this section, there is a certain amount of overlapping with the alternative provided for growth corporations by section 435(e) and resort may be had to that section for relief under circumstances which parallel the qualifications for section 443 relief.

It should be noted that the "gross" and "net" incomes of the first branch of the test requirement do not have special meanings for section 443, so that their definitions will conform to the familiar concepts of sections 21 and 22 of Chapter I. However, these sections are not concerned with the allocation of items of net and gross income, which is, of course, essential under sections 443(a)(1) and 443(a)(2). In connection with the sale of goods, there has been a rule of long standing to the effect that the gross income therefrom consists of the gross sales less the cost of goods sold.94 It is logical that the same rule should apply for purposes of the gross income test of section 443(a)(2). Where services are sold, however, gross income is essentially the equivalent of gross receipts for other purposes of the code and undoubtedly the same rule will be followed in the present context. Factually, the gross income test appears to present simpler problems than the net income formula of section 443(a)(2), which involves the allocation to the new products of "overhead" deductions as well as those specifically related to the goods or services sold. It has been suggested95 that the rule of allocation of portions of net income to sources within and without the United States might be followed, which places against each class of income those deductions which are directly connected with it, with a ratable apportionment of the other deductions.96 The suggestion seems to be well taken. However, the net income test can be expected to produce substantial problems in the close cases.

The presence in section 443 of the net and gross income tests arouses some speculation as to why these more rational descriptions of operating results were ignored in meeting the problem of industry

classification in this and the other relief sections. It would seem to indicate that impracticality was not the reason, despite the admitted difficulty in applying the net income test in certain cases. The dichotomy of approach in section 443 may very well provide the most obvious examples of the absurdity of the gross receipts test of industry classification, because corporations might establish that a preponderant portion of net income was attributable to a new product in order to qualify, while having to resort for the measure of relief to the industry index determined by an old product which happened to produce more receipts but less profit.

C. **Substitution of Average Base Period Net Income under Section 443.** The relief formula which under section 443 provides for a reconstruction of average base period net income where a qualified change in products or services has occurred is fundamentally the same as in section 442(d). A qualified corporation applies the base period rate of return for its industry to total assets at the latest of the following two dates: (1) the last day of the year immediately preceding its first excess profits tax year, or (2) the last day of the year in which the corporation first qualifies for section 443 relief under the requirements stated above.\(^97\)

The taxpayer’s industry classification for the purposes of section 443 is determined according to the usual gross receipts test, based in this case on the receipts for the taxable year in which falls the day used to measure total assets.\(^98\)

Section 511 of the Revenue Act of 1951 amended section 443 to provide for reconstruction of average base period net income in certain circumstances which involve a commitment to change products or services made during the base period, where an actual change did not take place until after the base period. Section 443(f) now provides that if, after the taxpayer’s base period, there was a substantial change in the taxpayer’s products, the change shall, for the purpose of section 443 (a)(1), be considered to have occurred on the last day of the base period if the taxpayer prior to July 1, 1950 commenced the construction of facilities for the production of the new product and if such construction and the production of the new product are in furtherance of a course of

\(^{97}\)I.R.C., §443(b).

\(^{98}\)I.R.C., §443(c). In computing substituted average base period net income under §443, the interest deduction for the year specified in §443(b) is eliminated. The excess profits tax credit for a qualifying year which is an excess profits tax year does not include any net capital addition or reduction determined under §435(g) for that year, but does for capital changes in later years. I.R.C., §443(d). No allowance for base period capital additions is made.
action to which the taxpayer (or a corporation with which the taxpayer has the power under section 141 of filing a consolidated return for its first excess profits taxable year) was committed before the close of the base period by contract with another person which contract granted a license, franchise or similar right essential for the production of the new product. It is quite obvious that the change made by section 511 will have but limited application. While there may be many cases where taxpayers were committed to the production of new products in one way or another before the base period, it can be expected that only a few of these will also involve the granting of the required license or franchise. It should also be noted that section 511 not only requires the introduction of a new product, as did section 443 before the amendment, but it requires that such introduction be associated with an addition of productive facilities, i.e., capacity. A taxpayer can qualify under the provisions of section 443 by introducing a new product during the base period even though it used old facilities for the production thereof, but that is not the case under the commitment rule.

VIII. Increase in Capacity

Section 444, like 443, grants relief in respect of a change in the character of the taxpayer's business, in this case measured by an increase in capacity for production or operation during the base period. The rationale of the relief is the recognized unfairness of treating as mobilization profits and hence as "excess" for tax purposes, income which in fact is attributable to an increase in the taxpayer's producing assets. Section 444 is derived from section 722(b)(4) of the World War II law which included an increase in capacity for production or operation as a cause of base period income distortion which entitled a taxpayer to relief.

In order to qualify under section 444, the taxpayer must demonstrate that it commenced business on or before the first day of its base period,\(^99\) and that there was an increase in its capacity for production or operation during the last 36 months of its base period.\(^100\) As in section 443 cases, the first base period year is always available for purposes of comparison.

A qualified increase is deemed to have occurred if the corporation (a) added to or replaced "facilities," meaning real property and depreciable tangible property held in good faith for the purposes of the

\(^{99}\) I.R.C., §444(a).

