28 T.C. 364 (1957)

When calculating excess profits net income for the base period, the relevant method is determined by the taxpayer's existence throughout the entire base period, despite any affiliation changes or filing of separate tax returns for portions of the period.

Summary

Underwriters Service, Inc. challenged the Commissioner's method of calculating its excess profits net income for 1946, a base period year. The company was affiliated with Kaiser for a portion of 1946. The Commissioner used the company's actual excess profits net income for the full year, including income reported in a consolidated return during the affiliation period. The Tax Court agreed, ruling that the second sentence of section 435(d)(1) of the Internal Revenue Code, which provides for a specific calculation when a company exists for only a portion of a year, did not apply because Underwriters Service existed for the entire year. The court emphasized that the company's affiliation and separate tax returns for parts of the year did not alter the method of calculating its base period net income.

Facts

Underwriters Service, Inc. (petitioner) became a wholly owned subsidiary of Kaiser on September 20, 1946, and remained so until December 18, 1946. Kaiser filed a consolidated return for its taxable year ending June 30, 1947, which included the petitioner's income for the affiliated period. Underwriters Service filed separate returns for the periods before and after the affiliation. The Commissioner determined the petitioner's excess profits net income for 1946, based on the full-year profit of $139,787.76. The petitioner contended that a different calculation method under section 435(d)(1) should apply.

Procedural History

The petitioner filed its income and excess profits tax returns for 1950, 1951, and 1952. The Commissioner determined deficiencies in these taxes. The petitioner challenged the method used to calculate its 1946 excess profits net income, which impacted the excess profits credit in the later years. The case was heard by the United States Tax Court.

Issue(s)

1. Whether the petitioner's excess profits net income for 1946 should be calculated under the first sentence of section 435(d)(1), using its actual excess profits net income for the 12 months of 1946?

2. Whether the second sentence of section 435(d)(1) applies, requiring a different calculation method due to the affiliation with Kaiser and the filing of separate returns?

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Holding

1. Yes, because the first sentence of section 435(d)(1) applied.

2. No, because the second sentence of section 435(d)(1) did not apply.

Court’s Reasoning

The court focused on the interpretation of section 435(d)(1) of the Internal Revenue Code, which addresses the calculation of average base period net income for excess profits tax purposes. The court found that the first sentence of section 435(d)(1) was applicable. The second sentence of the section was intended to provide relief where a taxpayer only existed for a portion of its taxable year, but that was not the case here. The petitioner existed throughout the entire taxable year of 1946, despite being affiliated with Kaiser for a portion of the year. The court reasoned that the fact that the petitioner filed separate returns for different periods in 1946 did not affect its excess profits net income for any of the 12 months of the year. The court referenced the fact that the petitioner’s books were closed only once for the entire year, showing a profit credited to surplus. The court stated that the petitioner’s attempt to use the second sentence of section 435(d)(1) would unreasonably extend the 12-month period and was not authorized.

Practical Implications

This case clarifies the method for computing excess profits net income for the base period, particularly when corporate affiliations and the filing of separate returns are involved. Practitioners should focus on the taxpayer’s existence throughout the entire base period in determining whether the first or second sentence of section 435(d)(1) is applicable. This decision underscores the importance of correctly identifying the period of the company’s existence and whether that impacts the appropriate method for calculating base period income for excess profits tax purposes. The case highlights that the court will give the statute a “reasonable construction”. This case helps to resolve factual scenarios where a company experiences a change in status (such as affiliation) during a tax year, but remains in existence.

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