Philadelphia, Germantown and Norristown Railroad Company v. Commissioner of Internal Revenue, 6 T.C. 789 (1946)

A taxpayer is not entitled to excess profits tax relief under Section 722 of the Internal Revenue Code based solely on increased income tax rates and the inclusion of larger amounts of federal income taxes paid by a lessee as additional rent, pursuant to a long-standing lease agreement, in the taxpayer's gross income.

Summary

Philadelphia, Germantown and Norristown Railroad Company (PG&N) sought relief from excess profits taxes under Section 722 of the Internal Revenue Code for 1941 and 1942. PG&N argued that increased federal income tax rates and the inclusion of larger amounts of these taxes, paid by its lessee (Reading Co.) as rent, resulted in an excessive and discriminatory tax. The Tax Court denied PG&N's claim, holding that the increased tax rates were events occurring after December 31, 1939, which Section 722(a) prohibits from being considered when determining constructive average base period net income. Furthermore, the court noted that the lease agreement requiring the lessee to pay PG&N's taxes had been in effect since 1870, and was not an unusual or abnormal event during the base period.

Facts

PG&N leased its railroad properties to Philadelphia & Reading Railroad Co. (later Reading Co.) in 1870 for 999 years. The lease obligated the lessee to pay a yearly rent, maintain PG&N's corporate organization, pay ground rents, and, critically, pay all taxes assessed on PG&N's capital stock, payments, dividends, and the leased premises. Reading Co. paid PG&N's federal income and excess profits taxes directly to the collector. PG&N included these tax payments in its gross income as additional rent, as required by Supreme Court precedent. During the years 1936 to 1942, PG&N's sole activity was owning property and distributing its proceeds.

Procedural History

The Commissioner of Internal Revenue disallowed PG&N's applications for relief under Section 722 of the Internal Revenue Code and claims for refund of excess profits taxes for 1941 and 1942. PG&N petitioned the Tax Court, arguing that the Commissioner's disallowance was erroneous.

Issue(s)

Whether the imposition of federal income taxes at increased rates in 1941 and 1942, and the inclusion of greater amounts of these taxes paid by the lessee in PG&N's income, entitles PG&N to relief under Section 722(a) and (b)(5) of the Internal Revenue Code.

Holding

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No, because Section 722(a) prohibits consideration of events occurring after December 31, 1939, when determining constructive average base period net income, and the lease agreement requiring the lessee to pay PG&N's taxes was a long-standing arrangement, not an unusual event during the base period.

Court's Reasoning

The court emphasized that Section 722 requires a taxpayer to demonstrate that its base period net income is not a fair measure of normal earnings due to a factor affecting the taxpayer's business. PG&N argued that the increased income tax rates and the inclusion of larger amounts of taxes paid by the lessee constituted such a factor. However, the court cited Section 722(a), which states that "In determining such constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer… occurring or existing after December 31, 1939." The court reasoned that the increased tax rates were events after this date and therefore could not be considered. The court further noted that the requirement for the lessee to pay PG&N's taxes originated in 1870 with the lease agreement. The court stated that under Section 722(b)(5), the "event or condition affecting the taxpayer" must occur or exist "either during or immediately prior to the base period." Since the lease was well-established long before the base period, it did not meet the criteria for relief. The court also addressed PG&N's argument that the excess profits tax was not intended to apply to its type of income. The court referenced Ways and Means Committee Report No. 2894, 76th Congress, 3d Session, pp. 1-2, emphasizing that the tax applied to corporate profits from all sources and not merely those engaged in defense programs.

Practical Implications

This case clarifies that Section 722 of the Internal Revenue Code provides limited relief, and that events occurring after December 31, 1939, cannot justify adjustments to base period income. It also demonstrates that long-standing contractual obligations, even if they result in increased tax liabilities due to later tax rate changes, generally do not qualify as factors warranting relief under Section 722. This decision reinforces the importance of demonstrating that the factor affecting the taxpayer's business occurred during or immediately before the base period. Later cases have cited this ruling as an example of the strict limitations on Section 722 relief, particularly when the alleged abnormality stems from changes in tax laws or long-established business practices.

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