\(^{100}\) Ibid.
business,\textsuperscript{101} and (b) if such additions or replacements had one of the following three consequences:

(1) capacity on the last day of the base period was 200 per cent or more of capacity on the day before the beginning of the 36 month period mentioned above;\textsuperscript{102} or 

(2) capacity on the last day of the base period was 150 per cent or more of capacity on the day before the beginning of the 36 month period, and the adjusted basis for determining gain of the taxpayer's facilities on the latter day was 150 per cent or more of such basis on the former day;\textsuperscript{103} or 

(3) the unadjusted basis of the taxpayer's facilities on the last day of the base period was 200 per cent or more of such basis on the day before the beginning of the 36-month period.\textsuperscript{104}

Many service industries are excluded from the benefits of section 444 because increases in capacity resulting from the addition of intangibles are not covered. Such cases might involve department stores, advertising agencies, or other corporations for which the ability to do more business depends upon an increase in personnel rather than upon the addition of "real property" or "depreciable tangible property," as the statute requires. Similarly, an increase in capacity to do business due to an investment in an advertising campaign would not be covered. The same principle bars section 444 relief in two related categories of capacity increase. Where the physical additions consist of leased property, there would be no basis for this relief, since the holding of property required by the definition of qualified facilities in section 444(d) has been construed to mean ownership rather than possession for use, in connection, for instance, with the availability of the depreciation deductions.\textsuperscript{105}

The reactivation of property which was idle prior to the last three years of the base period is also not covered, because the increase in capacity resulting from placing such property in service is necessarily the product of intangibles.\textsuperscript{106} A different view has been stated largely on the strength of certain statements in the committee reports which suggest that the rationale of section 444 is the desirability of permitting the excess profits credit to reflect increases in operations in the base period.\textsuperscript{107}

\textsuperscript{101} I.R.C., §§444(b) and 444(d).
\textsuperscript{102} I.R.C., §444(b)(1).
\textsuperscript{103} I.R.C., §444(b)(2).
\textsuperscript{104} I.R.C., §444(b)(3).
\textsuperscript{105} See Dougherty Co. v. Commissioner, (4th Cir. 1946) 159 F. (2d) 269.
\textsuperscript{106} Ibid.
\textsuperscript{107} See note, 64 HARV. L. REV. 1143, 1151 (1951).
If that were the intention, it is not realized in the statute. For example, the alternative tests for qualification based on increased capacity for production or operation and increased basis, are both stated as measures of the same thing, addition to facilities. Since the reactivation of idle equipment could not result in any increased tax basis in property, it would seem that reactivation could not be meant by the term "additions to . . . facilities," even though increased capacity for purposes of the first and second alternative tests is in a sense brought about thereby. Furthermore, idle equipment possesses that potential for operation which the word "capacity" implies.

There is some danger, however, that the admitted exclusion of intangibles might be held to bar relief where the increase in capacity resulted from a combination of factors. For instance, the situation of a manufacturer which leased additional factory space, hired more labor, and purchased additional machinery. In such a case the additional investment in equipment might not meet the second and third tests which depend on relative tax bases, but qualification under the first test based on capacity should not be denied because the increase is not wholly the "result of" physical additions of facilities as defined in section 444(d). A common-sense approach will clearly be necessary in cases of that kind. Frequently the addition of some intangibles will be present, even where the capacity increase is mostly attributable to physical additions and the statute quite properly does not require that the tests measuring capacity increase shall be met *exclusively* as the result of physical additions.

It is interesting to note that under section 722 any change in the taxpayer's capacity for production or operation which occurred after the close of the base period was deemed to have occurred on the last day of the base period for the purpose of reconstructing average base period net income if the taxpayer was committed, prior to the end of the base period, to a course of action which resulted in the qualifying increase.¹⁰⁸ For example, if the corporation contracted to purchase new machinery and made a down payment in 1939, even though delivery and full payment were not made until 1940, the change in the character of the business was deemed to have happened on December 31, 1939. Moreover, under the so-called "two year push-back rule," reconstruction of base period earnings for such a corporation proceeded as if the added capacity became available on December 31, 1937.¹⁰⁹ This latter benefit is not pertinent to section 444, because substitution

¹⁰⁸ I.R.C., §722(b)(4).
¹⁰⁹ Ibid.
of average base period net income under the new law does not take into account the effect on earnings of added capacity but depends only upon the investment in the new facilities.

In view of the substantial business expansions which took place in 1949-1950, the omission of a commitment provision in the 1950 law was regretted by many taxpayers. What may appear to be a substitute for the rule under section 722 is contained in section 520 of the Revenue Act of 1951, amending section 444(f). However, closer examination indicates that section 520 is too narrow in scope to be considered the equivalent of the earlier provision. Under section 444(f) as amended, if a corporation, during the base period, was committed to and began the construction of additional facilities, and completed the facilities during its first taxable year ending after June 30, 1950, the additional facilities, for the purpose of determining whether there was an increase in capacity under the provisions of section 444(b), are considered to have been added to its total facilities on the last day of its base period. Section 444(f)(2)(A) imposes an additional condition for qualification in that the taxpayer must, during the base period, have completed construction of a part of the new facilities representing more than 40 per cent of the total cost thereof. Obviously the benefits of section 442(f) are severely limited by the language which defines qualified "commitment" facilities: section 444(f)(2) in terms covers only "a factory building or other manufacturing establishment" and "machinery or equipment" for use therein. This language implies that section 442(f) additions must include a new building or other structure, a requirement not found elsewhere in section 444. There appears to be no sound reason why a corporation which enlarged its capacity by the construction or acquisition of new equipment or machinery, intended to operate in an existing structure, should be denied this relief. It is possible, however, that the term "other manufacturing establishment" will be construed to refer to a productive unit exclusive of a building, although this interpretation requires some stretching of the statutory language. It may also be noted that the purchase of an existing building to house new productive facilities may not be covered by section 442(f), the language of which implies a requirement of actual construction.

