T.C. Memo. 1952-251

When calculating an acquiring corporation's excess profits credit, income derived from financing installment sales, integral to the main business, should be included in the base period net income, even if a separate finance company was later formed.

Summary

A.C. Burton & Co. sought to include finance income from 1936-1937 when calculating its excess profits credit as an acquiring corporation. The IRS argued this income should be excluded because it stemmed from a separate finance business later acquired by Burton Finance Company. The Tax Court held that because the finance income was an integral part of the automobile dealership's operations during the base period, it should be included in the calculation of the excess profits credit. The court emphasized that the finance income was directly linked to automobile sales and not an independent business activity.

Facts

A.C. Burton operated an automobile dealership as a sole proprietorship from 1936 to 1940. The business accepted installment notes for car sales, generating finance income. In October 1938, Burton Finance Company was formed. On July 1, 1940, A.C. Burton & Co. (the corporation) acquired substantially all the properties of the sole proprietorship. The amount of installment notes held by the proprietorship varied during the base period, decreasing significantly after 1937. The corporation also held some notes in 1940 after acquiring the business.

Procedural History

The Fifth Circuit Court of Appeals previously determined that A.C. Burton & Co. was an "acquiring corporation" under section 740(a)(1)(D) of the Code, reversing the Tax Court's initial decision. The IRS then argued alternatively that the base period net income should be reduced by reasonable salaries and finance net income from 1936-1937. This case addresses the finance income issue, remanded from the Fifth Circuit's prior decision.

Issue(s)

Whether finance income, derived from installment sales during 1936 and 1937 by the sole proprietorship, should be excluded from the calculation of the acquiring corporation's excess profits credit under section 742 of the Internal Revenue Code.

Holding

No, because the finance income was an integral part of the automobile dealership's business and not a separate, independent finance business.

Court's Reasoning

The Tax Court reasoned that Section 742 of the Code does not require an acquiring corporation to compute its average base period net income on a departmental basis. While the IRS argued for excluding the finance income, the court found that this income was directly related to the business of selling automobiles. The court stated, "It was in the normal course of trade that the proprietorship acquired installment notes in payment for cars just as it acquired used cars traded in for new cars. Whether it held the notes and derived a profit from finance charges and interest or sold the notes at a discount to procure ready cash was a matter of business discretion. It was not a matter of operating a separate finance business." The finance income was considered part of the proprietorship income, just like income from used car sales or repairs.

Practical Implications

This decision clarifies that when determining excess profits credit for acquiring corporations, the focus should be on the integral nature of the income-generating activity to the primary business. Legal practitioners should analyze whether the income in question is directly tied to the core business operations or represents a distinct, separate business. This case illustrates that even if a separate entity is later formed to manage a specific aspect of the business, income generated before the separation, directly related to the primary business, should be included in the base period net income calculation. Later cases may distinguish this ruling based on whether the finance activity was truly an integral part of the main business or a distinct operation.

