Woman C.P.A.

Volume 6 | Issue 3 Article 8

4-1944

Excess Profits Relief under Section 722(b)

Mary Gildea

Follow this and additional works at: https://egrove.olemiss.edu/wcpa

Part of the Accounting Commons, Taxation Commons, and the Women's Studies Commons

Recommended Citation

Gildea, Mary (1944) "Excess Profits Relief under Section 722(b)," *Woman C.P.A.*: Vol. 6 : Iss. 3 , Article 8.
Available at: https://egrove.olemiss.edu/wcpa/vol6/iss3/8

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Woman C.P.A. by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Mary Gildea, a partner in the accounting firm of H. E. Snyder & Company, Chicago, Illinois, is well known throughout both societies, being immediate past president of ASWA and particularly proud of being one of the original members of AWSCPA.

A Hoosier by birth, Chicagoan by adoption and Irish by descent, she studied accounting at DePaul University School of Commerce and has an A.B. degree from University of Chicago School of Business.

She is also a member of the Illinois Society of Certified Public Accountants.

Excess Profits Relief
Under Section 722(b)

MARY GILDEA, C.P.A., *Chicago, Illinois*

To levy an excess profits tax the first requirement is to define excess profits. Many legislators and economists felt that a normal profit could be measured in terms of a fixed percentage of invested capital since profits are the reward of capital in the same manner as salaries and wages are the reward of labor. However, just as salaries and wages are determined not only by the quality and quantity of the labor expended but also by the type of industry in which they are expended, so also do profits vary by type of industry rather than by amount of investment. Consequently, the setting of a fixed percentage which would be a normal return on investment presents many difficulties. The excess profits tax law as passed by Congress was a compromise; normal profits are measured either by a fixed return on investment—8% on the first $5,000,000.00 and lesser percentages on higher amounts—or by the average of earnings over a normal period. Feeling that the period 1936 to 1939, inclusive, could be considered as fairly normal, Congress set that as a criterion. This was considered a normal period because general business had come out of the depths of the depression, had some good years and at least one dull year during that four year span, and the impact of the war in Europe had only slightly affected general business conditions by the end of 1939.

Many businesses felt that neither an 8% return on investment nor the average annual earnings of the period from January 1, 1936 to December 31, 1939, were fair standards for them. Pressure was brought for relief and was supported by those businesses which were incorporated after January 1, 1940, and which under the excess profits statute were required to use the percentage of investment method in determining which profits were to be considered subject to the excess profits tax. As a result there was added to the law those provisions for relief which are better known as Sections 722(b) and 722(c).

Section 722(b) provides for relief to those corporations which are entitled to use the average earnings method for determining normal profits but whose profits for the base period—1936 to 1939, inclusive—are not a correct reflection of normal profits. It sets forth five categories for judging the abnormality of base period profits, as follows:

1. An interruption or diminution of normal production, output, or operations in one or more of the base period years because of the occurrence of events unusual and peculiar in the experience of the taxpayer;

2. The depression of the business of the taxpayer in the base period because of temporary economic circumstances unusual in the case of such taxpayer or the depression of the industry of which the taxpayer is a member because of temporary economic circumstances unusual in the case of that industry;

3. The depression of the business of the taxpayer in the base period because of conditions prevailing in the industry of which the taxpayer is a member, either because the industry has a profits cycle which is different in length and amplitude from the general business cycle or because the industry is one which has sporadic and intermittent profits and such a period of profit is not adequately reflected in the base period;

4. A change in the character of the business of the taxpayer either during or immediately preceding the base period which has not found normal reflection in the base period income; and

5. Any other factor which may reasonably be considered as resulting in an inadequate standard of normal earnings during the base period.

To determine whether a corporation is entitled to relief under any of these provisions, it is necessary to delve into the history of the particular corporation under consideration and also into the experience of the industry of which it is a member. Regulations 112 treat at some length of the Commissioner's interpretation of the meaning of each of the five categories aforementioned. It is still the taxpayer's or tax practitioner's problem, however, to determine how and into what classification of relief a particular corporation fits. Each corporation has its own peculiarities and its relief application will be judged on its individual merits. There is no definite pattern to be followed in the preparation of all these claims but perhasp we may be able to set forth a few general ideas.

