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THE REVENUE ACT OF 1943 A QUICK VIEW OF ITS INCOME AND EXCESS PROFITS TAX PROVISIONS OF GENERAL INTEREST TO CORPORATIONS

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The Revenue Act 1943,[1] is, in many parts, not informative. This is due to several reasons. It is not a complete taxing statute in itself, but rather a series of amendments to the Internal Revenue Code and other acts of Congress, which require reference to the context to be understood. Moreover it suffers from the handicaps of all of our current revenue legislation in that the paramount need is to be definite. If in being definite the statute is so replete with cross references to other parts of the Code, which are made only by section numbers, as to be incomprehensible, that is too bad but still true. In the choice between readability and definiteness, the legislative draftsmen had perforce to choose definiteness, relying heavily on the legal maxim, "That is certain which can be made certain."

The net result is that the worst place to go to glean the meaning of the statute is the Act of Congress itself. True, this must be studied for the final decision in many cases, but it is better for the average taxpayer and indeed almost anyone else to start with a lucid explanation of what the amendment is supposed to accomplish rather than to decide such fact from inspection of the Act itself.

There are already in print several summaries of the Revenue Act of 1943 giving an explanation, section by section, but even

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[1]This Act was passed by Congress over the President's veto on February 25, 1944, but is still called the Revenue Act of 1943.

these summaries are quite lengthy, and because they are complete, they do not distinguish between provisions which are found to be of interest to the average corporate taxpayer and those which are of very limited and technical nature, nor are they always presented with the view of being easily grasped.[2]

I. Effective Date

In general, the income tax and excess profits tax amendments are effective only with respect to taxable years beginning after December 31, 1943. The Act states that such shall be the case unless otherwise expressly provided.[3] This means that in the case of taxpayers on a calendar year basis, the returns which were due March 15, 1944, for the year 1943 were not affected.

However, there are a number of provisions which are retroactive in varying degrees and apply to designated prior taxable years, and some elections are granted which must be exercised, if at all, by varying dates in 1944. For example, election to secure the benefit of debt retirement amendment in connection with post war refund of excess profits tax in the case of certain fiscal years must be exercised within ninety days after the date of enactment or not later than May 25, 1944.

II. Rates, Returns, Etc.

The income tax rates on corporations are not affected by the Act, but several changes are made in the structure of the excess profits tax.

The rate of excess profits tax is changed from 90% to 95% of the adjusted excess profits net income.[4]

The specific exemption for excess profits tax which had been $5,000 is changed to $10,000 on separate[5] and on consolidated returns.[6]

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[2]Unless otherwise indicated, Section numbers not preceded by an abbreviation in this article will refer to the Sections of the Revenue Act of 1943. Sections of the Internal Revenue Code will be indicated by the abbreviation I. R. C. preceding the number. It will be noted that in the Act itself section numbers of the Act and of the Code are not distinguished as they occur, but by paragraph (b) of the enacting clause it is provided that except as otherwise expressly provided wherever an amendment is expressed "in terms of an amendment to a chapter, subchapter, title, supplement, section, subsection, subdivision, paragraph, subparagraph, or clause the reference shall be considered to be made to a provision of the Internal Revenue Code." This results in two series of section numbers being scattered throughout the Act and is productive of much unnecessary confusion.

[3]Secs. 101, 201.

[4]Sec. 202, amending I. R. C., Sec. 710 (a) (1) (A)

[5]Sec. 204, amending I. R. C., Sec. 710 (b) (1)

[6]Sec. 204, amending I. R. C., Sec. 141 (c).

The credit based on invested capital for the excess profits tax remains at 8% for the first $5,000,000 of invested capital, but the credit on the second $5,000,000 of invested capital is computed at 6% instead of 7%, and on all over $10,000,000 the credit is computed at 5% in place of 6% on the amount from $10,000,000 to $200,000,000 and 5% on the excess.[7]

Corporations exempt from income tax under I.R.C., Section 101, are subjected to certain duties by a new subsection (f) inserted after subsection (e) in I.R.C., Section 54, by Section 117 of the Revenue Act of 1943. The new subsection requires annual returns stating specifically the items of gross income, receipts, and disbursements and such other information as the Commissioner prescribes. Certain corporations are relieved from the necessity of filing such returns, notably religious organizations, certain educational organizations, and certain charitable organizations, but labor organizations are required to file such reports. It has been stated by the Senate Finance Committee in its report on H.R. 3687 (which was the Revenue Bill of 1943) that many of these organizations "are now engaged in the operation of apartment houses, office buildings, and other businesses which directly compete with individuals and corporations required to pay taxes on income derived from like operations." These corporations are required to file returns of income for taxable years beginning after December 31, 1942, in order to secure sufficient information to determine whether such corporations should be subject to taxation.

