***30 T.C. 96 (1958)***

For purposes of excess profits tax, a "class of deductions" is not limited to deductions that are inherently abnormal for the taxpayer, but can include normal deductions as well.

**Summary**

The United States Tax Court considered whether increased officers' compensation in 1947 constituted an "abnormal deduction" that required adjustments to the company's excess profits tax credit. The Court held that officers' compensation constitutes a "class of deductions" under the relevant tax code, even if such compensation levels are a regular part of the business. The Court found the taxpayer met the burden of proof to show that increased compensation was not tied to increased gross income, thus entitling the company to adjustments in its excess profits tax credit. The court also determined that the IRS could not make adjustments to the company's tax liability under section 452 based solely on the application of the rules regarding excess profits tax credit.

**Facts**

Thompson-Hayward Chemical Company (Petitioner) was a manufacturer's agent and distributor of chemicals. Charles T. Thompson, the president and a majority stockholder, determined the compensation for officers. Petitioner claimed deductions for officers' compensation. The Commissioner of Internal Revenue (Respondent) determined deficiencies in the petitioner's income tax for fiscal years ending January 31, 1951 and 1952, based on an asserted abnormality in deductions, primarily due to increases in officers' compensation. Petitioner sought adjustments to its excess profits tax credit.

**Procedural History**

The Commissioner determined tax deficiencies for fiscal years 1951 and 1952. The Tax Court reviewed the case to determine if the officer's compensation was an abnormal deduction, and if adjustments were merited under the tax code to calculate the excess profits tax credit. The Commissioner also asserted an adjustment under section 452 of the code.

**Issue(s)**

1. Whether the increase in officers' compensation in fiscal year 1947 resulted in an abnormal deduction, requiring adjustments to the excess profits tax credit.
2. Whether compensation paid to petitioner's president in fiscal year 1947 was unreasonable, necessitating an adjustment under section 452.

**Holding**

 

1. Yes, because the court found the increase in officer's compensation was not a cause or consequence of an increase in gross income in the base period.
2. No, because the taxpayer did not maintain an inconsistent position, as the position was required to be maintained only by the party adversely affected by the adjustment.

**Court's Reasoning**

The court first addressed the definition of "class of deductions." The court determined that the deduction for officers' compensation constituted a "class of deductions" within the meaning of section 433(b)(9) of the 1939 Internal Revenue Code. The court rejected the Commissioner's argument that a "class of deductions" must be intrinsically abnormal for the taxpayer. The court noted that the statute itself did not limit the term, and the historical context of the tax code supported this view. Specifically, the court cited the language of the statute: "If, * * * any class of deductions for the taxable year exceeded 115 per centum of the average amount of deductions of *such class* for the four previous taxable years * * * the deductions of such class shall * * * be disallowed in an amount equal to such excess."

The court then considered whether the increase in officers' compensation for the fiscal year 1947 met the requirements of the code that would permit the increase to be considered an abnormality. The court held that the petitioner had met its burden to show that the increase in officers' compensation was not a consequence of an increase in gross income. The court noted the independence of the president in setting his compensation and the lack of a clear relationship between compensation and gross income over the relevant years.

The court also addressed the Commissioner's argument for an adjustment under section 452. The court reasoned that Section 452 did not authorize adjustments where the difference in the treatment of an item was due to adjustments required by section 433(b). The court stated, "It is evident that section 452 does not authorize an adjustment where the difference in the treatment of an item is occasioned solely by reason of an adjustment required by section 433 (b)." The court also found that petitioner did not take an inconsistent position regarding its tax treatment. The court therefore ruled that section 452 was not applicable.

**Practical Implications**

This case clarifies that, for excess profits tax purposes, a "class of deductions" is not limited to those that are inherently abnormal to the taxpayer's operations. This definition is broad and encompasses typical business expenses such as officer's compensation. This ruling significantly broadens the scope of what can be considered for excess profits tax credit calculations. The case demonstrates that if a company can demonstrate a valid reason for an increase in a class of deductions (in this case, compensation) that is not tied to changes in gross income or business operations, it may be entitled to adjustments in its excess profits tax credit. The case also serves as a precedent for the limitations of Section 452 adjustments, illustrating that these adjustments are inapplicable when the inconsistency arises solely due to another provision of the tax code.

 