Journal of Accountancy

Volume 70 | Issue 6 Article 6

12-1940

Excess Profits Net Income and Exemptions under the Income Method

Walter A. Cooper

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

Part of the Accounting Commons

Recommended Citation
Cooper, Walter A. (1940) "Excess Profits Net Income and Exemptions under the Income Method," *Journal of Accountancy*: Vol. 70: Iss. 6, Article 6.
Available at: https://egrove.olemiss.edu/jofa/vol70/iss6/6

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 Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Excess Profits Net Income and Exemptions under the Income Method

By Walter A. Cooper

Foreword

The November, 1940, issue of The Journal of Accountancy contained three articles dealing with the new excess-profits-tax amendments to the Internal Revenue Code. These, written from the point of view of the legislator, the attorney, and the accountant have furnished subscribers with a broad survey of the law as a whole, and readers should now have its general pattern and principles well in mind. This, in turn, should facilitate the detailed study of technical aspects, an understanding of which is essential to the professional accountant.

Much of the burden of preparing the necessary tax returns will fall on the accounting profession and, even if returns are not prepared, the correctness of accrued excess-profits-tax liabilities must be ascertained before informed opinions on financial statements can be expressed.

Members of the American Institute of Accountants committee on federal taxation have undertaken to prepare a series of articles covering, in considerable detail, the various phases of the problem. By way of review it is to be noted that in determining the tax liability seven specific tasks are involved:

(1) The determination of excess-profits net income for the base period.
(2) The determination of current year excess-profits net income under the income-credit or exemption method.
(3) The determination of current year excess-profits net income under the invested-capital-credit or exemption method.
(4) The determination of the net addition to or reduction of paid-in capital for adjustment of the exemption under the income method.
(5) The determination of average invested capital for the current year.
(6) Consideration of the abnormality relief provisions to determine their applicability or otherwise to each case.
(7) Consideration of the special provisions relating to reorganizations, etc., to determine their effect, if any, upon excess-profits net income and/or invested capital.

Definition of Terms

This article will cover the first four tasks described above. The term excess-profits net income is used in the law, and in this article, to describe the net income resulting from making certain adjustments to net income computed for normal income-tax purposes. From that amount is deducted a combination of credits and exemptions which together represent, in theory, normal earnings, leaving a balance termed "adjusted excess-profits net income," representing, also in theory, the excessive profits subjected to excess-profits tax.

The credits or exemptions consist of:

(a) Under the income method:
- (1) 95 per cent of the average annual base-period income—called a credit.
- (2) Plus a specific exemption of $5,000.
- (3) Plus 8 per cent of the net capital addition, or
- (4) Minus 6 per cent of the net capital reduction.

(b) Under the invested-capital method:
- (1) 8 per cent of the average invested capital.
- (2) Plus a specific exemption of $5,000.

For convenience the term "exemption" will be generally used in this article to refer to all deductions from excess-profits net income as the three terms "credit," "exemption," and "adjustments" may be confusing. Also, accounting methods or forms will be used rather than statutory form or order.

The Chart Annexed, Form "A," and Its Implications

To facilitate study of the excess-profits net-income computations, a chart has been developed and is annexed as form "A." This form may well be used as a working sheet and guide in actual practice, as following it will require consideration, in each case, of all possible adjustments. It has been prepared for this article with illustrative figures to bring out more forcefully the possible effect of the required adjustments. It illustrates the adjustments to be made to income of the base period and to income of the first taxable year beginning after December 31, 1939, if the excess-profits-tax exemption is computed under the average-income method. It also provides for the computation of excess-profits net income for the first taxable year beginning after December 31, 1939, if the invested-capital method is used for computing the excess-profits exemption. A glance at the last line will show that the amount of current-year excess-profits net income computed for use in connection with the income-exemption method may differ very materially from the amount of excess-profits net income where the exemption is based on invested capital.

It is to be emphasized that in almost every case it will be essential to make complete computations of the excess-profits-tax liability, using both methods of computing the exemption—"income" and "invested capital"—before deciding upon which method to use in the return to be filed, since the option to choose one method or the other, once exercised, probably cannot be changed for that year. It is stated that the election for any particular year is probably binding because we are informed that such is the intention of the framers of this new act. However, we must not overlook the possibility that the courts may hold that an election is not binding when it is impossible to know the results of the election because of uncertainties with respect to the determination of invested capital and/or prior year income which, in turn, may also affect invested capital through the medium of the accumulated earnings and profits. In connection with other elections which were supposed to be binding, the courts held that no binding election could be made until the result of the election could be known. Though this possibility is mentioned, it nevertheless seems desirable to proceed on the assumption that the election will be binding for the particular year.

Further, in connection with this election, consideration must be given to the possibilities of changes in base-period income as a result of the examination and audit of the returns, as well as the effect of such changes on invested capital in so far as they affect the item of current accumulated earnings and surplus.

A third feature to be considered involves pending disputes with respect to proposed deficiencies or claims for refund for the tax years in the base period. It might be observed, for example, that if there is a dispute regarding the inclusion of an item in income or the allowance of a deduction during the base period as compared with taking the item into an account during 1940 or a later year, it will be less expensive to pay the tax during the base-period year rather than during the current year, not only because of the higher income taxes applicable to 1940 and later years, but also due to the possibility of excess-profits taxes being payable thereon. Furthermore, if the income

method of exemption is used, the increase in the base-period income will increase the excess-profits credit by one fourth of the amount involved, less tax thereon. If the taxpayer's income be in the 50 per cent excess-profits-tax bracket, the increased exemption will save the equivalent of about 11 per cent[1] of the amount involved in the base-period income or deduction item, so that in two years the excess-profits-tax saving alone will considerably exceed the base-period income tax (which ranged from 15 per cent to 18 per cent). On the other hand, if the taxpayer should be in only the 25 per cent bracket, the saving in excess-profits taxes will be equal to 5½ per cent of the amount of the income or deduction item, so that in three years the excess-profits-tax saving will equal the additional income tax payable for the base-period year. In each case there will be a further potential future saving under the excess-profits-tax law.

On the other hand, if the invested-capital method is found advantageous, the allowance of the disputed item in the government's favor may increase invested capital if it affects the accumulated earnings and surplus, thus increasing the exemption for excess-profits taxes by 8 per cent of the amount thereof, less tax. If the taxpayer's income is in the 50 per cent excess-profits-tax bracket, the net reduction in excess-profits tax will be equal to 3.4 per cent of the amount of the income item, so that it would require such savings in excess-profits taxes for approximately five years to equal the additional tax payable for the base period.

The foregoing computations do not take into account the interest payable on the deficiency for the base period, but it might be noted here that the interest will be an allowable deduction for excess-profits and income-tax purposes in the current year.

[1] For purpose of these estimates the 95 per cent computation is omitted.

These observations lead to the conclusion that if the disputed item is likely to affect income during the excess-profits-tax years, it will be cheaper to concede the Internal Revenue Bureau's contentions with respect to the base-period years, assuming that the taxpayer will have net income for 1940 and/or later years. On the other hand, if the disputed item cannot possibly affect the net income for current or later years, then it still would be desirable to concede the Bureau's contentions in the cases of companies that will use the income-exemption method and are likely to pay excess-profits taxes, but it is an open question with respect to companies that will use the invested-capital method for determining excess-profits-tax exemption.