III. Post War Refund—Debt Retirement

The Internal Revenue Code provides for a post war refund of a portion of the excess profits tax, normally 10% thereof.[8] By Section 783 of the I.R.C. 40% of the amount of debt retirement is a credit at the election of the taxpayer within the limits set out. Section 251, which is described as a "Technical Amendment to Credit for Debt Retirement" amends I.R.C., Section 783 (b)(2) which states the limitation on the debt retirement. As amended the credit shall not exceed an amount equal to 40% of the amount by which.

(A) The amount of indebtedness as of September 1, 1942, or (B) The smallest amount of indebtedness as of the close of any preceding taxable year ending after September 1, 1942, *whichever is lesser,* exceeds the amount of indebtdness as of the close of the taxable year.

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[7]Sec. 205, amending I. R. C., Sec. 714.
[8]I. R. C., Sec. 780.

The purpose of the amendment is to remedy what was deemed to be an injustice. The former rule was "40 per centum of the amount by which the smallest amount of indebtedness during the period beginning September 1, 1942, and ending with the close of the preceding taxable year exceeds the amount of indebtedness of the taxable year."[9] The result was that if at *any time* within the period stated the indebtedness had been temporarily reduced this became the figure used in computing the debt retirement credit. This was an error in draftsmanship for there was no reason to let a temporary reduction of indebtedness, not availed of for tax purposes, enter into the calculation. .Now the figure used is either the amount of indebtedness on September 1, 1942, or the smallest amount *at the close of* any preceding taxable year ending after that date. The election to apply this amendment to prior years beginning after September 1, 1942, must be made within ninety days from enactment of the Revenue Act of 1943,[10] and so must be made not later than May 25, 1944.

The post war refund of excess profits tax may under I.R.C., Section 780, be represented by bonds of the United States. It was intended that until the cessation of hostilities in the present war such bonds should be non-negotiable. Sale, exchange, or pledge of the bonds was prevented by I.R.C., Section 780(c). This might have prevented a transfer even in case of a reorganization or corporate liquidation. There was no reason why a successor of the taxpayer should not be allowed to receive such bonds and accordingly this is permitted by Section 250, Revenue Act of 1943, which amends I.R.C., Section 780(c) and adds new subsections I.R.C., 780(f) and (g)

After bonds have been issued for the post war refund it might occur that the tax itself was reduced, which would call for a reduction in the amount of bonds representing the refund. But if said bonds are not made available then the amount of reduction which would have been applied to the bonds is applied instead against the amount of the tax reduction itself. This is provided by Section 250(e) amending I.R.C., Section 781(b) The reduction of the credit in place of the reduction of the bonds will be disadvantageous to the taxpayer since the bonds do not bear interest, whereas some of the refund will bear interest and at all events the refund will presumably be promptly paid in cash to the taxpayer.

[9]I. R. C., Sec. 783 (b) (2)
[10]Sec. 251 (c)

I.R.C., Section 781(d), limiting the refund which recognizes that the effect of a 90% excess profits tax less a 10% refund is an 81% net tax, had to be altered to conform with the new rate of 95% less 10% which comes to 85½% net. This is accomplished by amendment of I.R.C., Section 781(d), by Section 250(f) of the Revenue Act 1943.

The post war refund as applied to fiscal years is treated in Section 250(a) and (f) of the Revenue Act of 1943 to conform the post war refund provisions to the changes in treatment of fiscal years which are discussed below under the heading "VII Fiscal Years."

IV Consolidated Returns, Acquisition of Corporation to Avoid Tax

By I.R.C., Section 727, certain corporations, such as personal holding companies, are exempted from the excess profits tax unless the corporation is "a member of an affiliated group of corporations filing consolidated returns under Section 141." This means that if the affiliated group of which they are a part decide to file a consolidated return, the exemption from excess profits tax is lost. The Revenue Act of 1943, Section 131, grants these corporations the privilege of continuing their exemption by electing not to be included in the consolidated return of the group of which they are a part. The change is accomplished by adding at the end of I.R.C., Section 141(e), which defines "includible corporations," a new paragraph (7), which applies only to taxable years beginning after December 31, 1943.