The first step in approaching the problem would be to read carefully through Regulations 112, Sec. 35.722-3, and prepare therefrom a list of items under each of the subsections which might affect the particular corporation being considered. For example, have its operations been subjected to interruption from fire, flood, changes in management, changes in facilities, changes in the type of product, changes in markets; or, if no interruption has occurred, have its profits been affected by such items? Next, get as complete a history of the organization as possible, not only for the base period and the years subsequent thereto but for many years prior to the base period. This is particularly necessary in determining whether or not the base period earnings have been affected by changes in management, in facilities, in product, in markets as well as by strikes or unusual occurrences either in its own or in related businesses. Thus, an automobile accessories manufacturer might be affected by strikes in the automobile industry; a corporation selling retail goods in an agricultural community would be affected by the size and price of crops in that community; a corporation having one or two large customers or suppliers could easily be affected by a change in management of such customers or suppliers. The investigator is not merely interested in variations in production, sales, or profits but also in the ultimate reasons for such variations.

To get this history of the corporation will usually mean a review of the financial statements, review of the minutes of meetings of stockholders or board of directors, and interviews with management and sometimes with other employees. As previously stated, each case is an individual problem and discovering whether or not there is a basis for a relief claim depends largely upon the ingenuity, intelligence and analytical skill of the investigator.

If it is found that some unusual event has occurred which it is believed affected the base period profits, it should be tested against the following paragraph from Regulations 112, Sec. 35.722-3:

> "Not every interruption or diminution of normal production, output, or operation in the base period may furnish the basis of a claim for relief under section 722. The interruption or diminution must be a direct result of events unusual and peculiar in the experience of the taxpayer, and must occur in or immediately prior to the base period. A direct result of an unusual or peculiar event is a result which would occur as a normal consequence or effect of the event and one to which the event bears a casual relationship. The diminution or interruption of normal production, output, or operation may occur not only in the year in which such event occurs but may result in a later year directly affected by such event."

Similarly, an analysis of a business should reveal rather readily whether or not it comes under the fourth category and should request relief because it has changed the character of the business either during or immediately preceding the base period. However, the phrase "immediately preceding the base period" is somewhat vague. The Commissioner states:

> "Generally, the commencement of business or the change in character of a business will be deemed to have occurred immediately prior to the base period if under normal conditions the normal earnings level of a business so commenced or changed would not be realized until some time during the base period and would be principally and directly related to such commencement or change."

Thus, if the business is of a type which will reach a normal earnings level within six months after it is started, the fact that a change was made a year before the base period will not give it relief under this section. On the other hand, if the business is of a type which requires a number of years to reach a normal level of production and profits, any change in the character of the business which would not be reflected in profits until after the start of the base period may be the basis for a claim for relief.

A change in business or a commencement of a business is deemed to have occurred during or prior to the base period if commitments have been made for such change or commencement during or prior to the base period. For example, if a corporation entered into a contract for a new plant in 1938 or 1939, and this new plant made changes both in its method of operation and in its capacity, it will be deemed to have made a change in its business during the base period even though the plant was not put into operation until during 1940.

After having determined that a corporation has a basis for a claim for relief under one of the reasons set forth in Section 722(b), the corporation's tax counsel is then faced with the necessity of determining how much that relief should be. That is, the setting up of constructive base period earnings which would represent normal earnings if one of the events set forth in Section 722(b) had not occurred. Here again, the procedure will depend upon the findings in the particular case. If an unusual event has occurred, it will be necessary to determine to what extent that unusual event affected profits in one or more years of the base period. For example, suppose a foundry lost an important customer because the customer built his own foundry. If possible, it would be well to determine what that customer's output was for the year or years in question, how much he would have used of the foundry's production and at what price, and how much that work, if it had beeen done by the foundry corporation, would have affected the net profits of the foundry corporation. If a business has commenced or changed the character of its business, the problem would be to determine its normal capacity, how it is normally affected by the upswings and downswings of general business conditions, and then to set up a chart of what its probable profits would have been during the base period if it had reached its normal business level by the beginning of the base period.

