3 T.C. 1160 (1944)

A taxpayer consistently including bad debt recoveries in gross income while using the reserve method can exclude pre-1940 bad debt recoveries from excess profits tax net income, invalidating conflicting Treasury Regulations.

Summary

J.F. Johnson Lumber Co. consistently included recoveries of bad debts in its gross income, even while using the reserve method of accounting for bad debts. The Commissioner sought to include these recoveries in the company's excess profits tax net income, arguing that the reserve method precluded such exclusion per Treasury Regulations. The Tax Court held that the plain language of Section 711(a)(1)(E) of the Internal Revenue Code allowed the exclusion, regardless of the accounting method, and invalidated the conflicting regulation. This case clarifies the application of excess profits tax law when a taxpayer consistently treats bad debt recoveries as gross income under the reserve method.

Facts

J.F. Johnson Lumber Co. maintained its accounts on an accrual basis with a fiscal year ending January 31. The company consistently used the reserve method for accounting for bad debts. Critically, the company's established practice, unchallenged by the Commissioner, was to include all collections on previously charged-off bad debts in its gross income, not as a credit to the bad debt reserve. In fiscal years 1941 and 1942, the company collected $13,308.07 and $20,020.58, respectively, on debts previously charged off and included these amounts in gross income. The company then excluded these amounts from income subject to excess profits tax, which the Commissioner disallowed.

Procedural History

The Commissioner determined excess profits tax deficiencies for the fiscal years ending January 31, 1941, and January 31, 1942. The Commissioner refused to exclude bad debt recoveries from excess profits net income based on Treasury Regulations. J.F. Johnson Lumber Co. appealed this determination to the Tax Court.

Issue(s)

Whether a taxpayer, consistently including recoveries of bad debts in gross income while using the reserve method of accounting for bad debts, can exclude income attributable to the recovery of bad debts deducted in taxable years beginning before January 1, 1940, from excess profits tax net income under Section 711(a)(1)(E) of the Internal Revenue Code.

Holding

Yes, because Section 711(a)(1)(E) of the Internal Revenue Code allows for the exclusion of income attributable to the recovery of bad debts deducted in pre-1940 taxable years, regardless of whether the taxpayer uses the reserve method, especially when the taxpayer consistently includes such recoveries in gross income. The Treasury Regulation to the contrary is invalid.

Court's Reasoning

The Tax Court emphasized the clear and unambiguous language of Section 711(a)(1)(E) of the Internal Revenue Code, which mandates the exclusion of income from bad debt recoveries if the deduction was allowed for a taxable year beginning before January 1, 1940. The court stated,