"Loophole closing" is the purpose of Section 128 of the Revenue Act adding new Section 129 to the I.R.C. There are many instances in the tax law where the acquisition of the control or property of one corporation by another will result in a tax benefit through unused excess profits credits or present or prospective losses or deficits. Some of these are curtailed by existing provisions of the Code, but it was felt necessary to strengthen the law in this respect. The new section provides that such deduction, credit, or other benefit shall not be allowed where the "principal purpose" of such acquisition was evasion or avoidance of Federal income or excess profits tax by securing the benefits described in the section. The exact limitations under which the disallowance can occur are set out in detail in the section. It applies only (a) where a person or persons (this includes corporations) acquire

on or after October 8, 1940, directly or indirectly, control (50% of voting power or value) of a corporation, or (b) where a corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation which was not controlled before acquisition, and where the basis in the hands of the transferee corporation is determined by reference to the basis in the hands of the transferor The Commissioner is also given power to make a partial disallowance.

I.R.C., Section 45, which for many years has permitted the Commissioner to reallocate "gross income or deductions" between several organizations, is broadened by an amendment[11] inserting in lieu of the last quoted words "gross income, deductions, credits or allowances."

It is also provided that the amendments made by Section 128 shall be applicable only to taxable years beginning after December 31, 1943, and in the determination of law applicable to prior years any inference from the enactment of said provisions is expressly prohibited.[12]

V Publicity of Relief

It will be remembered that I. R. C., Section 722, is the general relief provision under the excess profits tax. A new subsection (g) is added to it by Section 206 of the Revenue Act of 1943, providing for publication in the Federal Register, not only of the names and addresses of taxpayers who receive such relief, but also of a number of enumerated details concerning the case, notably the amount of gross decrease in excess profits tax and gross increase in income tax which results from the operation of this section. Such a compilation will make interesting reading and no doubt furnish ammunition to persons who desire a repeal of the relief provisions.

VI. Various Provisions Concerning Reorganized Corporations

We group here certain provisions scattered through the Revenue Act which deal with reorganized corporations.

In the President's veto message of February 22, 1944,[13] he states that the bill contains provisions which will afford indefensible special privileges to favored groups and enumerates, among others, the following·

"(a) Permission for corporations reorganized in bank-

[11]Sec. 128 (b).
[12]Sec. 128 (c).
[13]90 Congressional Record, 1973.

ruptcy to retain the high excess profits credit and depreciation basis attributable to the contributions of stockholders who are usually eliminated in the reorganization."

This movement started in the Revenue Act of 1942.[14] This applied only to railroad reorganizations, and provided that loss should not be recognized if property of a railroad corporation is transferred in railroad reorganizations in a receivership proceeding or in a proceeding under section 77 of the National Bankruptcy Act. Consistently with the provision for non-recognition of loss was the provision for preservation of basis of such property accomplished by adding a new paragraph (20) to I.R.C., Section 113(a). One effect of the amendments was to include the former valuation in the invested capital of the reorganized railroad. The railroad amendments were made retroactive to taxable years beginning after December 31, 1939. The Revenue Act of 1943[15] makes them further retroactive to years beginning after December 31, 1938.

As explained by the Senate Finance Committee Report on the Revenue Bill of 1943,[16] the purpose of the section now numbered 121 was "to provide equality of tax treatment for all corporations undergoing insolvency reorganization under court supervision."

The treatment is said by the Finance Committee report to include the rules with respect to gain or loss and basis of assets which shall be used both for the determination of depreciation and gain or loss on subsequent sale, and for determination of credit for excess profits tax purposes. Rules applicable to the determination of gain or loss, and basis of new securities to shareholders and creditors participating in the reorganization are likewise provided.

The primary provision is the amendment of I.R.C., section 112(b), by addition of a new paragraph (10) for non-recognition of gain or loss if property of a corporation is transferred in pursuance of an order of court "to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.[17]

The situation where the exchange is made not only for stock or securities in the other corporation but also for other property is also dealt with. In such case, according to a new paragraph (22)

[14]Rev. Act of 1942, Sec. 142 (a), which added a paragraph 9 to I. R. C., Sec. 112 (b).

[15]Sec. 126.

[16]See C. C. H. reprint of said Report, p. 49, heading "Section 115, Reorganization of Certain Insolvent Corporations."

