3 T.C. 423 (1944)

For excess profits tax purposes, unrealized gains from insurance proceeds that were not recognized in computing net income cannot be included in the calculation of accumulated earnings and profits when determining invested capital.

Summary

Butter-Nut Baking Company received insurance proceeds exceeding the adjusted basis of its property destroyed by fire in 1938. The company reinvested the entire amount in a new plant and reported the gain as non-recognizable on its 1938 income tax return. In 1941, Butter-Nut attempted to include the previously unrealized gain in its invested capital calculation for excess profits tax purposes, claiming it as part of its accumulated earnings and profits. The Tax Court held that because the gain was not recognized in computing net income, it could not be used to increase earnings and profits for calculating invested capital, pursuant to Section 501(a) of the Second Revenue Act of 1940.

Facts

Butter-Nut Baking Company's plant was destroyed by fire in 1938. The company received insurance proceeds that exceeded the adjusted basis of the destroyed assets by $13,049.16. The company reinvested the insurance proceeds in a new plant. On its 1938 income tax return, Butter-Nut treated the gain as non-recognizable, and no gain was recognized or taxed. In its accounting, Butter-Nut initially credited the $13,049.16 against the cost of the new assets. Later, in 1940, an entry was made restoring the full cost of the new assets to the books by charging "Buildings" and crediting "Surplus" with the $13,049.16.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Butter-Nut Baking Company's income tax and excess profits tax for 1941. The Commissioner eliminated $13,049.16 from accumulated earnings and profits when computing invested capital. Butter-Nut Baking Company petitioned the Tax Court for a redetermination of the deficiencies.

Issue(s)

Whether the Commissioner properly excluded the $13,049.16, representing the previously unrealized gain from insurance proceeds, from the accumulated earnings and profits when computing invested capital for excess profits tax purposes in 1941.

Holding

No, because Section 501(a) of the Second Revenue Act of 1940 dictates that earnings and profits can only be increased by gains to the extent that the gains were

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recognized in computing net income, and the gain from the insurance proceeds was not recognized in Butter-Nut's 1938 income tax return.

Court's Reasoning

The court distinguished the case from *National Grocer Co.*, 1 B.T.A. 688, which involved a deduction from recognized gain under the Revenue Act of 1921. The court emphasized that Section 501(a) of the Second Revenue Act of 1940 specifically addressed how gains and losses affect earnings and profits. The court quoted the statute: "Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made." Because the $13,049.16 gain from the insurance proceeds was treated as non-recognizable in 1938, it could not be included in the accumulated earnings and profits for the purpose of calculating invested capital in 1941. The court found that the respondent did not err in disallowing the amount in the computation of invested capital.

Practical Implications

This decision clarifies that unrealized gains, even if later reflected on a company's books, do not automatically increase earnings and profits for the purpose of calculating invested capital under the excess profits tax. It highlights the importance of recognizing gains in computing net income for the year in which the disposition occurred. This case serves as a reminder that the tax treatment of gains and losses depends heavily on the specific provisions of the tax code in effect at the time and the extent to which those gains or losses are recognized for income tax purposes. Later cases applying or distinguishing this ruling would likely focus on whether a gain was, in fact, "recognized" under the applicable tax law.

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