The commitment required under section 444(f) is not narrowly defined as it is under section 443. For qualification under section 444(f), there must only have been a plan to which the taxpayer was committed prior to the end of its base period. The statute does not specify what constitutes a qualifying plan. It may be presumed, however, that the
Government will take a position on section 444(f) similar to that expressed in the Bulletin on section 722 with respect to section 722(b)(4). The Bulletin said that a legally binding form of commitment was not required, but that there must have been some change of position unequivocally establishing the corporation's intention to increase capacity and commitment to a course of action leading to the addition. Despite the inherent ambiguities of the language of section 442(f), it need not be unworkable and it may permit a latitude of interpretation to take into account the many variations of commitments which have business substance.

The qualifying tests of section 444 are based upon potential for operation and not actual operation. As a result, it is clear that the actual physical addition or replacement of facilities must have taken place or have been completed during the last three years of the base period. Where facilities were constructed during the first year, even though the full level of operation of which they were capable was not attained until some time during the last three years, none of the three alternative tests of qualification could be met, since the addition of "capacity" and "basis" would have occurred prior to the end of the first base period year. However, where the facilities were not completed before the end of the first year, the first test, based exclusively on the capacity comparison might be met, even though the corporation could not meet the second and third tests because it would have had a tax basis in the uncompleted property at the close of the first year.

In many cases, the question of whether an increase in capacity has taken place, and the measure of it, will be fairly simple; for instance, where a fruit packer adds equipment to double the number of cases handled per day, or a grain terminal operation is enlarged by the construction of additional storage space and handling facilities. However, just as the industry rate of return technique is complicated by the fact that many corporations produce more than one product, meeting the capacity tests of section 444 may be difficult where the increase in capacity is combined with a change in product, or the addition of a new one. How does one ascertain the relative capacities of facilities for the production of radios and those for the manufacture of television sets? Or the equipment to make wooden window screens as against that needed to make aluminum ones? Developments of this kind are fairly common and will present a real problem in the application of section 444. For many business purposes useful comparisons of capacity can be made using dollar figures such as cost of the product or sales values. But the use of such measures under section 444 would inevitably have
to be limited by their components which do not reflect capacity, e.g., relative price levels, relative profit margins, extent of utilization of capacity, etc. In the cases where such "apples and oranges" are to be compared, the concept of capacity tends to be quite elusive, and meeting the first and second tests of qualification under section 444 may call for a considerable exercise of ingenuity. Admittedly, these problems involve the measurement of capacity rather than the establishment that facilities have been added and that an increase has occurred. However, since the burden of proof is on the taxpayer, inability to arrive at a reasonable denominator of increase may be the equivalent of being unable to show an increase at all.\footnote{110}

It should be noted that the second alternative test which combines increase in capacity with increase in investment for qualification depends upon the adjusted tax basis for gain,\footnote{111} while the third test which is met solely by investment depends upon the unadjusted basis.\footnote{112} The principal difference in the two statutory bases is that the former reflects depreciation allowed or allowable with respect to the property involved. The investment factor of the second test will in many cases require substantially less investment in the new facilities because the 150 per cent comparison will be made between the cost of the new facilities, reduced at most by three years of depreciation with the cost of the old facilities reduced by an amount of depreciation which increases with the age of the facilities. Under the third test, reference will be had to the original cost of the old and new facilities in most cases, so that taxpayers whose property was old at the beginning of the 36-month period must have made a considerably larger expenditure to meet the third alternative test than to meet the second.

The use of comparative investment alone as a measure of increased capacity in the third test could in some cases lead to qualification under section 444 where there was no real increase in capacity. The cost of reproduction of ten year old facilities during the base period might easily have been double the original cost. Expenditures made primarily to promote economy or efficiency rather than capacity thus might qualify for section 444 relief because of the lack of correlation between the cost of facilities and their potential output.

Reconstruction of average base period net income under section 444 closely follows sections 442 and 443. Industry classification is based\footnote{110} This problem was present under §722(b)(4). See Bulletin, Part V(I)(C)(3), where the definition and measurement of capacity increase is discussed.\footnote{111} I.R.C., §444(b)(2)(B).\footnote{112} I.R.C., §444(b)(3). See I.R.C., §113(b).
upon gross receipts for the last year of the base period. The base period industry rate of return is applied to total assets as of the last day of such last base period year.

IX. New Corporations

Corporations which began business after the beginning of the base period may resort for relief to the provisions of section 445 for "New Corporations." The growth formula of section 435(e) is available only to corporations which commenced business before the close of the base period and the general relief provisions already discussed apply only to corporations which were in business before the start of the base period. New corporations compute their alternative average base period net income under section 445 solely by reference to the industry rate of return. The basic income credit computed under section 435 is also available to them, and in some cases its use could be advantageous.

Two alternative formulas for the computation of average base period net income are used under section 445, depending upon which year's excess profits tax liability is to be determined.