The base period

In form "A," the base period shows four years which are headed 1936, 1937, 1938, and 1939. That will be the usual situation, but in some cases, by reason of changes in fiscal periods, the base period might include more or less than forty-eight months. Specifically, the base period covers all taxable years or periods beginning *after December 31, 1935*, and *before January 1, 1940*. Thus, a corporation which used a fiscal year ending November 30th until, for instance, November, 1936, and then changed to a calendar-year accounting period, would have in its base period the one month ended December 31, 1936, and the calendar years 1937, 1938, and 1939, a total of only thirty-seven months. On the other hand, if a taxpayer used a calendar-year accounting period until December 31, 1935, or later, and during the base period changed to a fiscal year ending November 30th, it would have in its base period the eleven months ended November 30, 1936, and the four twelve-month periods ended November 30, 1937 to 1940, inclusive, or a total of fifty-nine months.

Treatment of doubtful items

At the moment there are some uncertainties of interpretation which will be pointed out. It is not considered desirable to express personal views at this time, as the regulations have not been issued. Frequently, when several interpretations are possible, the one adopted by the administrative authorities acquires the force and effect of law. Furthermore, the law may be amended retroactively to dispose of some of them. Hence, it is too soon to express proper opinions on these doubtful matters.

In the preparation of tax returns the treatment most favorable to the taxpayer should be adopted. However, if the election to use either the income or invested-capital-exemption method should or may turn on the treatment of the uncertain item, then the particular problem should be brought up for careful and detailed study in the light of such rulings or regulations as may have been promulgated. It probably will be desirable in such cases to defer filing the return, by obtaining an extension for filing same, until a considered conclusion can be reached or an official ruling obtained.

With these preliminaries having been discussed, each item shown on form "A" will now be explained.

(1) Income (or loss) as shown on forms 1120*

Because of differences in tax forms and statutory terminology during the base period, the final line in the "Adjusted net income computation" on page 1 of the 1938 and 1939 returns (line 32) and the corresponding figure shown in the 1936 and 1937 returns (specified by line number) have been taken as the most convenient starting point for the computation of "excess-profits net income."

This figure is equal to "net income," as defined in section 21, less the amount of the credit for interest on certain government bonds provided in section 26 (a), but before deducting the credit for 85 per cent of dividends on stocks of domestic corporations.

Particular attention is drawn to the footnote reading as follows:

"Reference to 'returns' means federal income tax returns as revised upon examination by the Bureau, or as corrected, if erroneous but not audited or amended, whether or not adjustment of tax liability is barred by the Statute of Limitations."

(2) Amount of net capital loss (if any) shown by return, eliminated as a starting basis

The law does require elimination of *all* capital gains and losses. However, it does require that the amount of such gains and losses, for the base period, be recomputed as though the provisions of sections 23 (g) (2), 23 (k) (2), and 117 of the Internal Revenue Code, as amended to October 8, 1940, had been part of the law in each of the years in the base period, and then requires that certain other adjustments and eliminations be made. For this reason, it is considered more convenient in setting up the form to provide that all capital gains and losses, in the returns filed *for the base period*, first be eliminated, and then adjustments to net income made to give effect to the provisions of the new law concerning what have been defined as capital gains and losses under the revenue acts from 1936 to date. However, *for the current taxable year*, the return for which is based on the existing Internal Revenue Code, it is simpler not to make such elimination, but merely to make the proper adjustments to determine excess-profits net income. In this connection, it is to be remembered that the treatment of capital gains and losses in returns for the years beginning after December 31, 1939, for normal income-tax purposes,

*Red.

is radically different from that for the year 1939 as well as in prior years. The 1939 change in section 117, Internal Revenue Code, relating to the treatment of capital gains and losses in the case of corporations, was made applicable only to taxable years beginning after December 31, 1939. The effect of these changes will be pointed out in connection with the several items in form "A."

(3) Net long-term capital loss (determined under section 117)

Since *all* net capital gains and losses for the years in the *base period* are eliminated by items 2 and 17, no further adjustment is necessary to eliminate any "net long-term capital loss" for those years. However, since a corresponding elimination is not otherwise provided for in form "A" for the current taxable year, it is necessary to eliminate the net *long-term capital loss* of the current taxable year. In the example illustrated in form "A," it is assumed that the corporation has a long-term capital *gain* (see item 18) and, therefore, no amount on this account is shown for item 3, but if the result had been a long-term capital loss, it should be added back here to net income.

By way of further explanation, it is to be noted that under the Code presently applicable, capital assets, by definition, do not include assets used in a trade or business of a type subject to depreciation, and long-term assets are those held for more than eighteen months. This adjustment, therefore, refers to property, other than depreciable assets or inventories, held for more than eighteen months.

(4) Stocks becoming worthless (taxable periods beginning before January 1, 1938, only)

(5) Bonds becoming worthless (taxable periods beginning before January 1, 1938, only)

Under the law in force for taxable years beginning after December 31, 1937, losses through worthlessness of stocks and bonds are treated as losses on sale or exchange of capital assets, either long-term or short-term, depending upon the length of time that the securities had been held *as of the close of the year of worthlessness*. Hence, for the years starting after December 31, 1937, including the current taxable year, such losses have been (or should have been) included in determining the amount of the net long-term and short-term capital gain or loss shown by the returns, and no adjustment is required with respect thereto. However, for 1936 and 1937, such losses were allowable as "ordinary" losses, deductible in full, and should not have been reflected in the return as part of the net capital gain or loss. If the return was correctly prepared in that respect, an adjustment is required for taxable periods beginning before January 1, 1938, to add back such losses as were deducted in full.

For the purpose of this adjustment, see sections 23 (g) (3) and 23 (k) (3) of the Code for a description of the types of stocks (or rights) and bonds included.

In some 1936 and 1937 returns, it was not important to distinguish between losses resulting from sale or exchange or losses resulting from worthlessness. Losses of the latter type may have been included in the capital-gain-or-loss schedule, so care should be exercised to see that this adjustment is not duplicated in adjustments (2) or (17) relating to net capital gains or losses shown by the returns.

Furthermore, bond losses may have been shown in returns as bad debts. Hence, that deduction should be examined for possible adjustments.

(6) Net short-term capital gain (determined under section 117)

Under section 117, as now in force, the amount of a net short-term capital gain (on capital assets which do not

include depreciable assets held eighteen months or less) for the current taxable year is to be included in income subject to normal tax as well as the new excess-profits tax. As such gain is included in net income (item 1) no adjustment is required for the current taxable year. However, for the years in the base period, since *all* capital gains shown by the applicable returns have been eliminated by adjustment (2), it is necessary to restore or add back the amount of any net short-term capital gain. A net short-term capital loss is not deductible during any year.

It is also important to bear in mind that losses through worthlessness of bonds and stocks, held eighteen months or less at the close of the year of worthlessness, are to be taken into account in determining the net short-term gain.

For 1940 computations, the carry forward of net short-term capital losses against short-term capital gains of the succeeding year is disregarded in computing base-period income. However, for 1941, when such carry forward will be permitted for normal income and thus for 1941 excess-profits net income purposes, the base-period income must be recomputed if a short-term capital loss in any year is followed by a short-term capital gain in the succeeding year.

