28 T.C. 185 (1957)

An inventory adjustment reflecting a reduction in the value of inventory is not a "deduction" under Section 23 of the Internal Revenue Code of 1939 and therefore cannot be considered an abnormal deduction for the purpose of computing excess profits tax credit.

Summary

The McKay Machine Co. sought to increase its excess profits tax credit by treating an inventory adjustment as an "abnormal deduction." The adjustment stemmed from a contract to manufacture machinery for the U.S.S.R., which was ultimately abandoned due to the inability to obtain an export license. The company reduced its inventory to reflect the reduced value of the machinery components. The Tax Court held that this inventory adjustment was not a "deduction" as contemplated by the relevant tax code provisions (specifically, Section 23) and therefore could not be classified as an abnormal deduction to increase the company's excess profits credit. The Court emphasized that inventory adjustments affect the cost of goods sold, not deductions from gross income, and thus did not fall within the scope of the provision for abnormal deductions.

Facts

McKay Machine Co. (Petitioner) manufactured machinery. In 1946, it contracted to manufacture an atomic hydrogen weld tube mill for V.O. Machinoimport, a U.S.S.R. purchasing agent, for $600,000. The contract specified delivery by November 30, 1947, but the mill was not completed by the deadline, and an export license was subsequently denied. By 1949, it was determined the mill could not be exported, and Machinoimport closed its U.S. offices. The company had $420,513.17 in work-in-process inventory related to the contract. McKay made a year-end inventory adjustment, reducing the inventory by $78,589.17 to reflect the reduced value. In calculating its excess profits credit for 1950, McKay claimed this adjustment as an abnormal deduction.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in McKay's 1950 income tax, disallowing the claimed adjustment as an abnormal deduction. The Tax Court heard the case.

Issue(s)

1. Whether the inventory adjustment made by McKay Machine Co. in 1949, due to the inability to export machinery under a contract, qualifies as an "abnormal deduction" under Section 433(b)(9) of the Internal Revenue Code of 1939.

Holding

1. No, because the inventory adjustment is not a “deduction” as contemplated by the statute, it cannot be considered an abnormal deduction.

Court’s Reasoning

The Court focused on the statutory interpretation of “deductions” within the context of the Excess Profits Tax Act of 1950. It reasoned that the term “deductions” in Section 433(b)(9), which allows for adjustments to base period net income for abnormal deductions, is limited to those deductions specifically listed under Section 23 of the Internal Revenue Code. Section 23 allows deductions from gross income. The court held that inventory adjustments, which affect the cost of goods sold, are not deductions from gross income. The court cited *Doyle v. Mitchell Bros. Co.,* 247 U.S. 179 (1918), to emphasize that inventory valuation is related to determining gross income, not deducting from it. Further, the court referenced *Universal Optical Co.,* 11 T.C. 608 (1948), stating that “deductions” refers to “those specified as deductions under the Internal Revenue Code.” It found that inventory adjustments are governed by different code sections related to the determination of gross income, not through deductions. The Court differentiated this inventory adjustment from other permissible deductions such as bad debts or casualty losses. The Court noted that the company followed proper accounting practices when reducing the inventory. Finally, the Court found the adjustment was not an error, as the contract did not protect the company against loss.

Practical Implications

This case clarifies that inventory adjustments, which affect the cost of goods sold, are distinct from deductions that reduce gross income. Attorneys and accountants should carefully distinguish between these two concepts in tax planning and litigation. Businesses cannot increase their excess profits tax credits by treating inventory adjustments as abnormal deductions, even if those adjustments reflect unforeseen losses. This decision informs the analysis of similar cases by highlighting the importance of adhering to the statutory definition of “deductions” within the context of excess profits tax. It also underscores the proper application of inventory valuation methods and their role in determining gross income.