A. First, Second or Third Taxable Year, if Subject to Excess Profits Tax. In computing the excess profits credit for any of the taxpayer's first three years which is also an excess profits tax year, the corporation's total assets for such year are multiplied by the appropriate industry base period rate of return, and the product is reduced by the interest deduction for such year, giving the average base period net income to be used. For the purpose of section 445(b)(1), "total assets" consist of the following:

1. the corporation's total assets [as defined in section 442(f)] on the last day of the taxable year first preceding the corporation's first taxable excess profits taxable year, plus
2. the net capital addition or reduction for the year whose excess profits tax liability is being determined.

In the case of a corporation beginning in an excess profits tax year, the first branch of the formula will always give a zero result, so the average base period net income for that year will be the first year's

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113 I.R.C., §444(e).
114 I.R.C., §444(c)(1). The interest deduction for the last base period year is eliminated [§444(c)(2)]; no adjustment is made for base period capital additions.
115 I.R.C., §445(c)(1). See also §512 of the Revenue Act of 1951, which amended §445(c) to provide for the inclusion of 100% of the increase or decrease in borrowed capital in the "total asset" base used under §445(c), instead of 75% as was the case under the 1950 law.
capital investment multiplied by the industry rate of return. For the second and third years of such a corporation, assets holdings as of the end of the previous year would come into the base through the provision for the inclusion of capital additions. Profits for the current year do not figure in the base to which the industry rate of return is applied. Profits for the one or two preceding years do enter the computation to the extent that they were retained for the purposes of the business.

B. Excess Profits Tax Years Other Than Taxpayers' First, Second or Third Taxable Year. For other taxable years, the alternative average base period net income is computed by applying the industry base period rate of return to total assets [computed as under section 442(f)] on the later of the following two dates:

1. the last day of the taxable year immediately preceding the corporation's first excess profits tax year; or
2. the last day of the corporation's third taxable year;

and reducing the product by the interest deduction for the year which ended on the later of the two dates specified above.\(^{116}\)

In determining the industry classification of a new corporation the gross receipts test may be expected to result generally in fewer difficulties than will occur in connection with the other relief provisions, because of the likelihood that such corporations will have concentrated on products or services attributable to a single industry.

In the new corporation's early years, section 445 is likely to provide quite favorable treatment, because in such years new businesses may frequently earn somewhat less than the industry average.

In order to deny section 445 relief where intercorporate transfers of assets have taken place to get the benefit of new corporation treatment, section 445(g) enumerates certain transactions, participation in which makes the new corporation ineligible for the benefits of the industry average rate of return. The transactions are acquisitions of property from other corporations which take place on or after December 1, 1950, and before the end of the new corporation's first three years, where the basis of the property was carried over from the old

\(^{116}\) I.R.C., §445(b)(2). Net capital additions or reductions for the taxable year are not reflected in total assets in determining the substitute average base period net income under §445(b)(2). Subsequent additions or reductions are reflected in the usual manner as a part of the credit based on income, but only from the date used to measure total assets in the formula of §445(b)(2). The taxpayer's industry classification is determined for purposes of §445(b)(1) by reference to the taxable year for which the excess profits credit is determined thereunder, and for purposes of §445(b)(2) by reference to the taxpayer's third taxable year, and in either case it is the industry classification under §447 to which is attributable the largest amount of the taxpayer's gross receipts for such taxable year.
corporation into the new, or where 50 per cent or more of the stock of the corporations involved is owned directly or indirectly by the same interests. These provisions prevent, for instance, the formation, by a corporation which commenced business prior to the beginning of the base period, of a new subsidiary to carry on a part or all of the old business with the benefits of section 445 relief to which the parent was not entitled. They also make it unprofitable for the owners of a going concern to form or find a new corporation to carry on the old business substantially as before with the benefit of a higher excess profits tax credit derived from section 445. Some transactions technically covered by section 445(g) are, however, excluded from its prohibition as provided in section 462(g). For instance, if the corporations involved in certain transfers interdicted by section 445 were both new corporations, section 462(g) allows section 445 relief under a formula which allocates the several factors upon which the reconstruction of average base period net income depends in order to equate the tax situation of the combination with that which several components would have enjoyed.

X. Depressed Industries

Where a corporation was a member of an industry which was generally depressed during the base period, it may use a substituted average base period net income under section 446 in computing its credit. The technique of relief for such corporations is to utilize a period which includes the war years as a standard of comparison to determine the existence of industry-wide depression, and to base relief on industry performance during the extended period. Section 446 was particularly designed to improve the credit of corporations in such industries as aircraft and machine tools which suffered during the post-war period a sharp decline in prosperity as compared with previous years because of the absence of military requirements and the presence of substantial war surpluses in the market. Obviously, for such corporations, reconstruction determined by the base period performance of their industries would have afforded no relief.

