20 T.C. 702 (1953)

When determining excess profits tax, abnormal income derived from credits against unemployment insurance taxes should be allocated to prior years based on the events that gave rise to the income, with consideration of direct costs, and expenses.

Summary

The Horn and Hardart Company received a credit against its New York State unemployment insurance tax liability due to a surplus in the state's unemployment insurance fund. The company reported this credit as income for 1945 and attributed it to prior years, based on its contributions to the fund during those years. The Commissioner of Internal Revenue argued that the credit was not attributable to prior years or that the 1945 contributions should offset the prior year allocation. The Tax Court held that the credit constituted abnormal income, which should be allocated to prior years, considering the cumulative contributions that led to the surplus, with a modification to account for the 1945 income.

Facts

The Horn and Hardart Company, a New York corporation, made annual payments to the New York State Unemployment Insurance Fund from 1936. In 1945, New York passed a law creating a surplus in the fund when it exceeded a certain threshold, and it provided for credits against employer contributions. Because of the surplus, Horn and Hardart received a credit of $86,181.50 in 1945. The company reported this as income and attributed the credit to prior years based on its payments to the fund during 1936-1944.

Procedural History

The Commissioner determined a deficiency in the company's 1945 excess profits tax. The company contested the Commissioner's determination, leading to the case being brought before the United States Tax Court.

Issue(s)

1. Whether the credit of $86,181.50 represented abnormal income under Section 721 of the Internal Revenue Code.

2. If so, whether the abnormal income was attributable to prior years.

3. If so, whether direct costs and expenses should reduce the abnormal income allocated to prior years.

Holding

1. Yes, the credit represented abnormal income because it was the result of a

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surplus generated by the state law.

2. Yes, the abnormal income was attributable to prior years, as the payments made in those years contributed to the surplus.

3. No, the required payments to the fund were not direct costs or expenses which, if incurred, would reduce the abnormal income.

Court's Reasoning

The court first addressed whether the credit qualified as abnormal income under Section 721. The court found that the credit was indeed abnormal income. The court then determined that it could be allocated to prior years because the contributions made in previous years helped create the surplus, even though the law authorizing the credit was passed in 1945. The court rejected the Commissioner's argument that only payments made in 1945 could be considered, and the credit should offset prior year contributions. The court distinguished payments into the fund, which are deductible as taxes, from "direct costs or expenses" that would be an offset. It stated that all payments before July 1, 1945 contributed to the surplus and those payments were not direct costs or expenses through which abnormal income was derived. However, the court also noted that the petitioner's allocation method, which attributed all of the credit to prior years, was incorrect, as part of the income should be allocated to 1945.

Practical Implications

This case illustrates how the Tax Court interprets the allocation of abnormal income for tax purposes. Businesses must consider the entire history of events contributing to income, not just a single tax year. Specifically, for excess profits tax calculations, the ruling highlights:

- The need to analyze the origins of income events when determining how to allocate income between tax years.
- The distinction between ordinary business expenses, like unemployment contributions, and expenses directly related to generating a specific item of abnormal income.
- The importance of carefully choosing the method of allocation to best reflect the facts and circumstances.

The case suggests that companies should maintain detailed records of all contributions and other events affecting the generation of abnormal income to justify the allocation to past years, if applicable. The specific method of allocation used by the court, which considered the annual net increase in the fund balance, provides a practical approach for similar situations.

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