13 T.C. 336 (1949)

For the purpose of calculating excess profits tax credit using the base period income method, taxpayers are permitted to adjust their base period income to correct improperly taken deductions, but abnormalities resulting from business changes are not eliminated under Section 711 of the Internal Revenue Code.

Summary

Kawneer Co. challenged the Commissioner's determination of a deficiency in its excess profits tax for 1941. The dispute centered on the computation of Kawneer's excess profits tax credit, specifically whether losses on contracts, losses on bank deposits, and excessive depreciation deducted during the base period years (1936-1938) should be adjusted. The Tax Court held that adjustments were proper for excessive depreciation and losses on long-term contracts that were improperly deducted. However, abnormalities related to these deductions and unrecovered bank deposits, stemming from changes in Kawneer's business, could not be eliminated under Section 711(b)(1)(K)(ii) of the Internal Revenue Code.

Facts

Kawneer Co. computed its excess profits tax credit using the base period income method. The company had acquired Coleman Bronze Co. in 1930 and Zouri Drawn Metals Co. also around that time. Kawneer operated Coleman Bronze as a subsidiary and later as a division after acquiring its assets in 1934. Among the assets acquired were long-term contracts that resulted in losses due to increased costs under the National Industrial Recovery Act (NIRA). Kawneer initially followed a completed contract method of accounting, recognizing losses upon completion. Kawneer also experienced losses from bank deposits when banks holding the deposits of its subsidiaries failed. Furthermore, the IRS determined that Kawneer had been taking excessive depreciation deductions.

Procedural History

Kawneer Co. filed its excess profits tax return for 1941. The Commissioner determined a deficiency, leading Kawneer to challenge the determination in the Tax Court. The Commissioner argued that the losses and depreciation should not be adjusted when calculating the excess profits tax credit. The Tax Court considered the issues and rendered its decision.

Issue(s)

1. Whether Kawneer is entitled to adjust its base period income for excessive depreciation improperly deducted during the base period years.
2. Whether similar adjustments are proper for losses on long-term contracts under NIRA improperly deducted in the base period.
3. Whether any abnormality relating to such deductions and to others taken for

unrecovered bank deposits acquired from liquidated subsidiaries can be eliminated under Section 711 of the Internal Revenue Code.

Holding

1. Yes, because base period income can be adjusted for erroneous deductions of excessive depreciation, provided the facts supporting the proper amount were known during the base period.
2. Yes, because base period income may be adjusted for the proper reflection of losses on long-term contracts.
3. No, because the abnormalities related to the deductions for losses and unrecovered bank deposits were a consequence of changes in Kawneer's business, thus preventing their elimination under Section 711.

Court's Reasoning

The Tax Court reasoned that while abnormalities caused by changes in the size or structure of the business could not be eliminated under Section 711(b)(1)(K)(ii), adjustments could be made to correct errors in the original tax returns. The court relied on *Pacific Gas & Electric Co.*, emphasizing that the deductions would not have existed but for the acquisitions. However, the court distinguished between deductions that were inherently improper and those that were merely abnormal due to business changes. For excessive depreciation, the Court cited *Leonard Refineries, Inc.* and determined that adjustments were warranted as the company knew the underlying facts. For losses on long-term contracts under NIRA, the Court cited *Byus-Mankin Lumber Co.* allowing the losses to be excluded from the base period.

Practical Implications

This case clarifies the distinction between adjustments to base period income for errors and the elimination of abnormalities for excess profits tax credit calculations. It emphasizes that taxpayers can correct past errors in deductions, such as depreciation or recognizing losses on long-term contracts, even when calculating excess profits tax credit. However, abnormalities stemming from business changes, such as acquisitions or mergers, are not grounds for eliminating deductions under Section 711. This ruling reinforces the importance of accurate accounting and tax reporting during the base period years for excess profits tax purposes. The case is helpful for attorneys and tax professionals dealing with excess profits tax calculations or similar situations where base period income is used to determine tax liabilities. Later cases have cited this one for the principle that errors can be corrected but abnormalities caused by business changes at any time generally cannot.