When the taxpayer or tax practitioner decides that there is the basis for a claim for relief under Section 722(b) and when the amount of relief has been decided upon, the next problem is that of setting up the claim in such a way as to make it clear and persuasive. All points should be clearly set forth and any charts or graphs submitted should be drawn and marked in such a way as to be self-explanatory. Accompanying the claim and the charts should be a brief, setting forth clearly the basis for the claim and the supporting evidence for that basis, the computation of the constructive base period net income and the method used in arriving at that base. In the March, 1944, issue of the Journal of Accountancy there is an excellent article by Gustave Simons on the common defects in the preparation of claims under Section 722, in which he states:

> "Unfortunately the comparatively few relief claims which are technically perfect frequently fall down in the editorial presentation of data. Graphs, schedules, and the like are essentials, but they will be largely wasted if not accompanied by a smooth running, well worded, imaginative, and vivid essay."

This article has attempted to point out that the submission of claims under Section 722(b) is not merely a matter of filling out a form. Such claims require study and analytical investigation of the business and industry in question, the careful preparation of data supporting the claim, and the writing of an effective explanation of the data and a persuasive argument for the allowance of the claim. It is work which requires a great deal of time, of patience and of imagination.

On somewhat the same basis will be the investigation to determine if there is a depression in the business of the taxpayer or of the industry of which the taxpayer is a member because of temporary and unusual economic circumstances. It must be remembered, however, that individual businesses in an industry are not always affected in the same degree or in the same manner by economic circumstances.

Thus, while steel and iron foundries are members of the iron and steel industry, one foundry may be profoundly affected by adverse circumstances in the automobile industry because it sells to the automobile manufacturers while a neighboring foundry will be only slightly and indirectly affected. It becomes necessary, therefore, to analyze the business to determine how it might be affected by changes in its own general industrial classification and also by changes within other industrial classifications. Having made this analysis, the investigator can build up his data by reference to the industrial publications, to the statistics published by the various departments of the United States Government, and to other similar sources of business information.

Among the most usual references to consult are the statistics published by the United States Department of Commerce, Bureau of the Census, and by the United States Department of Labor. From these sources can be determined general production for various industries, price ranges of raw materials and products, indices of general business conditions, data regarding the number and extent of strikes or other labor disturbances in various industries, and much more which is valuable in analyzing occurrences which affect the profits of an industry or of a particular business. The data from the particular business under review must then be compared and contrasted with the information at hand.

To determine whether or not a business or an industry has an unusual profits cycle of sporadic periods of profits it is necessary to carry the analysis of the business back over a considerable span of years, to build up a comparison of its profits cycle or profits periods with those of general business and of related industries. The fact that a business or an industry varies somewhat from the general business trends cannot of itself be taken as an indications that it has an unusual business cycle. Quite naturally, because of the larger number of elements involved, the trend of general business tends to be somewhat more even than the ups and downs of a specific industry, and certainly the swings upward or downward will not be as sharply defined as those of a particular business organization. It would seem that a taxpayer would have to be particularly careful in attempting to set up a claim under this third category of an unusual business cycle or of sporadic profits. Attention is called to the following quotations from the Regulations 112:

> "The profits cycle of a taxpayer will be deemed to differ in length and amplitude from the general business cycle if its period of normal profits has not occurred during the base period but at some prior time entirely without the base period, or partly within and partly without the base period. . . . Only in case the normal average earnings of the taxpayer and an industry of which it is a member are substantially greater than the average profits earned during the excess profits tax base period will the profits cycle of a taxpayer be considered to differ materially from the general business cycle. . . . A taxpayer which claims to be a member of an industry in which conditions prevail which subject the taxpayer to a profits cycle differing materially from the general business cycle must establish that the business experience both of itself and of such industry is susceptible of segregation into a cyclical pattern. . . . A taxpayer which claims to be a member of an industry in which conditions prevail which subject the taxpayer to sporadic and intermittent periods of high production and profits must establish that business depression was encountered during the base period because of such conditions. It must establish that such conditions were not peculiar to it alone in the base period but were also present in the case of such industry."

It must also be remembered that because a business has had some years of unusually high profits it does not necessarily follow that it is a business in which sporadic profits are always encountered. The high profits in some years might be caused by unusual circumstances, by windfall profits of one kind or another, or even by poor accounting procedures.

The determination of whether a corporation has a claim for relief under the first section—that of an unusual occurrence—is comparatively simple in contrast to the determination of the effects of unusual economic circumstances or of unusual cyclical performances.