(7) Net gains on sales or exchanges of depreciable property held not more than eighteen months (taxable periods beginning before January 1, 1938, only)

Under the excess-profits-tax law, gains resulting from the sale or exchange of depreciable assets held eighteen months or less are to be included in income for both the base period and the current year. In tax returns for periods beginning on or after January 1, 1938, depreciable assets were not regarded as capital assets and, hence, the gain on the sale or exchange of such assets has been included in the net income with which form "A" starts (item 1). However, taxable periods starting before January 1, 1938, are covered by the 1936 and 1937 revenue acts, under which depreciable assets were regarded as capital assets. Inasmuch as adjustment (17) provides for eliminating the net capital gain on such assets during those years, it is necessary under this form to add back the gain from the sale or exchange of depreciable assets held not more than eighteen months. Item 19 (a) provides for a similar adjustment for net losses resulting from the sale or exchange of such assets.

(8) Losses and expenses (deductible under section 23 (a) in connection with retirement of bonds)

This is the first of six adjustments, following in order, items 8 to 13, inclusive, permitted by Congress in an effort to "normalize" base-period income. They eliminate certain deductions, thus increasing base-period net income for exemption purposes, which otherwise would produce abnormally low base-period income for many corporations. Similar deductions during the current taxable years *do not have to be added back to net income* and thus are allowable deductions for excess-profits-tax purposes.

The first adjustment relates to deductions on account of retirement or discharge of any bond, debenture, note, or certificate or other evidence of indebtedness, if the *obligation of the taxpayer* has been outstanding for more than eighteen months.

What deductions? They are described in the law as:

(a) Expenses in connection with such retirement.
(b) Deduction for losses allowable by reason of such retirement; and
(c) If the bonds were issued at a discount, the amount deductible on account of such discount unamortized at the time of retirement.

What is includible under the heading of "expenses in connection with the retirement of bonds" will depend on each case. Among other things, they will include attorneys' fees relating thereto, expenses of a registrar or transfer agent who may effect the retirement, and premium on call unless the premium be regarded as a loss deductible under item (b). Presumably, one may also go so far as to add back any portion of the salaries paid to company employees for services in connection with such retirement. A complete statement of all the items that might be covered by the term "expenses" is not possible in this discussion, but in any case where bonds were retired, the make-up of all expense deductions should be looked into in order to ascertain what might be attributed to the retirement of the bonds.

The item of losses allowable by reason of retirement will, of course, include premiums on call unless such premiums be regarded as expenses deductible under the expense heading, and perhaps unamortized expense of issue, if that be not considered part of the discount.

The third item covers unamortized discount, and it is to be noted that the amount to be added back is the discount *unamortized at the time of retirement.* Hence, any discount applicable to the portion of the taxable year preceding the date of retirement cannot be added back.

Nothing specific appears in the law with respect to unamortized expenses of issue. It has been customary for tax purposes to treat the issue expenses as part of the discount and amortize them accordingly. Hence, it might be possible to regard the expense of issuing bonds as a reduction of the amount received for the issuance of the bonds and thus part of the discount, or else as a "loss" allowable by reason of the retirement so that the amount thereof may be added back as part of item (b). In any event, in preparing the tax return the unamortized expense of issue should be treated as an item to be added back to net income for the base years; but if there is a close question regarding the advisability of using either the income or invested-capital method, consideration should be given to the possibility that unamortized expenses of issue cannot be added back to the base-period income.

Another question may arise, however, and that involves deductions resulting from the retirement of the obligations originally created by someone else but which the present taxpayer either assumed or took property subject to and later liquidated. Further, if such evidences of indebtedness be regarded as obligations of the taxpayer, is the eighteen-month period to apply only to the time subsequent to the taxpayer's assumption of or taking of property subject to the debt?

Here the difference between a statutory merger and consolidation, under which the continuing corporation is, under most state laws, regarded as in fact being the predecessors, and a nonstatutory method of accomplishing the same result may be important. It is hoped that the regulations, when promulgated, will relieve taxpayers of some of these problems, but even if they do, litigation may be necessary to dispose of some of them.

(9) *Losses from fire, storm, explosion, or other casualty, and from theft, etc., deductible under section 23 (f)*

This adjustment also applies *only* to years in the *base period* and has the effect of increasing the income for such period.

It covers losses (to the extent not covered by insurance) deductible under section 23 (f) of the Internal Revenue Code, resulting from fire, storm, explosion, or other casualty, or from theft. For ordinary income-tax purposes it has not been material whether casualty losses were deductible under section 23

(f) or some other section, but the reference in the excess-profits-tax chapter to the specific section now makes that important. It raises particularly the question whether deductions under section 23 (f), and correspondingly this adjustment, are limited to losses to or on property of the taxpayer, or also include damages payable to others for their loss of life, health, or property, which are not property losses of the taxpayer.

(*10*) *Losses from demolition, abandonment, or loss of useful value of property*

This adjustment also applies *only* to income of years in the *base period* and also has the effect of increasing income by the amount of any such loss, which was allowable in returns for base years, in determining net income. Such losses may have been claimed in the returns for the years in the base period as capital losses, as non-capital losses, "other" losses in the deduction section of the return, or included in operating expenses. Therefore, to be sure of making the correct adjustment on this account, it is important to make a thorough search for such items in all accounts covering the base period.

Furthermore, it should be noted that items which may appear in tax returns or accounts as losses on sale—because the assets were sold—may involve a loss of useful value or abandonment loss preceding the sale. This is particularly apt to be the case when large losses resulted from sale—and also when sales proceeds are relatively nominal—in relation to depreciated cost. Abandonment loss or loss of useful value relate to the *purposes for which the property was acquired by the taxpayer.* Thus, an asset may have *lost its useful value to the taxpayer*, yet still be of enough value to someone else to have a sale value rather than merely a scrap value.

(*11*) *Repayment to vendees attributable to processing tax*

This adjustment is likely to be applicable primarily to the year 1936, though there may be a few cases in which such deductions were taken in later years. It involves repayments to vendees attributable to processing taxes included in sales prices but refunded after the law was held unconstitutional. Note particularly that the repayments must be "attributable" to processing taxes and need not represent actual processing taxes.

The adjustment is to be made according to a specific formula which involves two factors:

(1) The refunds to vendees which are attributable to the processing tax; and
(2) The amount collected from vendees during the base period, attributable to processing taxes which were not, in fact, paid to the appropriate collecting authorities or others.

In effect, the adjustment required is for the net difference between (1) and (2) above and represents, in its final result, the amount by which the taxpayer suffered a net deduction of the amounts refunded to customers, less the amounts collected from customers. This adjustment is permitted because in most instances the taxes were originally collected from the customers in the year 1935 or prior to the base period, but the refunds were made during the base years. By reason of the fact that the law was not declared unconstitutional until January 6, 1936, there may have been some charges against customers during the year beginning January 1, 1936, representing sales during the first week of the year.

Under the statute, however, the amount to be added to income for any particular year is not merely the difference between the refunds to customers during that year, less the amount collected from customers during that year.

