3 T.C. 593 (1944)

A taxpayer seeking to exclude an abnormal bad debt deduction from base period income for excess profits tax purposes must prove the abnormality was not a consequence of increased gross income during that base period.

Summary

William Leveen Corporation challenged a deficiency in its 1940 excess profits tax. The company sought to adjust its base period income (1936-1939) by excluding an abnormally large bad debt deduction from 1939. The Tax Court held against the taxpayer, stating that the taxpayer failed to demonstrate that the abnormal bad debt deduction in 1939 was not a consequence of the increase in gross income for the same period, a requirement under Section 711(b)(1)(K)(ii) of the Internal Revenue Code.

Facts

William Leveen Corporation, a woolens jobber, used the accrual method of accounting. Prior to 1939, the company deducted bad debts on the actual charge-off basis. In 1939, the company switched to the reserve method and claimed a bad debt deduction of $14,729.99, reflecting actual charge-offs of $14,499.79. The bulk of these bad debts stemmed from accounts with I. Schwartz and Son, Best Made Middy Co., and Emory Sportwear Co. Sales to these customers, and overall net sales, increased significantly in 1939 compared to prior years.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency in the taxpayer’s 1940 excess profits tax. William Leveen Corporation petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

Whether the taxpayer established that the abnormality or excess in the amount of its bad debt deduction in 1939 was not a consequence of an increase in the gross income of the taxpayer in its base period, as required by Section 711(b)(1)(K)(ii) of the Internal Revenue Code.

Holding

No, because the taxpayer did not prove that the increased bad debt deduction was unrelated to the increase in gross income, as mandated by the statute.

Court’s Reasoning

The court emphasized that Section 711(b)(1)(K)(ii) places a clear burden on the taxpayer to demonstrate that the abnormal bad debt deduction was not caused by increased gross income. The court noted that proving a negative can be difficult, suggesting that the taxpayer could have tried to show the abnormal deduction was a consequence of something other than increased gross income. However, the court found that the stipulated facts did not support such a conclusion. Gross income increased from an average of $44,649.94 for 1936-1938 to $61,902.76 in 1939, while the abnormal portion of the bad debt deduction was $9,993.96. The court stated, "Although such a relation is not necessarily that of cause and consequence, the taxpayer's success depends upon proof that it was not." The court also rejected the taxpayer's argument that the bad debt reserve charge was related to specific customers, noting that sales to I. Schwartz and Son had also increased significantly in 1939. Therefore, the court found no basis to conclude that the bad debt deduction was unrelated to the increase in gross income. The court stated, "We are of opinion that the taxpayer has not established, as the statute requires, that the abnormality or excess amount of its bad debt deduction in 1939 is not a consequence of the increase in its gross income, and the Commissioner's determination must be sustained."

Practical Implications

This case illustrates the stringent burden placed on taxpayers seeking to adjust base period income for excess profits tax purposes by excluding abnormal deductions. It highlights the importance of demonstrating a clear lack of connection between an abnormal deduction and increased gross income during the relevant period. Taxpayers must present compelling evidence showing an alternative cause for the deduction's abnormality. The case also suggests that a mere increase in sales to customers who subsequently default may not be sufficient to meet this burden if overall gross income also increased. Later cases may cite this decision as precedent for requiring taxpayers to provide strong evidence to overcome the presumption that an abnormal deduction is related to increased income.

