12 T.C. 287 (1949)

To claim an exclusion from gross income for excess profits tax purposes based on net abnormal income attributable to prior years, a taxpayer must prove the earnings of the subsidiary at the time of dividend distributions were less than the amounts distributed.

Summary

Carborundum Co. sought relief from excess profits tax for 1940, claiming certain dividend distributions from its Canadian subsidiary constituted “net abnormal income” attributable to prior years. The Tax Court denied the claim, finding that Carborundum failed to prove that the Canadian subsidiary’s earnings at the time of the dividend distributions were less than the amounts distributed. The court also addressed the proper calculation of foreign tax credit against excess profits tax, adjustments for abnormal deductions in base period years, and adjustments for a fire loss. Several claimed abnormalities related to advertising and other expenses were also disputed. The Tax Court’s decision highlights the taxpayer’s burden of proof in establishing entitlement to these complex tax benefits.

Facts

Carborundum Co., a Delaware corporation, received dividend distributions from its wholly-owned Canadian subsidiary in 1940. These dividends totaled $554,059.65 (U.S. dollars). Carborundum sought to exclude a portion of these dividends from its 1940 excess profits tax calculation, arguing they represented “net abnormal income” attributable to prior years under Section 721 of the Internal Revenue Code. The Canadian subsidiary’s net earnings after taxes for 1940 were $470,975.16. Carborundum also claimed adjustments for various abnormal deductions in its base period income, including advertising, entertainment, and retirement annuities.

Procedural History

Carborundum Co. filed its excess profits tax return for 1940, computing its income credit method. The Commissioner of Internal Revenue determined deficiencies in income, declared value excess profits, and excess profits taxes. Carborundum petitioned the Tax Court, contesting the Commissioner’s determinations and claiming a refund. The Tax Court addressed several issues related to the computation of excess profits tax, including the exclusion of abnormal income and adjustments for abnormal deductions in base period years.

Issue(s)

1. Whether Carborundum was entitled to relief from excess profits tax for 1940 under Section 721 of the Internal Revenue Code by applying net abnormal income to prior years.

© 2025 SCOTUSreports.com. All rights reserved.

2. Whether the Commissioner erred in applying the limitation on credit for foreign taxes against Carborundum's excess profits tax under Section 729(d) of the Code.

3. Whether Carborundum was entitled to adjustments for abnormal deductions in determining base period net income under Section 711(b)(1)(J) of the Code.

4. Whether the Commissioner erred in decreasing net income for the base period year 1936 by additional income tax attributable to the disallowance of an abnormal deduction for bad debts.

5. Whether Carborundum was entitled to an adjustment to income for its base period year 1936 for a fire loss.

Holding

1. No, because Carborundum failed to prove that the Canadian subsidiary's earnings at the time of the dividend distributions were less than the amounts distributed.

2. No, because the Commissioner correctly determined Carborundum's excess profits net income from sources within Canada by reducing total Canadian income by the portion of income tax attributable to the Canadian income.

3. Yes, in part, because deductions for advertising, entertainment, store conference expense, and retirement annuities were abnormal in amount within the meaning of Section 711(b)(1)(J)(ii) of the Code, and Carborundum was entitled to adjustments in its excess profits net income for base period years.

4. Yes, because the provision of Section 711(b)(1)(A) authorizes an increase in the deduction for taxes equivalent to the amount of tax payable under Chapter 1 for the base period year involved, not an increase equivalent to the tax which might have been paid upon net income increased as the result of an adjustment under Chapter 2 for an abnormality.

5. No, because Carborundum failed to prove that the amount of the fire loss was deducted in its return for 1936.

Court's Reasoning

The Tax Court reasoned that Carborundum failed to provide sufficient evidence to support its claim for excluding abnormal income. Specifically, Carborundum did not demonstrate that the Canadian subsidiary's earnings at the time of the dividend payments were less than the distributed amounts. The court rejected Carborundum's attempt to presume a ratable accrual of earnings throughout the year, citing *Dorothy Whitney Elmhirst, 41 B.T.A. 348*, and highlighting Carborundum's failure to prove that the actual earnings of the Canadian subsidiary to the dates of the distributions could not be shown. Regarding the foreign tax credit, the court sided with the Commissioner's calculation, which reduced total

© 2025 SCOTUSreports.com. All rights reserved.

Canadian income by the portion of income tax attributable to it. On the issue of abnormal deductions, the court allowed adjustments for certain expenses (advertising, entertainment, store conference expenses, and retirement annuities), finding that Carborundum demonstrated that these abnormalities were not a consequence of increased gross income, decreased deductions, or changes in the business. The court stated, "the question…is 'the other way around,' viz., Were the abnormal expenditures a consequence of an increase in gross income in the base period or of a change in the type, manner of operation, size, or condition of the business?" Finally, the court rejected the claimed fire loss adjustment due to lack of proof and pleading deficiencies.

Practical Implications

The *Carborundum* decision illustrates the high burden of proof placed on taxpayers seeking to claim benefits related to excess profits tax, particularly regarding the exclusion of abnormal income and adjustments for abnormal deductions. It emphasizes the importance of meticulous record-keeping and the need to provide concrete evidence supporting claims, rather than relying on presumptions or approximations. The case also provides guidance on the proper calculation of foreign tax credits and the factors considered when determining whether deductions are truly "abnormal" under the relevant code provisions. Later cases have cited *Carborundum* for its emphasis on the taxpayer's burden of proof and the need to establish a clear causal link between abnormal expenses and changes in business conditions.

© 2025 SCOTUSreports.com. All rights reserved.