It is necessary to ascertain the aggregate of both items for the entire base period, and then adjust the income of each year for the percentage which the net cost or expense to the taxpayer bears to the gross repayments for all years. To illustrate: Assume the case of a taxpayer which during the first year, probably the first week, charged its customers with $10,000, representing processing taxes which later it did not pay to the government; during the same year, 1936, refunded its customers $50,000; and in the year 1937 refunded its customers an additional $50,000. Taking all the base years together and assuming no adjustments in 1938 and 1939, the taxpayer in the assumed case made total refunds aggregating $100,000 and collected from its customers $10,000, leaving a net deduction or cost of $90,000. The $90,000 is thus 90 per cent of the aggregate refunds and, accordingly, there would be added back to income of the years 1936 and 1937 ninety per cent of the refunds to customers during each of those years. That would be $45,000 (90 per cent of $50,000) in each year, making the aggregate addition to base-period income $90,000. However, it will be noted that the percentage is figured on an over-all basis, even though the ultimate result for all years is the same as it would be if there were added to 1936 income the net difference of $40,000 for that year, and to 1937 income $50,000. This method will result in no difference if each year shows a net income but it might make an appreciable difference if one year or the other showed a net loss.

(12) *Payment of judgments, etc. (including interest thereon) if abnormal or grossly disproportionate*

In a further effort to normalize the base-period income, the law provides that any deductions attributable to any claim, award, judgment, or decree against the taxpayer (or interest on any of them) deducted in the returns covering the base period are to be restored to net income, "if in the light of the taxpayer's business it was abnormal to incur a liability of such character," or if normal for some such liabilities to be incurred, if "the amount thereof in the taxable year was grossly disproportionate to the amount of such items in the four preceding taxable years."

Thus, it first becomes necessary to ascertain whether or not it was normal for the taxpayer to incur liabilities for claims, etc., of the type involved, in any amount, and if not normal to incur any amount of liability, then the amount deducted in any or all of the base-period years may be added back to net income.

If, however, the taxpayer normally incurred such liabilities but sustained a loss that was grossly disproportionate during one of the base years, a question arises as to whether the adjustment should be only for the disproportionate or excessive amount or for the full amount of the judgment. From the language of the law it would appear that it would be proper to add back the full amount of the judgment rather than merely the disproportionate, excessive amount. However, it is doubted that such an interpretation will be sustained by the courts, as it seems to have been the intent of Congress to provide only for an adjustment of abnormal deductions. Nevertheless, it is suggested that in the preparation of tax returns the entire amount of the deduction be added back rather than what may be regarded as the excessive portion, but due consideration should be given to the possibility of that treatment being held incorrect. The regulations when issued may throw some light on that question.

A second problem arises with respect to the periods to be used for making the comparison which will indicate whether or not the amount in any particular year was disproportionate. The law states that the comparison should be

made of the base year with the four previous years. This would apparently mean the four years immediately preceding the year involved so that, if there be involved a 1939 deduction, the amount thereof would be compared with the deduction for similar claims, etc., during the four years 1935 to 1938, inclusive. However, the law deals with the four base-period years as a whole. Therefore, it is possible that it may be necessary to compare the amount deducted in any base year with the four years 1932 to 1935, inclusive, rather than the four years that immediately precede the year involved. Here also the regulations, when issued, may throw some light on the matter, but until anything appears to the contrary it is suggested that the method most favorable to the taxpayer be adopted.

More important—what constitutes a "claim," the deduction attributable to which may be added back, if abnormality be involved? Fundamentally, it can be argued that practically every disbursement of a corporation, save perhaps voluntary contributions or dividends, is preceded by or results from a "claim"—even wages. Though awards, judgments, or decrees generally signify the existence of dispute regarding the liability, claims do not necessarily involve disputes. Does the coupling of such a term, not necessarily implying a dispute, with other terms generally implying settlement of a dispute limit the first term to "disputed" claims?

It is to be doubted that Congress so intended, else it would have said so. At least that is the technical theory to apply, though the manner in which much of the law was developed and adopted may lead one to doubt that anyone, even the draftsmen, knew what was intended. At the same time, it is to be doubted that any disbursement or expense can be considered as a possible adjustment for if that were intended there would seem to have been no need to particularize on the other adjustments. Probably a "no-man's land" or "twilight zone" will develop, the treatment of items falling either side will be clear, and it will take years to dispose of those falling within it.

The abnormality requirement will naturally eliminate from consideration normal expenses, even if they technically arise out of "claims," but it would seem desirable to cover, either by adjustment in computing the exemption deducted on the return, or in a timely refund claim, all abnormal deductible expenditures (paid or accrued as the case may require).

Suffice for the moment to direct attention to the foregoing and other possibilities to be borne in mind. They may find their way to oblivion next year anyway if a new law should be enacted. Meanwhile, should these and other uncertainties complicate the decision whether to use the income or invested capital exemption method, be wary in expressing opinions. When legislators indicate they do not understand the laws enacted, and attorneys say they cannot tell us what the law means because it is what the Supreme Court will think, some years later, it ought to be—what can the accountant do—*even though he has to sign the return?*

Before leaving this prospective heaven for the tax lawyer, one further rather obscure point should be brought forward. The adjustment specifically includes interest on claims, etc., and not as part of the claim. Hence, interest may be the subject of adjustment even though the claim itself is not because the principal of the claim, etc., was nondeductible. A typical illustration is interest, covering a period of years, on an additional income-tax claim.

(13) Intangible oil-and-gas-well drilling and mine-development expenses, etc., if abnormal or grossly disproportionate

This adjustment is similar to the

item of claims and awards, etc., discussed above, except for two differences. It should be noted first that it applies only to *intangible* drilling costs in the case of oil and gas wells, and, therefore, excludes the tangible drilling costs which, briefly, mean the physical properties or assets installed in connection with the drilling operation. Under the provision of the law, it is permissible to add back to net income the amount *deducted* for such expenditures if it was abnormal for the taxpayer to incur any liability for expenditures of that type. However, if it was customary for the taxpayer to incur liability for expenses of that type, then an adjustment is permitted only to the extent that the amount in any of the base years was grossly disproportionate to the liabilities incurred for similar items during the four preceding years.

Presumably, rules and regulations will be issued under which the methods of determining whether or not such expenditures were disproportionate will be set forth. Meanwhile, however, several open questions require consideration. The first is whether the amount in any particular year is to be compared with the four years immediately preceding, even if part or all of the preceding four-year period is also a part of the base period, or whether the comparison is to be made with the four years preceding the base period as a whole; in other words, the years 1932 to 1935, inclusive. In this respect the problem is similar to that discussed with respect to the adjustment for claims and awards, etc.

Second in importance is the reference in the law to a comparison of the amounts of liabilities incurred rather than of the expenses deducted. This is important because some expenditures of the type here involved were elective and could either be capitalized or deducted as expense. Inasmuch as the law provides for a comparison of the liabilities incurred rather than the expenses deducted, it would seem logical to assume that it will be necessary to compare the total expenditures, whether treated as expense or capital charges, and not limit the comparison only to such amounts as were deducted as expenses, thus excluding those capitalized. If, on that basis, the liability incurred during any year was abnormally disproportionate, the abnormal portion may be added back to net income (item 1) *if it was deducted in determining same.*

But what is to be done, if the liability incurred was abnormal and the amount expensed was only normal? For instance, if the liability normally incurred during the four previous years was $100,000 per annum, all expensed, and if of the abnormal liability of $200,000 only $100,000 was expensed and the balance capitalized, what is to be done? The writer in traveling about rather extensively has often seen in hotels a sign that many readers must have seen and which supplies the best answer presently available. It reads "Ask Mr. Foster."

