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Some "Curves" in the New Excess Profits Tax

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The Second Revenue Act of 1940, Title II (hereinafter called "the Act"), amends the Internal Revenue Code by adding thereto Subchapter E, Sections 710 to 752, inclusive; and thus is imposed upon corporations the Excess Profits Tax of 1940. This tax is an existing fact. It must be dealt with *now*.

Under the Act the first taxable period is any accounting year beginning after December 31, 1939. Corporations which close their books at the end of the calendar year are, consequently, immediately faced with the problem of filing their first excess profits tax return, under existing law, by March 15, 1941. The preparation of such returns is, in many instances, a formidable task—a job that one would, perhaps, like to postpone as long as possible. May an extension of time for filing be secured if timely application is made therefor? Undoubtedly, in proper cases an extension of time beyond March 15 next would be granted. Is there any reason why such an extension should not be secured? There is. In the filing of an excess profits tax return pursuant to extension granted, but technically "out of time," one encounters a "curve" in the Act. To make this apparent some discussion of the provisions of the Act will be necessary.

It will be recalled that the purpose of the excess profits tax law is to subject to a higher rate of tax such income as is supposed to be abnormal in amount. This excess income is that over and above the sum of certain credits provided by the Act, which may be deducted from income before the excess profits tax rates are applied. *(Act, Section 710 (b).)* There are three such credits and two methods are provided by the Act for computing one of them. That one is technically known as the Excess Profits Tax Credit" and it is with it, and the effect of its two methods of computation, that this discussion will mainly treat.

The first method of computing the excess profits tax credit is provided by Section 713 of the Act. It is based upon the average income of the corporation for the years 1936, 1937, 1938 and 1939. This is

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the so-called "base period net income" and the credit thus computed will be available to all domestic corporations in existence before January 1, 1940, the average, once computed, remaining the credit for all future years, unless the law is changed The provision for this computation was inserted in the Act by Congress against the opposition of the Treasury Department and is, by far, more favorable to most corporations than the second method.

The second method of computing the excess profits tax credit is specified in Section 714 of the Act. This is the "invested capital method." Eight per cent of the corporation's invested capital, computed in accordance with highly technical rules, constitutes the credit to be deducted from income in arriving at income subject to the excess profits tax rates. This method must be used by all domestic corporations not in existence before January 1, 1940, and in some circumstances, corporations that were in existence before 1940 may be forced to it. Also, any corporation so desiring may elect to use it.

The right to a credit, computed according to either (a) the base period net income method, or (b) the invested capital method, is granted by Section 712 (a). That section, so far as material here, is as follows:

> "In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall, at the election of the taxpayer made in its return for such taxable year, be an amount computed under section 713 or 714 * * *. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. In the case of a domestic corporation which for any taxable year does not file a return before the expiration of the time prescribed by law for filing such return, the excess profits credit for such taxable year shall be an amount computed under section 714."

Section 713 is the base period net income method and Section 714 is the invested capital method of computing the excess profits credit.

Carefully examining the foregoing statute, now, to determine which method is available, what do we find? Apparently, if your corporation was in existence before 1940, and if you are required to file your excess profits tax return by March 15, 1941, because your accounting year ends December 31, 1940, then you are safe in using the base period net income method of computing your excess profits credit. But, if you fail to file "before the expiration of the time prescribed *by law* for filing such return" then there is danger that you may be forced to the invested capital method of computing your excess profits credit. A filing pursuant to an extension granted would not be a filing "before the expiration of the time prescribed by law." The date prescribed *by law*, for corporations closing their books on December 31, is March 15 of the ensuing year. And for all other corporations it is the fifteenth day of the third month following the end of the month on which the books are closed.

Thus it seems safe to conclude that an extension of time for filing an excess profits tax return is at least dangerous; that if the Treasury Department, as a matter of grace, permits disregard of the "time prescribed *by law*" for the required filing, on the one hand, it would, probably, have statutory authority on the other hand, to force any corporation involved to use the less favorable invested capital method of computing its excess profits tax credit if, from the Government's angle, such action seemed desirable. So much for the first "curve."

The second "curve" concerns the use of the word "election" in Section 712 (a) excerpted above. Corporations may choose either the base period net income method or the invested capital method of computing their excess profits tax credit. Will the Government contend that mere *use* of the base period net income method, without a definite statement adopting it as the method *elected*, is not the requisite "election" and remit corporations so situated to the invested capital method more favorable to the Government? That question may not be answered now, but certainly safety counsels a definite statement of election as a part of the excess profits tax return. This much is sure: In construing the election provisions of the Revenue Act of 1934, with respect to depletion of mines, the Government has been very illiberal and has been sustained by the courts. *(J. E. Riley Investment Co. v. Commissioner, 1940, ___ U. S. ___, 85 L. Ed. 1, 35; Commodore Mining Company v. Commissioner, 1940, 111 Fed. 2nd 131.)*

The third "curve" for discussion here is perhaps the most dangerous of all. Suppose a corporation to be in existence before January 1, 1940, and consequently entitled to elect the base period net income method of computing its excess profits tax credit. However, due to other credits, provided by Section 710 (b), and the size of its net income as determined by its own auditors and accountants, its officers properly conclude that it is not liable to excess profits tax and hence no such return is filed. Subsequently, the books and records of the corporation are examined by the Bureau of Internal Revenue and certain transactions are viewed as altering the income situation so that, according to the Government, the corporation should have filed an excess profits tax return and paid tax. Clearly, in such circumstances, no excess profits tax return was filed "before the expiration of the time prescribed by law for filing such return," as required by Section 712 (a), above; and without doubt any corporation so situated would be forced (should the Government's claim of income be sustained) to use the invested capital method, however disadvantageous that might be. The moral is, of course: Completely fill out and file an excess profits tax return, electing the base period net income method, if that is to your advantage, regardless of whether or not your corporation appears to be liable for excess profits tax.

The fourth and last "curve" to be discussed here has to do with the assessment of a deficiency in excess profits tax and the statute of limitations thereon. It will be recalled that all corporations are required by regulations of the Bureau of Internal Revenue to file income tax returns annually, regardless of whether or not there is any income to report. And the running of the statute of limitations on all income tax deficiencies *(except those based on fraud)* begins on the date a return is filed. After the bar of the statute has dropped in front of the Government, no deficiency may be assessed. Conversely, if no return is filed, the bar never falls. Although no regulations in this particular behalf have yet been issued with respect to excess profits tax returns, it would seem advantageous to file such a return, completely filled out and executed in strict observance of all formalities, even if the result of the computations thereon disclose no present liability to excess profits tax. The excess profits tax rates range upward from 25 per cent on the first $20,000 of adjusted excess profits net income to 50 per cent on adjusted excess profits net income of $500,000 and over. It might be quite disastrous for a taxpayer to receive in a "lean" year a "stale" demand for a large excess profits tax; and caution would seem to dictate acquiring a position behind the bar of the statute of limitations on assessment of tax deficiencies where that is possible.