118 I.R.C., §§445(g)(2)(B) and (C). See also I.R.C., §§462(g) and 461(d) of Part II which deny new corporation relief under §445 to corporate successors of partnerships or sole proprietorships which were doing business before the beginning of the base period. It is interesting to note that this rule does not apply to the ceiling tax on new corporations referred to in note 27 above.
119 The earlier law contained §722(b)(3)(A), which allowed reconstruction of base period earnings where the taxpayer showed that it had suffered from a depression which was characteristic of the industry to which it belonged.
Industry classifications for the purposes of section 446 are based not upon the 64 groups which govern the application of sections 442-445, but upon narrower and more numerous "subgroups" which compose the major groups.\textsuperscript{120} A subgroup is deemed to have been depressed in the base period where its average rate of return on total assets during the years 1946 through 1948 is less than 63 per cent of the average rate of return for the industry in the period 1938 through 1948.\textsuperscript{121} The substitute average base period net income computed for members of depressed industry subgroups under section 446 is computed by multiplying the taxpayer's average total assets\textsuperscript{122} for the base period by 80 per cent of the subgroup's rate of return for the special 11-year base period, 1938 through 1948.\textsuperscript{123}

Classification in an industry subgroup is done under section 446 by a variation of the usual gross receipts test: the taxpayer must show that 50 per cent or more of its gross receipts for taxable years beginning with or within the base period was attributable to the depressed industry.\textsuperscript{124} The variation may be quite disadvantageous to corporations which produced more than two products during the base period, since if no product accounted for more than half the total receipts, no relief whatsoever is available under section 446, whereas under the other relief formulas classification in at least one group is always possible. The difficulty is increased by the relative narrowness of some of the subgroups, since there is less possibility for variety within the subgroups and hence more likelihood that the corporations' second or third products will fall outside the classification.

The use of the subgroups in section 446 raises a question about why they were not used instead of the major groups in the other relief sections. As noted above, classification in groups which were homogeneous internally would have resulted in more realistic rates of return for reconstruction purposes.

\textsuperscript{120} See U.S. Treas. Reg. 130, \$40.446-2(c). One of the "subgroups" for which tentative adjusted rates of return have been proclaimed in the regulation—"Transportation by Air," No. 8, is actually a "major group" and thus a composite of several subgroups.

\textsuperscript{121} I.R.C., \$446(c).

\textsuperscript{122} Unlike the other relief provisions, \$446 does not define "total assets" by reference to the provisions of \$442(f) hereinafore described. Presumably, this was an oversight, since the pattern of \$446 would seem to require "total assets" to mean what it does elsewhere in the relief provisions.

The fog which surrounds this point has been slightly thickened by the Revenue Act of 1951. Section 446 was not amended to refer to \$442(f). But \$510 of the 1951 law, which amends I.R.C., \$442(f) (as to which see note 115 above), reads as follows: "Definition of Total Assets for Purposes of Sections 442-446."

\textsuperscript{123} I.R.C., \$446(b). The average annual interest deduction is eliminated.

\textsuperscript{124} I.R.C., \$446(g).
XI. Growth Corporations

One further category of corporations for which the 1946-1949 period cannot be considered normal are those whose operations in that period were characterized by growth substantially greater than that enjoyed by industry in general. A principal example is television, which was just getting started in 1946. In computing average base period net income for a television set manufacturer, an obviously low result would be produced if equal weight were given to the results of the early and late years of the base period. The section 435(e) alternative generally allows growth corporations to use the best part of their base period experience in determining the credit. The reconstruction of growth corporation income is considered so fundamental to the concept of normal base period income that the pertinent relief provisions are in section 435 itself as an alternative method for computation of the income credit, rather than with the relief provisions proper. It differs from the other relief provisions in that the substitute credit is based upon actual experience rather than the industry average.

A. Qualified Growth under Section 435(e). In order to qualify for relief under the growth formula a corporation which began business before the end of its base period is given the option of meeting either one of two alternative sets of tests established by section 435(e).

The "A" Tests. The corporation seeking relief under the A tests must meet one of two conditions established to measure qualifying growth.  \(^{125}\) These are

(1) The corporation's total pay roll for the last half of its base period was 130 per cent or more of its total pay roll for the first half of the period, or

(2) The corporation's gross receipts for the last half of its base period were 150 per cent or more of its gross receipts for the first half of the base period.

The alternatives were necessary to account for cases where growth depended upon mechanization or other capital investment rather than upon increases in labor force.  \(^{126}\) The measuring percentages reflect the congressional judgment that corporations meeting the standards

\(^{125}\) I.R.C., §435(e)(1)(A).

\(^{126}\) Senate Report, Part III, §11. Before the enactment of the Revenue Act of 1951, corporations which began business after the beginning of the base period were excluded from the benefits of the growth formula. The inclusion of corporations which commenced business before the end of the base period results in automatic eligibility for relief under §435(e) for corporations which commenced business after two years of the base period had elapsed. This comes about because the requirements of §435(e)(1)(A) (other than the $20,000,000 asset limitation) depend upon a comparison of the corporations' total payroll...
grew to a substantially greater extent than did industry generally during the base period.

No corporation can meet the A tests if its assets at the beginning of the base period exceeded $20,000,000.\footnote{127} In computing assets for this purpose, the property of certain affiliated corporations is included, whether or not consolidated tax returns were made.\footnote{128} The reasons for discrimination against large corporations are somewhat obscure. The committee reports state that the restriction is intended to exclude from the benefits of the provision large corporations "whose earnings experience does not justify additional relief on account of growth" during the base period,\footnote{129} which implies that the attainment of a certain size gives some information about earnings experience. It seems likely that the exclusion of large corporations proceeds from an aversion to their size for its own sake. Certainly, size at the beginning of the base period has no logical connection with the normalcy of the corporation earnings during the base period if growth in fact occurred. The criticism may be academic because of the rarity of $20,000,000 corporations which can meet the A tests. But the lack of general application will, of course, not make the fault of logic any sweeter to the taxpayers for which the size limitation may be critical.