(14) Interest on borrowed capital, to the extent of 50 per cent thereof

Adjustment on account of interest on borrowed capital is required only for the taxable year, and then only if the excess-profits credit is to be computed on the basis of invested capital. In such case, one half of the interest on "borrowed capital" is to be added back to net income shown by the return. "Borrowed capital" comprises all indebtedness of the taxpayer evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust. However, it does not include any indebtedness not so evidenced. Since one-half of all such borrowed capital is to be included in daily invested capital, the law provides that one half of the interest paid on such borrowed capital is to be disallowed as a deduction in arriving at excess-profits net income.

The adjustment must be made for one half of the total of all such interest on borrowed capital, so that where indebtedness of various types carries varying interest rates it will not be permissible to adjust only for interest on indebtedness carrying the lowest rates.

(*15*) *Exempt interest if the taxpayer elects* (*under section 720* (*d*)) *to treat as admissible assets the obligations described in section 22* (*b*) (*4*)

The net income with which form "A" starts is the amount left after eliminating all interest on securities of the United States Government, its instrumentalities, and the states or subdivisions thereof. The interest on some obligations of the government or its instrumentalities could have been subjected to excess-profits taxes, but under the law as enacted none of the interest on any United States securities or securities of the states or their subdivisions is subject to excess-profits taxes. Hence, up to this point, all such interest has been eliminated, but, if this exempt interest is treated as such, the securities producing it must be treated as inadmissible assets and the invested capital reduced thereby.

However, taxpayers have been given an opportunity to elect to include the exempt interest, all not part, in taxable income, subject to excess-profits tax, and possibly also to normal income tax, and if that is done, they are permitted to treat the securities as admissible assets. It is not clear whether the interest must be included in the income subject to normal income tax, as well as excess-profits tax, or whether the inclusion is limited only to excess-profits tax. From the language of the law and, more particularly, the reports of the Senate and House committees dealing therewith, it would appear that the income should be included for normal income tax as well as excess-profits tax. However, there is some doubt as to the meaning of the law and, particularly, whether or not rather ambiguous language in subchapter E of title II, relating to excess-profits taxes, can be regarded as a modification of title I, relating to income taxes, when title I itself has not been specifically amended. The regulations dealing with this phase of the law should be studied, when issued, for further enlightenment. Meanwhile, the possibility of having to include the exempt interest for normal tax as well as excess-profits-tax purposes must be considered in determining whether to treat the interest as nonexempt in order to obtain the larger invested capital.

If not taxable for normal income-tax purposes, it is likely to be advantageous in most cases to include the interest, as few, if any, of the securities involved return as much as 8 per cent.

This elective adjustment applies only when the invested-capital exemption method is used. It does not apply if the income method is used.

(*17*) *Amount of net capital gain* (*if any*) *shown by return eliminated as a starting basis*

As stated under the explanation of item 2, the law does not require elimination of all capital gains and losses. However, for the reasons therein stated, it is considered more convenient in setting up the chart to provide that all capital gains and losses in the returns filed *for the base period*, first be eliminated and then adjustments to net income made to give effect to the provisions of the new law concerning what have been defined as capital gains and losses under the revenue acts of 1936 to date. However, *for the current taxable year*, it is simpler not to make such elimination, but merely to make the proper adjustments to net income on account of long-term and short-term capital gains and losses which will be shown by the return for that year.

(*18*) *Net long-term capital gains* (*determined under section 711, I.R.C.*)

The reason for deducting, for the current year, the amount of net long-term capital gains is the same as that given with respect to additions on account of net long-term capital losses, item 3. All such gains and losses, as now defined, are to be excluded.

(*19*) *Net losses on sales, etc., of depreciable property* (*for years beginning prior to January 1, 1938*)

(*a*) *Held not more than 18 months*

(*b*) *Held more than 18 months*

Since 1938, gains and losses on the sale or exchange of depreciable assets have not been treated as capital gains and losses. (See the explanation of item 7.) However, such gains and losses were included in the amount of net capital gain or loss for taxable years beginning prior to January 1, 1938. Therefore, since *all* capital gains and losses in returns for the years in the base period are eliminated by items 2 and 17, it is necessary to deduct from income *as shown by returns under the 1936 and 1937* laws the amount of net loss from sales or exchanges of depreciable property. Because of the distinction made in the new law with respect to the treatment of *gains* (but not losses) on sales or exchanges of such property *held more than eighteen months*, it is necessary to determine separately the amount of the *net* result of the sales of such property held not more than eighteen months on the one hand, and with respect to other similar property held more than eighteen months on the other hand. Net losses coming within each category are deductible in arriving at excess-profits net income but the net gain on assets held over eighteen months is to be excluded.

(*20*) *Net gains on sales of depreciable property held over 18 months* (*for years beginning after Dec. 31, 1937*)

All gains of the type described above have been required to be treated as noncapital items in returns for years beginning after December 31, 1937, and hence have been included in net income. Since the new law requires the exclusion of net gains from sales or exchanges of such property held more than eighteen months in arriving at excess-profits net income, it is necessary to deduct the amount of any such gains from net income as shown by returns for years beginning after December 31, 1937. For prior years they were deemed capital assets and hence have already been eliminated as part of item 17, so they should not here be eliminated again.

(*21*) *Dividends from domestic corporations*

Dividends from domestic corporations are to be entirely eliminated in arriving at excess-profits net income. Hence, deduct here all such dividends.

(*22*) *Dividends of foreign corporations* (*other than foreign personal holding corporations*)

Dividends from foreign corporations (other than foreign personal holding companies) are to be eliminated from income only for the taxable year (and not the years in the base period) and then only if the dividend credit is to be computed on the invested-capital basis. This adjustment will undoubtedly prove to be of great importance in many cases where corporations have foreign subsidiaries, since the elimination of such foreign dividends from the amount subject to excess-profits tax may frequently justify the use of the invested-capital method in computing the excess-profits exemption, even though the exemption so computed may be less than the amount computed under the average-income method.

However, in this connection, the possibility of excluding all or part of foreign dividends from current-year excess-profits net income on the grounds

of abnormality should also be considered.

There may be some cases in which the exclusion of abnormal foreign dividend income may make the income-exemption method preferable, while inability to make such an exclusion would indicate that the invested-capital method was advantageous. An illustration would be the case of a corporation receiving a large dividend of that type in 1940. It would be eliminated if the invested-capital method were used, though the investment would have to be treated as an inadmissible and invested capital reduced. This might result in some excess-profits tax being payable on other income.

But if it could be shown that the dividend receipt constituted an abnormality, it would be possible to exclude part or all of it from 1940 excess-profits net income and perhaps also to add the excluded portion to base-period income so as to increase the average base-period income and, in turn, the exemption on the income basis, thus making the income-exemption method preferable.

(*23*) *Income tax* (*after deducting credit for foreign income taxes*), *including surtax on undistributed profits but not including surtax under section 102* (*unreasonable accumulation of surplus*)

The law provides for deducting the amount of the income tax payable by the taxpayer for each of the years in the base period and in the current taxable year in arriving at excess-profits net income. Such income taxes include the surtax on undistributed profits, but the amount to be deducted is the net amount payable to the United States after deducting the credit for foreign income taxes. The deduction does not include any amount on account of the surtax on improper accumulations of surplus, under section 102. The old excess-profits tax, now called the declared value excess-profits tax, has been deducted in computing the net income on line 1.

