4 T.C. 783 (1945)

When computing equity invested capital for excess profits tax, Internal Revenue Code Section 718(b)(3) mandates the deduction of earnings and profits previously included from another corporation in a tax-free reorganization, regardless of subsequent operating losses.

Summary

Crossett Western Co. challenged a deficiency in excess profits tax, arguing that it should not have to deduct earnings and profits acquired from predecessor companies in a tax-free reorganization when calculating its equity invested capital because subsequent losses eliminated those earnings. The Tax Court ruled against Crossett, holding that Section 718(b)(3) of the Internal Revenue Code clearly requires such a deduction, regardless of later losses. The court reasoned that the statute's language is unambiguous and must be applied as written, without considering legislative history to justify an exception.

Facts

Crossett Western Co. was formed in 1923 through a tax-free reorganization of three other companies. As part of this reorganization, Crossett acquired the assets, including accumulated earnings and profits, of the predecessor companies. From 1924 to 1939, Crossett experienced operating losses exceeding the acquired earnings and profits. In calculating its equity invested capital for the 1940 and 1941 tax years, Crossett did not deduct the earnings and profits it acquired from its predecessors. The Commissioner of Internal Revenue determined that Section 718(b)(3) required this deduction, resulting in a deficiency.

Procedural History

The Commissioner assessed deficiencies in Crossett Western Co.'s income and excess profits taxes for 1940 and 1941. Crossett conceded the income tax deficiency for 1940 and part of the excess profits tax deficiency for 1941. The remaining portion of the 1941 excess profits tax deficiency, and the entire 1940 excess profits tax deficiency, were disputed and brought before the Tax Court.

Issue(s)

Whether, in determining a corporation's equity invested capital for excess profits tax purposes, Internal Revenue Code Section 718(b)(3) requires the deduction of earnings and profits acquired from predecessor corporations in a tax-free reorganization, even if those earnings have been eliminated by subsequent operating losses.

Holding

Yes, because Section 718(b)(3) clearly and unambiguously mandates the deduction of earnings and profits from another corporation previously included in accumulated earnings and profits due to a tax-free reorganization, irrespective of later operating losses that may have eliminated those earnings.

Court's Reasoning

The court emphasized the plain language of Section 718(b)(3), which states that equity invested capital must be reduced by the earnings and profits of another corporation previously included in accumulated earnings and profits due to a tax-free reorganization. The court found the language "previously at any time" to be unambiguous and controlling. The court rejected Crossett's argument that legislative history demonstrated that the purpose of the section was only to prevent duplication of assets, and that no duplication existed because the company had no accumulated earnings and profits in the tax years in question. The court stated, "When Congress has spoken in clear and unambiguous language the normal and reasonable meaning of an act is not to be argued to one side in favor of a construction made possible only by the distortion or disregard of such plain language." Judge Murdock, in his concurrence, explained the underlying rationale: including both the assets and earnings of the transferor corporations in the equity invested capital of the transferee corporation would result in a duplication, equivalent to the amount of the earnings and profits of the transferor corporations taken over by the transferee; therefore, such a duplication must be eliminated.

Practical Implications

This case establishes a strict interpretation of Section 718(b)(3) for calculating equity invested capital. It confirms that the deduction of previously acquired earnings and profits is mandatory, even if those earnings are later offset by losses. This ruling has implications for tax planning in corporate reorganizations. Attorneys must advise clients that acquiring a company with accumulated earnings in a tax-free reorganization will permanently reduce the acquirer's equity invested capital, even if those earnings are subsequently lost. Later cases citing Crossett Western Co. reinforce the principle that unambiguous statutory language should be applied as written, without resorting to legislative history to create exceptions.