The "B" Tests. The A tests depend on the taxpayer's overall growth during the base period. The B alternative, however, provides relief where growth of sufficient magnitude occurred as a consequence of the introduction of a new product. The B set has two criteria for qualification, the first having to do with the causes of the base period growth, and the second establishing the requisite amount of growth due to such causes.

The qualifying causes are those "attributable to a product, or class of products (including any article in which such product or class of products is the principal component and including any article which is a component of such product or class of products), of a kind not

\footnote{127 I.R.C., §435(e)(1)(A)(i).}
\footnote{128 I.R.C., §435(e)(3). The test of affiliation for this purpose is whether or not the several corporations are permitted to make consolidated returns under §141.}
\footnote{129 Senate Report, Part III, §11 at p. 27.}
There are three branches of the quantitative part of the B tests: (1) twice the corporation's net sales for the first six months of 1950 equals or exceeds 150 per cent of the average net sales for the years 1946 and 1947; (2) at least 40 per cent of the corporation's net sales for 1950 must have been attributable to the new product; and (3) the amount of net sales of such product for 1946 must not have exceeded 5 per cent of such amount for 1949.

We are told that "a product which is a modification of an old product, such as an improvement or change in style, is not a product of the type referred to." The concept of novelty for the purposes of section 435(e) closely resembles the requirement of substantial change of products or services under section 443, with the difference, however, that under section 435(e) the product must be new to the public rather than to the producer. But the regulations under section 435(e), by their failure to elaborate upon the meaning of "generally available to the public," suggest perhaps, that the growth formula in this respect will receive a fairly narrow and technical construction unlike the more generous approach which is indicated by some of the language of the regulations covering section 443.

A point to be remembered in interpretation of words "not generally available to the public," it would seem, is the underlying purpose of section 435(e) itself, which recognizes that substantial growth distorted the base period income of the growing corporation, making actual income an inadequate standard for measuring abnormal, or excess, income. The B tests contain a formula for determining how much growth qualifies, as well as stating what kind of growth qualifies. In view of the existence, therefore, of an exact standard of the amount of covered growth, administrative policy and judicial interpretation of the new product language should tend to be liberal rather than technical. It is the amount of growth which makes the income experience an unfair standard. Over-strict construction of the new product provision will tend to exclude from relief corporations with actual abnormal base period income due to growth, while narrow construction cannot result in relief for corporations with normal income experience because the quantitative provisions, by their very nature, can only be strictly con-

131 I.R.C., §435(e)(1)(B)(i), (ii) and (iii).
132 U.S. Treas. Reg. 130, §40.435-3(e).
133 Cf. note 86 supra.
strued. Against this principle, it can of course be argued that the \( B \) tests represent an additional tax concession and that the \( A \) tests are always available to growth corporations without reference to the causes of growth. It is not suggested, however, that the "cause" language be construed out of existence, but merely that growth and consequent income distortion be recognized as the primary issue, and the causes thereof as secondary in the context of relief against abnormal average base period experience. The danger of over-technical construction of the new product requirement in the growth formula is that criteria resembling those of the patent law field may become involved in tax controversies where they do not properly belong.

The phenomenal postwar growth of the frozen citrus concentrate industry might illustrate one of the possibilities. Frozen foods and powdered concentrates were both generally available to the public before 1946. The development of the frozen concentrates, especially in the citrus field, is undoubtedly a combination of old things in many respects. It would be unfortunate, however, if the technical problems of invention, novelty, combination, etc., were to predominate, or even become particularly important, in deciding the question of public availability. Reliance should rather be placed on criteria akin to the general understanding of the market. On the basis of the principle stated above, the latter approach would give results in accord with the philosophy of section 435 without denial of meritorious relief where growth actually distorted income.

The meaning of the term "generally available to the public" is ambiguous in another sense. Consider the case of a product which was fully developed before 1946 but which was not widely marketed until the base period, for lack of commercial interest or other business reasons. It could be argued that such a product was not covered by the \( B \) tests, because the public could have had it on demand. The argument appears to neglect the facts of commercial life. The requirement of general availability should be interpreted to refer both to supply and demand, again in conformance with general public understanding. The criterion of availability should be market development. The question arises, however, as to how much market? There may be cases of products available in a limited territory. Should growth based on introduction of the product to a new area be deemed covered? It might well be argued that the "public" referred to in section 435 is the public, or the portion of it, whose demand accounts for the qualifying growth. A similar question may arise in connection with goods or services first widely adapted for general public use during the base period, such as
home air-conditioning units. While these are perhaps a development of a device formerly available, it may well be that the exploitation of new markets, a new "public" in the commercial sense, should be considered covered growth within the meaning of section 435.

Apparently the provision of novel services is not covered by the B tests. This may be an oversight, since growth based on the expansion of the supply of services is of course covered by the A tests. In the case of services the definition of novelty is perhaps more difficult than in the case of tangible goods, but if a liberal interpretation of novelty based upon markets is followed, the difficulty should not be so serious as to interfere with administration, and logic seems to demand coverage of new services. This is true because corporations providing services rather than goods are particularly dependent upon the excess profits credit based on income rather than that based on investment.