The amount to be deducted is the amount of income tax payable for each of the years concerned and not the amount that would have been payable had any of the adjustments herein discussed been made. In other words, even though it is permissible to exclude from income, subject to excess-profits tax, some of the income that is subjected to income tax, it is nevertheless correct to deduct the tax that was payable on the excluded income. The converse is true with respect to deductions. This is just another one of the anomalies in the hastily drafted excess-profits-tax act and could, conceivably, result in no current-year income if it were possible to exclude, for excess-profits-tax net income, enough excludible income such as capital gains, abnormal income, etc., and still deduct as well the income tax on such excluded items.

(*24*) *Recoveries of bad debts allowable as deductions in years beginning before January 1, 1940*

In order to avoid hardship, the law provides for eliminating from current-year income, subject to excess-profits taxes, any recoveries of bad debts which constituted deductions *allowable* prior to an excess-profits-tax year. In other words, if the deduction was allowable in a year that was not subject to excess-profits tax, recovery in a later year is excluded for excess-profits-tax purposes. It is, of course, subject to income tax in the year of recovery just as it would be if there were no excess-profits tax.

On the other hand, if the deduction was allowable in a year that came under the excess-profits-tax law, regardless of whether or not any excess-profits tax was payable for that year, then the recovery must be included, for excess-profits taxes, in the year of recovery.

Observe particularly that the term

used is "allowable" rather than "allowed." Here litigation or dispute possibilities arise if a recovery was on a bad debt allowed in a year prior to 1940 but which, it can be contended, was in fact allowable in 1940 and hence the recovery is taxable for excess-profits taxes, or vice versa.

How this adjustment will affect corporations using the reserve method is not clear. In a technical sense, recoveries by such taxpayers are credited to the reserve and thus are not brought directly into the taxable income. Nevertheless, in most cases credit of recovery to the reserve will tend to reduce the current provision necessary to make the reserve adequate. This will be particularly true in the case of taxpayers determining the reserve provision by a comparison between the closing accounts receivable and closing reserve before making the final adjustment provision.

On the other hand, if taxpayers use a percentage of sales to determine the reserve provision, a bad-debt recovery might not immediately affect the reserve deduction, if the same percentage of sales is continued to be used. Fundamentally, however, the recoveries at some time must affect deductions for the reserve provision, else the reserve would eventually be too high.

Perhaps it would be desirable, in all cases of taxpayers using the reserve method, regardless of how the provision is computed, to credit recoveries, particularly of prior year write-offs, directly to income as a special item rather than to the reserve, and report recoveries in the tax return as other income, but then make the deduction for the addition to the reserve for bad debts that much greater.

(25) Income from retirement of bonds of the taxpayer outstanding over 18 months

The statute provides that any income derived by a corporation from the retirement or discharge of its obligation represented by a bond, debenture, note, certificate, or other evidence of indebtedness, if the obligation of the taxpayer was outstanding more than eighteen months, is to be eliminated in arriving at the excess-profits net income not only for the years in the base period but for current taxable years as well. The amount to be eliminated includes, in the case of bonds issued at a premium, the amount which becomes includible in income for such year because of the retirement or the discharge of the debt. In other words, if bonds were issued at $102 and, of the $2 premium, $1 had been amortized at the date of retirement, leaving a balance of $101, and the bonds were retired at $90, the difference of eleven points would ordinarily be included in net income subject to income tax. This income, however, is to be eliminated for excess-profits net-income purposes.

It should be borne in mind that the income-tax provisions contain a section under which the so-called gain resulting from the retirement of indebtedness may be excluded, under certain circumstances, from net income for income-tax purposes. If income has been excluded under such provision, it would, of course, not be part of the net income with which the chart starts, and hence this adjustment relates only to such income as may have been included for income-tax purposes.

With respect to income arising from the discharge or retirement of indebtedness assumed by, or with respect to which property was taken subject to, the same problems discussed with references to deductions on retirement, also arise and need not be again detailed here.

(26) Refunds of tax under A.A.A. and interest thereon

Since the agricultural adjustment act was held unconstitutional many taxpayers have filed claims for refund of

the taxes paid thereunder. Some of such refunds have been allowed and, probably, more will be allowed. Inasmuch as these refunds relate to prior years and hence are not a true measure of excessive current earnings, the law provides that they may be excluded or deducted from net income subject to income tax, to determine excess-profits net income.

The tax refunds which may be excluded include refunds of floor-stocks taxes paid when the A.A.A. went into effect in 1934, processing tax on commodities processed during the tax period, compensating tax, and custom-processing taxes.

Under the language of the statute as strictly interpreted, it would not seem proper to deduct refunds applicable to the tax burden in the inventory on January 6, 1936, refund of which was available to persons who bore the burden of such taxes even though they did not directly pay processing taxes to the United States Government. On the other hand, it must be recognized that the obvious intent of the statute was to eliminate from excess-profits net income such unusual income as does not relate to current-year operations. Hence it ultimately may be held that this provision also covers refunds received with respect to tax burden in inventories on January 6, 1936, even though it is rather difficult to hold that such refunds constitute refunds of "processing taxes" which is the term employed in the excess-profits-tax law.

Should a taxpayer have received refunds of tax burden in inventory, it is suggested that they be excluded from excess-profits net income even though there is presently some doubt about the correctness of such procedure.

(28) Balance—excess-profits net income

The net result, after all adjustments, appears on line 28 of form "A" and is what the new law defines as the "excess-profits net income." The illustrative figures used have been developed purposely to cover all possible adjustments and to show how the "excess-profits net income" for the base years may substantially exceed the net income reported for ordinary income-tax purposes and also how the current year excess-profits net incomes, determined under the two exemption methods, may differ.

The income-method credit or exemption is based on the average during the base period—the result of all taxable periods being added together, divided by the aggregate number of months and the result multiplied by twelve to obtain the annual average, which is then reduced to 95 per cent.

Should any one period show a net loss or minus result for item 26, it may be taken in at zero (though the period is not excluded, as the number of months it covers must be included in the aggregate). Thus if a taxpayer had three years of excess-profits net income and one loss year, the incomes for the three years would be added together and the result divided by forty-eight (representing four years) to obtain the monthly average income.

Should more than one period show a loss, zero may be substituted for the largest loss but the other losses must be deducted from the aggregate income of the other periods.

The average annual result cannot be less than zero, so the specific exemption of $5,000 or adjustment for added capital cannot be reduced for an average base-period loss. In such situation, however, the invested-capital exemption method is likely to be preferable.

"Constructive" Base-Period Income

The right to use the income-exemption method is available to all domestic corporations which were in existence before January 1, 1940. However, if a taxpayer meeting that requirement was not in existence for forty-eight months preceding the beginning of the first

taxable year under this new subchapter E, it is given a "constructive" income for the period preceding its incorporation. This constructive income is 8 per cent annually of its invested capital at January 1, 1940, or the beginning of the first taxable year under the new law, if a fiscal year is used.

