15 T.C. 918 (1950)

When a taxpayer elects to compute income from installment sales on the accrual basis for excess profits tax purposes, the deduction for charitable contributions is limited to a percentage of the net income computed on the accrual basis.

Summary

Leo Kahn Furniture Co. elected to compute its income from installment sales on the accrual basis for excess profits tax purposes, as permitted by Section 736(a) of the Internal Revenue Code. However, it continued to compute its normal tax net income on the installment basis under Section 44(a). The IRS limited the company's deduction for charitable contributions to 5% of its net income computed on the accrual basis for excess profits tax purposes. The Tax Court upheld the IRS's determination, finding that Treasury Regulations required this limitation to ensure equitable treatment between installment and accrual basis taxpayers. The court emphasized the validity of the regulation in preventing an inequitable result.

Facts

Leo Kahn Furniture Co., a Tennessee corporation, engaged in retail furniture sales, regularly utilizing the installment plan. The company elected under Section 736(a) of the Internal Revenue Code to compute its income for excess profits tax purposes on the accrual basis, while continuing to file its income tax returns on the installment basis under Section 44(a). On its 1942 excess profits tax return, the company deducted $4,130 for charitable contributions. The IRS disallowed $2,257.52 of this deduction, limiting it to 5% of the company's excess profits net income computed on the accrual basis.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the company's excess profits taxes for 1940, 1941, and 1942. The company petitioned the Tax Court, contesting the Commissioner's limitation on the charitable contribution deduction. The Tax Court upheld the Commissioner's determination, finding the relevant Treasury Regulation valid.

Issue(s)

Whether, when a taxpayer elects under Section 736(a) of the Internal Revenue Code to compute income from installment sales for excess profits tax purposes on the accrual basis, the deduction for charitable contributions is limited to 5% of its net income computed on the accrual basis.

Holding

Yes, because Treasury Regulations mandate that deductions limited to a percentage of net income (like charitable contributions) must be determined based on net income computed on the accrual basis when a taxpayer elects to use that basis for excess profits tax purposes.

Court’s Reasoning

The court reasoned that Section 736(a) is a relief provision intended to put installment sellers on equal footing with accrual basis taxpayers for excess profits tax purposes. Treasury Regulations 112, Section 35.736(a)-3, implementing Section 736(a), explicitly states that deductions limited to a percentage of net income must be calculated based on the accrual basis net income when that election is made. The court emphasized that the regulation is necessary to prevent an inequitable result where installment basis taxpayers would otherwise receive a larger charitable contribution deduction than accrual basis taxpayers. The court distinguished *Gus Blass Co., 9 T.C. 15*, because that case did not involve an election under Section 736(a). The court found the regulation reasonable and consistent with the revenue statutes, stating that it must be sustained unless unreasonable or inconsistent with the revenue statutes. The court also distinguished *Basalt Rock Co. v. Commissioner, 180 F.2d 281*, noting that this case did not involve the question of comparing a percentage of adjusted excess profits net income on one basis with a percentage of surtax net income on another basis. Instead, the court found the question to be whether, for excess profits tax purposes, in computing the percentage of net income permitted as a deduction for contributions, petitioner may start with the net income figure used in computing its income tax liability on the installment basis rather than on the installment income determined by the use of the accrual basis pursuant to its election under section 736(a).

Practical Implications

This case clarifies that taxpayers electing to use the accrual basis for excess profits tax calculations must also use that basis for calculating deductions limited by net income, such as charitable contributions. This prevents taxpayers from selectively using different accounting methods to maximize tax benefits. The decision reinforces the validity of Treasury Regulations in interpreting and implementing tax code provisions, especially when designed to ensure equitable treatment among taxpayers using different accounting methods. Later cases applying this ruling would likely focus on whether a specific deduction is indeed limited by net income and whether the taxpayer properly elected to use the accrual basis for excess profits tax purposes.