B. Reconstruction under Section 435(e). Corporations qualified for relief as growth companies are entitled to compute their credit on the best of three alternatives, and corporations qualifying under the B tests may choose from a fourth. The alternatives are as follows:

(1) average base period net income based upon the last 12 months of the base period;
(2) average base period net income based upon the last 24 months of the base period;
(3) average base period net income based upon income of the last six months of 1949 and 80 per cent of the income for the first six months of 1950.
(4) corporations which can qualify under the B tests, if their excess profits net income for 1949 was not more than 25 per cent of the amount of such income for 1948, have a fourth alternative in that they may compute average base period net income upon the last six months of 1948 and the first six months of 1950.

In the background of the general relief provisions, the relief for growth corporations is somewhat startling for its logic. The income which reflects the growth is considered normal, and that income is the measure of relief. There is no wholesale discard of normal base period experience for fictitious reconstructions which characterizes the other relief provisions.

XII. General Relief: Procedure

The procedure for obtaining the benefits of the new general relief provisions is generally simple and uniform with that provided for the

134 I.R.C., §435(e)(2).
administration of the Internal Revenue Code generally. Applications for relief are primarily to be made on the excess profits tax return; the forms now in use include sections for the computations necessary under each of the relief provisions. Applications may also be made within the period allowed for the filing of refund claims, and within any further period allowed the Commissioner for the assessment of deficiencies. In the latter case, the application of the relief provisions cannot reduce the tax by an amount greater than the amount of any deficiency determined without regard to the relief provisions. No special rules are given on applications for section 435(e) (growing corporations) relief, which is presumably to be treated simply as an alternative to the income credit of general application.

Where a petition is filed with the Tax Court concerning excess profits liability for any year, applications under sections 442, 443, 444, 445 and 446 must be filed prior to the time of the filing of such petition.

Section 447 also provides that the relief sections shall not be applied on any grounds other than those stated in applications filed seasonably pursuant to section 447(e). The regulations state that, "the application, however filed, must include a statement setting forth in detail each ground upon which the taxpayer relies, and facts sufficient to apprise the Commissioner of the exact basis for the application." It does not seem that the requirement of the regulations burdens taxpayers with the necessity for including excessive details in the statements which must accompany applications for relief. In this connection it may be noted that the bulletin on section 722 stated, "considerations of good administration require that the taxpayer should be given a reasonable opportunity to perfect the claim. In such cases the taxpayer should be advised of the defects or inadequacy and given a reasonable time to amend the claim or submit the information required." While the reasons for generosity in this regard are less compelling under the new law, it seems clear that the opportunity for

135 The rules governing application for the benefits of §§442, 443, 444, 445 and 446 are stated in §447(e).
136 I.R.C., §447(e)(A).
137 I.R.C., §447(e)(B). In such case the application of the relief sections shall be subject to the limitations on the amount of refunds provided in §322.
138 I.R.C., §447(e)(C).
139 Ibid.
140 I.R.C., §447(e).
141 U.S. Treas. Reg. 130, §40.447-3(b).
142 BULLETIN, Part IX ¶(B).
factual clarification should be no more limited under the general relief provisions than it customarily is in respect to ordinary claims for refund.

XIII. Conclusion

When the new general relief provisions are examined either in the light of their underlying philosophy or with respect to the details of their operation, objections appear which are too serious to be compensated for by considerations of expediency. The fundamental criticism has to do with the discrimination against the efficient business through the use of the industry rates of return. The credit based on earnings is given as an alternative in the code to eliminate the discrimination against such efficient producers which would come about if all corporations were required to determine their "normal" earnings with reference to a fixed rate of return on invested capital. In fact, the stated rate of return used with the investment credit was fixed high enough to benefit "taxpayers who happened to have poor earnings experience in the base period,"143 in other words the minimum rate of return allowed to be enjoyed free of excess profits tax under the invested capital alternative is itself a general average.144 The credit based on base period income is designed to provide fair taxation for corporations which normally earn more than that general average. It is intended to permit such corporations to earn free of excess profits tax the income which is normal for them. The rationale of the general relief provisions is the necessity to preserve for the efficient business the credit based on income which their normal experience justifies despite the existence of circumstances adversely affecting base period experience which are not the result of low efficiency. Reconstruction based on industry average rates of return is inconsistent with that rationale. The efficient corporation is denied the benefits to which it is entitled because of the effect upon the industry average of inefficient producers. On the other hand, the inefficient producer to whom relief is available is given a reduction in tax because of the superior performances of its betters which raise the industry rate of return upon which relief depends. It is of course no answer to say that in the long run the results average out to give fair relief. The relief provisions must be judged by their service to the efficient producer, not to the average corporation. The answer would be valid only if taxes were paid by industries instead of

143 Senate Report, Part III, §1 at p. 3.
144 Senate Report, Part III, §5.
corporations. That not being the case, the technique of relief is acceptable only if it reflects the relative efficiency of the particular taxpayer, and that is what the relief provisions based on industry rates of return do not do. The objection might be cured somewhat by a narrowing of the industry groups, because of the tendency of competitors in the same line to have similar efficiencies; but the results will be wrong as long as the groupings are made on the basis of "industries," however defined, only some of the errors will be smaller.