To prevent some confusion, let it be noted at this point that though the adjustment for later capital changes when the income exemption method is used is limited to paid-in capital, as will be later explained, the invested capital for this purpose is computed as though the invested-capital method were used.

The invested capital on which the "constructive" income is based thus includes accumulated earnings and profits as well as paid-in capital. Furthermore, a reduction must be made for inadmissible assets and it is in connection with that item that the only different procedure is required.

The computation of invested capital will be covered by a separate article, so in connection with "constructive" income for the income-exemption method only the one difference will be covered.

The regular invested-capital adjustment for inadmissibles requires that the ratio of the daily average for the year of inadmissible assets to the daily average for the year of both admissible and inadmissible assets be ascertained and that the average daily invested capital for the year be reduced by that percentage.

For "constructive" income purposes, however, the daily averages of both types of assets for the *taxable period preceding January 1, 1940*, rather than the amounts on January 1, 1940, provide the basis for computing the ratio. Thus invested capital on January 1, 1940, must be reduced by the inadmissible ratio for the calendar year 1939 (in the case of a calendar-year taxpayer).

As stated before, the "constructive" income is 8 per cent, annually, of the invested capital computed in the manner described. Hence, for a period of less than twelve months, the allowance is 8/365 per cent for each day of the constructive income period (or 8/366 per cent if February, 1936, is involved).

Having thus determined the "constructive" income for the period prior to existence—note that an existing but inactive company does not get the benefit of it for the inactive period—such "constructive" income is brought into the computation of the average base-period excess-profits net income, along with actual income, if any, for its period of existence.

A resident foreign corporation cannot use "constructive" income and must have been resident for a full four-year base period in order to be able to use the income-exemption method.

Abnormalities with Respect to Current Year Income

The law contains specific provisions relating to the adjustment of current year income in situations wherein there must be included in net income of the current year abnormal amounts arising from certain specified sources.

These are to be discussed in another article, but a discussion of excess-profits net income for the base period would not be complete without pointing out the possibility that any such abnormal income received during any current year and which may be allocable to a base-period year, may, perhaps, be added to the income of the base period in computing the average earnings for the purpose of figuring the exemption.

In the law as enacted, there appears to be no definite provision for increasing the income of the base period by the abnormal income collected during a later year but allocable to the base period. However, the Senate finance committee report specifically stated that the law was intended to accomplish that result, and the wording of the

law finally enacted is substantially the same as that which appeared in the Senate bill. It is possible, therefore, that it may be in order to increase the base-period net income by such portion of the abnormal income collected during a current taxable year as may be allocable to the base period. Pending the issuance of regulations, it is recommended that that procedure be followed, but if the decision to use the income-exemption method or the invested-capital method should turn upon the treatment of such an item, it is suggested that final action be deferred, pending the issuance of definite rulings on the subject.

To make confusion worse confounded, however, think of the situations in which there exists the *possibility* of the future collection, say in 1942 or later years (the later, the more serious the problem), of some abnormal income which may be allocable in part to the base period. Before the possible abnormal income materializes, if it does, the 1940 and perhaps other returns will have to be filed and either the income or invested-capital exemption method selected for those returns, despite the fact that the base-period income may be subject to change later.

Adjustment for Capital Additions or Reductions

To complete the determination of the exemption under the income method, one further computation must be made. That is to determine whether there was a net addition to or reduction of the paid-in capital on or after January 1, 1940, or the beginning of the first excess-profits-tax year if a fiscal year be involved.

For this purpose, then, it becomes necessary to—

(1) Ascertain the amount of additional capital paid in, after the start of the first taxable year, property being taken at its income-tax basis for figuring loss, thus excluding March 1, 1913, value, i.e., value or cost at acquisition unless a transferor's basis must be carried forward for income-tax purposes, in which event such basis is used;
(2) Reduce the above by the increase in inadmissible assets (securities, the income from which is not subject to excess-profits taxes). The net result, however, cannot be less than zero or a minus figure so that the worst effect an increase in inadmissible assets can have is to offset a capital addition;
(3) Ascertain the amount of distributions out of capital but in this case no offsetting adjustment is made for any decrease in inadmissible assets;
(4) When changes occur during the taxable year, the average of each change for the year is taken into account. To determine this average, the amount of the change is multiplied by the number of days remaining in the taxable year (not including the day of the change) and divided by the number of days in the year.

The computation of the addition or reduction differs materially from the ordinary computation of invested capital and the following important points are to be noted.

(1) No consideration is given to increases or decreases in accumulated earnings by reason of gains, losses or taxable dividend payments.
(2) No consideration is given to increases or decreases in borrowed capital.
(3) Increases in paid-in capital (reduced by increases in inadmissible assets) or decreases through distributions of capital are considered *only* if they occurred after the start of the first excess-profits-tax year (January 1, 1940, in the case of calendar-year companies).
(4) No consideration is given to stock dividends or stock rights even if they are of a taxable nature.

To illustrate the computation, assume in the case of a calendar-year taxpayer, that on the 183rd day of the year $100,000 additional capital was paid in and that on the 266th day $50,000 was added to the inadmissible assets. The computation would be as follows:

Capital addition—$100,000 × 183 ÷ 366 = ...	$50,000
Less offset—inadmissible asset increase $50,000 × 100 ÷ 366 = ...	13,661
Net capital addition	$36,339

If there were no other changes, the exemption would be increased by 8 per cent of the above $36,339. For subsequent taxable years, assuming no other changes in capital or inadmissible assets during subsequent years, the net capital addition would be $50,000. Distributions of capital are averaged in the same manner and if the amount thereof is less than the capital addition figured in the manner described, it is deducted therefrom and 8 per cent additional exemption is allowed on the balance. But if the reduction exceeds the addition, then 6 per cent of the net reduction is deducted from the 95 per cent of the average annual base-period income.

The method of recognizing capital changes presents some odd possibilities which seem hardly justified in a taxing statute. The first is that no recognition is accorded changes prior to 1940. Thus a calendar-year company into which additional capital was paid on December 31, 1939, receives no benefit, but had it been paid in on January 1, 1940, its exemption would have been increased by 8 per cent thereof.

No adjustment is required for changes in inadmissible assets if no additional capital is paid in—even though dividends are not taxed. Thus, a corporation averaging—say, $100,000 during the base period—and having then no inadmissible assets, might acquire some, increase its income as a result, and yet pay no tax. Conversely, if a corporation which earned no base-period excess-profits net income, as defined in the statute, but earned $100,000 through dividends, should dispose of its stocks and earn its profit through ordinary business operations, it would have no exemption on the income basis. It would be forced to use the invested-capital method which might result in an excess-profits tax even if the current year income were less than the base-period average actual earnings.

The only effect of changes in inadmissible assets is to offset additional capital paid in—and then it is not material whether or not the new capital was used to acquire the additional inadmissibles. In the illustration used, it was assumed that the inadmissibles were acquired after the additional capital but an adjustment would have to be made even if they were acquired before the new capital. Furthermore, the adjustment for new capital will change every time there is a change in inadmissibles.

And finally, to cap it all, no adjustment is allowed for decreases in inadmissibles when a capital reduction is effected. So, though inadmissibles paid in as additional capital would not increase the exemption—and properly so—inadmissibles distributed as a return of capital would decrease the exemption, despite the fact that such a distribution would in no way affect the excess-profits net income.

