8 T.C. 511 (1947)

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Cash recoveries on bad debts, previously written off under the reserve method of accounting, are excludable from excess profits net income, but adjustments to specific bad debt reserves based on a customer's improved financial position do not qualify as income attributable to the recovery of a bad debt.

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Summary

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Zellerbach Paper Co. and Crown Zellerbach Corporation sought to exclude certain amounts from their excess profits net income, arguing they represented income from the recovery of bad debts. The Tax Court addressed two main issues: (1) whether cash recoveries and reductions in specific reserves due to improved customer financial positions qualified for exclusion under Sections 711(a)(1)(E) and 711(a)(2)(H) of the Internal Revenue Code, and (2) whether Crown Zellerbach was entitled to depreciation/amortization deductions for a hydroelectric power plant, affecting its excess profits credit. The court held that cash recoveries were excludable, but adjustments based on improved financial positions were not. It also allowed the depreciation deduction, impacting the excess profits credit and triggering adjustments to base period income under Section 734.

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Facts

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Both Zellerbach Paper and Crown Zellerbach used the reserve method for accounting for bad debts, with specific and general reserves. Prior to 1940, certain receivables were written off as uncollectible. In 1941 and 1942, some of these accounts saw cash payments. Also, the credit position of certain customers improved, leading to reduced specific reserve requirements. Crown Zellerbach acquired a hydroelectric power plant in 1936, initially classifying certain construction expenses as non-depreciable. In 1944, the Federal Power Commission reclassified these expenses as depreciable.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in the petitioners' excess profits taxes for the fiscal years 1941 and 1942. Zellerbach Paper Co. and Crown Zellerbach Corp. petitioned the Tax Court for redetermination. The cases were consolidated. Crown Zellerbach later filed an amended petition after the Federal Power Commission's order, claiming a depreciation deduction.

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Issue(s)

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1. Whether cash recoveries on previously written-off bad debts are excludable from excess profits net income under Sections 711(a)(1)(E) and 711(a)(2)(H) of the Internal Revenue Code.

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2. Whether reductions in specific bad debt reserves due to improved customer financial positions qualify as income attributable to the recovery of a bad debt under the same sections.

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3. Whether Crown Zellerbach is entitled to a deduction for depreciation or amortization of a hydroelectric power plant for the fiscal years 1941 and 1942, and if so, whether the allowance of such deduction affects its excess profits credit under Section 713 and requires an adjustment under Section 734 of the Internal Revenue Code.

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Holding

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1. Yes, because Sections 711(a)(1)(E) and 711(a)(2)(H) exclude income attributable to the recovery of bad debts for which a deduction was previously allowed, and cash recoveries constitute such income regardless of whether the taxpayer uses the direct write-off or reserve method.

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2. No, because a mere improvement in a debtor’s financial position, without actual cash recovery, does not constitute the

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