Inevitably, the new relief provisions must be judged by comparison with section 722 of the World War II law, which was basically sound because it made the relief granted proportionate to the injury suffered. Yet it was discarded because Congress believed that it had excited widespread dissatisfaction; that the area of administrative discretion was so great and the law so complex that there were extended delays in settlement of cases; that too much subjective judgment was required; that proving a claim was too expensive for the small taxpayer. The objections go primarily to the administration, not the substance, of section 722. The complaint about slow-motion and an administrative log-jam has perhaps been seriously overdone. And it does not seem

146 The following information has been received from the Excess Profits Tax Council in a letter of June 12, 1951.
Under §722 there have been 56,000 claims (each relating to a single year) by approximately 20,000 corporations. Claims of fewer than 2,000 corporations are outstanding. These are in four stages of consideration as follows:
1. Pending before the §722 Field Committees in the Offices of the Internal Revenue Agents-in-Charge—Claims of approximately 175 corporations.
2. Pending before the Excess Profits Tax Council—Claims of approximately 625 corporations.
3. Pending before Units of the Bureau for computation of tax effect, consolidation of standard issues, issuance of statutory notice, etc.—Claims of approximately 500 corporations.
4. Pending before the Tax Court of the United States—Claims of approximately 650 corporations.
Thus, fewer than 10% of corporations which filed claims are without final determinations. It may be noted, however, that the unresolved cases concern approximately $2,500,-000,000 of tax reductions out of a total excess profits tax reduction claimed of approximately $6,500,000,000 by the 20,000 corporations mentioned above. Of the 175 corporations whose claims are still under consideration by the §722 Field Committees, fewer than 75 have yet to receive reports from revenue agents about their claims.
Since its organization, the Excess Profits Tax Council has acted with respect to the claims of more than 9,000 corporations. This actual and potential load now consists of the claims of about 800 corporations and the council has held hearings with respect to the majority of these. The council has made or approved allowances for more than 4,000 corporations. Eighty-seven corporations filed claims for tax reductions of more than $10,-000,000 for each corporation, and the council has acted on 29, or one third of the claims of such corporations. About 1,300 corporations filed a total of almost 1,600 petitions with the Tax Court of the United States. About one half of these have been disposed of either by stipulation or by trial. There have been trials of the cases of 90 corporations and the cases of about 560 corporations have ended by stipulation. Recent experience of the council indicates that the number of trials in the remaining cases will be between 20 to
that section 722 was inherently incapable of fair and efficient administration. In 1944, the Bureau gave its officials a very reasonable statement on the application and administration of section 722:

"References were made in committee reports to the desirability of 'sympathetic administration' in cases and problems arising under section 722. Sympathetic administration means a fair, reasonable, and intelligent administration, designed to afford to those taxpayers which establish their right to relief the full measure of relief available under section 722. It requires that the action taken with respect to applications for relief be grounded upon the exercise of a sound and informed judgment and an understanding not only of the taxpayer's business but also of the taxpayer's place in its industry and business generally.

"The basic problem to be met under section 722 is the determination of whether an excess profits credit is inadequate, whether the factors causing the inadequacy are the type in respect of which the section is designed to afford relief, and what constitutes the normal operations of the taxpayer upon which normal earnings can be computed. That problem is new and difficult and imposes upon examining officers broader procedures than the accustomed one of verification of facts submitted and application of law. It cannot properly be resolved unless and until a thorough study has been made of the entire background of the case to develop the conditions under which the taxpayer operates, as well as the relevant conditions of its industry and of business generally, so that the 'whole story' may be obtained."

The spirit of that directive was almost never followed. In the field, section 722 cases were committed to the hands of revenue agents whose ordinary professional outlook was dominated by the demands of the revenue; whose ordinary professional technique was the audit, i.e., "verification of facts submitted and application of law." Both the outlook and technique were wholly unsuited to the solution of section 722 problems, which essentially called for reasonable, informed business judgments of what the taxpayer would have done but for the

25% of the number of corporations filing petitions or between 15 and 20% of the number of petitions.

The Excess Profits Tax Council which only has authority to make determinations (the final disposition of the claims resting with either the claimant or the Tax Court) in the latter part of 1948 undertook to provide determinations with respect to most of the §722 claims within approximately three years. This program is virtually complete inasmuch as fewer than 75 corporations have not received reports from revenue agents and the claims of only 800 corporations have not been the subject of a determination by the Council.

abnormality. It is the kind of judgment that businessmen are always required to make in evaluating risks, competition, property, and economic uncertainty. Such judgments can never be made to the penny; they can never be made with the absolute certainty that a particular evaluation is the only one that reasonable men could reach; but businessmen are accustomed to act every day on the basis of such judgments. Section 722 called for no more; but in its administration taxpayers were too often faced with the necessity for making "penny" proofs or failing. By the very nature of the problems posed, such proofs could not be given. No wonder there was "widespread dissatisfaction" when the administration of relief degenerated into a broil over questions that could not be answered and should not have been asked. Reconstructions of base period net income under section 722 should have been committed at the first level to boards recruited from outside the Bureau of Internal Revenue, composed of men accustomed to the use of the kind of economic and financial data which was relevant in section 722 cases, directed to find answers that were reasonable and sound from a business point of view and no more. Without such bold administration, section 722 was perhaps doomed to pass away un lamented, as it did. It has received more praise since the present law was enacted than it ever got while it was current. It is not to be doubted that the new law will operate fast and without substantial controversy in many cases, but if the result is wrong, what does it matter how quickly it is reached?