15 T.C. 839 (1950)

A taxpayer who elects to compute income on the accrual basis for excess profits tax purposes under Section 736(a) of the Internal Revenue Code is entitled to include uncollected profits on installment accounts receivable in its equity invested capital.

Summary

Markson Bros., an installment seller, elected under Section 736(a) of the Internal Revenue Code to compute income on the accrual basis for excess profits tax purposes. The Commissioner denied the inclusion of uncollected profits on installment accounts receivable in the company's equity invested capital. The Tax Court held that the taxpayer was entitled to include such uncollected profits in its equity invested capital and that these profits should not be eliminated when determining the ratio of inadmissible assets to total assets. This decision emphasizes the importance of adhering to the accounting method elected by the taxpayer for excess profits tax purposes.

Facts

Markson Bros. was a retail business selling clothing and jewelry on the installment plan. The company initially reported income using the installment method under Section 44(a) of the Internal Revenue Code. For excess profits tax purposes, the company elected under Section 736(a) to report income on the accrual basis, including gross profits from uncollected installment accounts receivable. These receivables stemmed from sales made after December 31, 1939, and were included in the excess profits net income but not in income tax returns.

Procedural History

The Commissioner determined deficiencies in Markson Bros.' excess profits taxes for the years 1940-1943, excluding uncollected profits from equity invested capital and reducing invested capital by eliminating these profits when calculating inadmissible assets. Markson Bros. petitioned the Tax Court, contesting these adjustments.

Issue(s)

1. Whether the Commissioner erred in denying the inclusion of uncollected profits on installment accounts receivable in equity invested capital under Section 718(a)(4) of the Internal Revenue Code, after the taxpayer elected under Section 736(a) to report income on the accrual basis for excess profits tax purposes.

2. Whether these uncollected profits were properly eliminated when determining the reduction for inadmissible assets under Sections 715 and 720 of the Internal Revenue Code.

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Holding

1. Yes, because the taxpayer properly elected to compute its income on the accrual basis for excess profits tax purposes, entitling it to include uncollected profits in its equity invested capital.

2. No, because the Commissioner erred in eliminating these profits when determining the reduction for inadmissible assets, as the election under Section 736(a) should consistently apply to all aspects of excess profits tax computation.

Court's Reasoning

The Tax Court reasoned that the election under Section 736(a) required consistent treatment of income for excess profits tax purposes. The court emphasized that Regulation 112, Section 35.736(a)-2, permits the use of the elected method in including accumulated earnings and profits in equity invested capital if returns for either income tax or excess profits tax have been on the elected basis for years after 1939. The court noted that the Senate Committee Report on the Revenue Act of 1942 indicated that installment relief was intended for all purposes of excess profits tax. The court also distinguished *Commissioner v. South Texas Lumber Co., 333 U.S. 496*, as not involving an election under Section 736(a). The Court stated, "The petitioner having filed its election and reported and paid excess profits taxes on the new basis appears clearly not only within the language of section 736 (a) but also within the above-quoted language of the regulation." By including uncollected profits in taxable excess profits income, the taxpayer was entitled to include these profits in its equity invested capital and should not have them eliminated when calculating inadmissible assets.

Practical Implications

This case clarifies that when a taxpayer elects to use the accrual method for excess profits tax purposes under Section 736(a), that election must be consistently applied throughout the excess profits tax computation. This means that uncollected profits included in excess profits net income should also be included in equity invested capital and not eliminated when determining inadmissible assets. The decision emphasizes the importance of regulatory interpretation (specifically, Regulation 112, Section 35.736(a)-2) in understanding the scope and application of tax elections. Later cases must consider if an election was made under 736(a) to determine whether to follow the principles outlined in *Markson Bros.*

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