The Tax Computation

Having thus ascertained the excess-profits net income for all periods and the capital adjustment, only the tax computation remains and no complications should be experienced in that respect. The exemption—consisting of 95 per cent of the average annual base-period income, plus the specific exemp-

tion of $5,000 and plus or minus the adjustment for net capital additions or reductions as the case may be—is deducted from the current-year excess-profits net income *as determined under the income credit method* ($163,900 in the illustrative chart) and on the balance the tax is computed under the applicable brackets, which need not be detailed here.

It is to be noted, however, that if a resident foreign corporation should elect to use the income method its exemption is limited to the 95 per cent of average base-period income as it is not allowed the specific $5,000 exemption and no adjustment is permitted or required for capital additions or reductions after January 1, 1940.

Reorganizations, etc.

The final word to add is that in this article no consideration has been given to the possible effect of reorganizations, mergers, and liquidations, using those terms with their common tax meanings. If any such transactions have occurred in the corporate history since 1917 the special sections dealing with them may require modifications in computing base-period or current excess-profits net income, the capital adjustments, or even the tax brackets.

But reorganizations and their effect are major problems in themselves, and require a separate study, and they will be dealt with in later articles. It must suffice for this article merely to caution the reader that they must be faced.

EXCESS PROFITS TAX ACT OF 1940

FORM "A"

FORM TO BE USED FOR ADJUSTMENTS TO NET INCOME TO DETERMINE EXCESS-PROFITS NET INCOME

(All section numbers herein refer to sections of the I.R.C. as amended to and including October 8, 1940)

	Years in base period				First taxable year beginning after December 31, 1939	
	1936	1937	1938	1939	Using exemption based on income	Using exemption based on invested capital
1. Income or loss* as shown on forms 1120; line 32, page 1 of the 1938 and 1939 returns and the corresponding line of the 1940 return; line 31, page 2, of the 1937 return; and the amount of line 13 minus line 14 of page 1 of the 1936 return	$ 8,000	$ 12,000*	$206,000	$234,000*	$446,000	$446,000
ADDITIONS:						
2. Amount of net capital loss (if any) shown by return, eliminated as a starting basis	2,000	650	None	None	Not to be eliminated here. See items 3 and 18	Not to be eliminated here. See items 3 and 18
3. Net long-term capital loss (determined under Sec. 117)	Eliminated by item 2 above				None	None
4. Stocks becoming worthless (taxable periods beginning before January 1, 1938, only)	11,600	4,400	No adjustment required	No adjustment required	No adjustment required	No adjustment required
5. Bonds becoming worthless (taxable periods beginning before January 1, 1938, only)	5,000	3,000	do.	do.	do.	do.
6. Net short term capital gain (determined under Sec. 117)	None	6,550	None	56,200	do.	do.
7. Net gains on sales or exchanges of depreciable property held not more than 18 months (taxable periods beginning before January 1, 1938, only)	None	30,000	No adjustment required	No adjustment required	do.	do.
8. Losses and expenses (deductible under Sec. 23 (a)) in connection with retirement of bonds	None	3,900	5,100	12,000	do.	do.
9. Losses from fire, storm, explosion, or other casualty, and from theft, etc., deductible under Sec. 23 (f)	1,600	1,900	750	11,000	do.	do.
10. Losses from demolition, abandonment or loss of useful value of property	450	37,000	2,850	45,000	do.	do.
11. Repayment to vendees attributable to processing tax	80,000	10,000	None	None	do.	do.
12. Payment of judgments, etc. (including interest thereon) if abnormal or grossly disproportionate	None	None	None	250,000	do.	do.
13. Intangible oil-and-gas-well drilling and mine development expenses, etc., if abnormal or grossly disproportionate	None	120,000	None	None	do.	do.
14. Interest on borrowed capital, to the extent of 50% thereof	No adjustment required	No adjustment required	No adjustment required	No adjustment required	do.	25,000
15. Exempt interest if the taxpayer elects (under Sec. 720 (d)) to treat as admissible assets the obligations described in Sec. 22 (b) (4)	do.	do.	do.	do.	do.	Optional 12,000
16. Total net income plus additions ....Forward	$108,650	$205,400	$214,700	$140,200	$446,000	$483,000

NOTE.—References to "Returns" mean federal income-tax returns as revised upon examination by the Bureau, or as corrected, if erroneous but not audited or amended, whether or not adjustment of tax liability is barred by the Statute of Limitations.

* Red.

Form "A" (Concluded)

EXCESS PROFITS TAX ACT OF 1940

Form to Be Used for Adjustments to Net Income to Determine Excess-Profits Net Income

(All section numbers herein refer to sections of the I.R.C. as amended to and including October 8, 1940)

(Continued)

	Years in base period				First taxable year beginning after December 31, 1939	
	1936	1937	1938	1939	Using exemption based on income $446,000	Using exemption based on invested capital $483,000
Net income plus additions..........Forward	$108,650	$205,400	$214,700	$140,200		
DEDUCTIONS:						
17. Amount of net capital gain (if any) shown by return eliminated as a starting basis			$ 6,000	$ 40,000	Not to be eliminated here. See items 3 and 18	Not to be eliminated here. See items 3 and 18
18. Net long-term capital gains (determined under Sec. 711, I.R.C.)	Eliminated by item 17 above				$ 26,100	$ 26,100
19. Net losses on sales, etc., of depreciable property (for years beginning prior to January 1, 1938):						
(a) Held not more than 18 months	$5,900		No adjustment required	No adjustment required	No adjustment required	No adjustment required
(b) Held more than 18 months		$2,400				
20. Net gains on sales of depreciable property held over 18 months (for years beginning after December 31, 1937)	Eliminated by item 17 above for years 1936 and 1937		1,400	None	10,000	10,000
21. Dividends from domestic corporations	20,000	30,000	40,000	50,000	60,000	60,000
22. Dividends of foreign corporations (other than foreign personal holding corporations)	No adjustment required	No adjustment required	No adjustment required	No adjustment required	No adjustment required	80,000
23. Income tax (after deducting credit for foreign income taxes), including surtax on undistributed profits but not including surtax under Sec. 102 (unreasonable accumulation of surplus)	None	None	31,500	None	90,000	90,000
24. Recoveries of bad debts allowable as deductions in years beginning before January 1, 1940	No adjustment required	No adjustment required	No adjustment required	No adjustment required	15,000	15,000
25. Income from retirement of bonds of the taxpayer outstanding over 18 months	4,700	None	None	None	45,000	45,000
26. Refunds of tax under A.A.A. and interest thereon	No adjustment required	No adjustment required	No adjustment required	No adjustment required	36,000	36,000
27. Total deductions	$ 30,600	$ 32,400	$ 78,900	$ 90,000	$282,100	$362,100
28. Balance—Excess-profits net income	$ 78,050	$173,000	$135,800	$ 50,200	$163,900	$120,900

NOTE A.—For the purpose of this illustration exempt interest has not been added to net income subject to the ordinary corporate income tax, but if the option in Sec. 720 (d) is exercised, it is probable that such interest will also be subject to normal income tax.

NOTE B.—If there is included in *income* for the current taxable year certain types of abnormal income, a portion thereof may be eliminated for excess-profits-tax purposes under the provisions of Sec. 721 and, possibly, all or a portion of such abnormal income may be added to income of years in the base period.