[17]Sec. 121 (a).

added to I.R.C., Section 113(a) by Section 121(c) of the Revenue Act of 1943, the basis is increased by the amount of gain (but not decreased by the amount of loss) recognized, but such basis shall not be adjusted under subsection (b)(3) by reason of a discharge of indebtedness pursuant to the plan of reorganization under which the transfer was made.

The amendments are to be deemed to have been included in the revenue laws applicable to taxable years beginning after December 31, 1933, and therefore include transactions which took place in those years, but shall not affect any tax liability for any taxable years beginning prior to January 1, 1943.[18] There is also an interesting provision permitting a final determination made prior to the ninetieth day after the enactment of the Revenue Act of 1943 to govern as to the basis of exchanges.[19]

Section 122 of the Revenue Act 1943 amends I.R.C., Section 113(b), by adding a new paragraph (4) relating to the reorganization of a corporation consummated under Section 77B of the National Bankruptcy Act without transfer of assets to another corporation and in which a final judgment or decree was entered prior to September 22, 1938. The provision is that Section 270 of the National Bankruptcy Act shall not apply, with the result that the basis of the property is unaffected by the proceedings. Put another way, the "water" is not squeezed out of the basis of the assets of a corporation which "went through 77B." It has made a settlement with its creditors but still has the invested capital credit to which it would have been entitled before the settlement.

VII. Fiscal Years

Fiscal years are treated under Sections 108 and 203 of the Revenue Act of 1943.

The Revenue Act of 1942[20] increased the corporate excess profits tax by substituting a flat 90% rate for graduated rates ranging from 35% to 60%. It will be remembered that, because of the fact that the Revenue Act of 1942 was enacted late in the year (October 21, 1942), corporations with fiscal years ended on or before June 30, 1942, were not subject to the increased rates. However, Section 203 of the Revenue Act of 1942 amended I.R.C., Section 710(a), by inserting paragraph (3) relating to fiscal years beginning in 1941 and ending after June 30, 1942. As

[18]Sec. 121 (e).

[19]I. R. C., Sec. 112 (1) (2), added by Sec. 121 (b) of the Revenue Act of 1943.

[20]Rev. Act of 1942, Sec. 202.

explained by the Ways and Means Committee Report on the Revenue Bill of 1943 under heading "Section 203," it later developed that there was a flaw in paragraph (3) because of the omission of a provision which was obviously intended to be inserted with reference to the computation of the 80% limitation in case of fiscal year corporations. The regulations issued by the Commissioner supplied the omission, but, of course, the question remained whether they were valid under the circumstances. It was necessary to deal with the change in excess profits tax rates between 1943 and 1944 in any event. Therefore the Committee states that it has made an exception to its policy of not including amendments merely clarifying the 1942 Act in the 1943 Act.

The provision for the fiscal years ending in 1942 after June 30 was to first compute tentative normal and surtaxes under the laws applicable to 1941 and 1942 respectively, and then prorate with reference to the number of days in the fiscal year after June 30, 1942. It was the intention that in computing the second tentative excess profits tax under I.R.C., Section 710(a)(3)(B), the amount of the tax under Chapter 1 to be used in computing the 80% limitation should be the second tentative normal and surtax computed under subparagraph (B) of I.R.C., Section 108(a)(1). By technical inadvertence, however, Section 710(a)(3)(B), which describes the second tentative excess profits tax, simply states that it shall be computed as if the amendment made by the Revenue Act of 1942 were applicable to the taxable year. Among these amendments, of course, was the provision *for normal and surtax* on fiscal year corporations computed by the prorating method above referred to. There should have been a provision inserted that for the purpose of the second tentative tax these provisions (for arriving at the total tax by prorating, etc.) should be disregarded. In other words, the second tentative excess profits tax should have been entirely on a 1942 basis and not a mixed 1941 and 1942 basis. The provision for fiscal years including parts of 1943 and 1944 had to be different from the analogous situation in 1941 and 1942 because there was no reason to include June 30, 1944, in the calculations, as June 30, 1942 was included, the Revenue Act of 1943 having been passed early enough in 1944 to justify making it apply to all of 1944. With this exception, however, the treatment of 1943-4 fiscal years is analogous to the treatment of 1941-2 fiscal years.[21]

[21]Rev. Act of 1943, Sec. 203, adding a new paragraph (6) to I. R. C., Sec. 710 (a).

VIII. Inventories

Section 119 of the Revenue Act of 1942 amended I.R.C., Section 22(d), to provide relief in certain cases of involuntary liquidation of inventory by taxpayers using the "last in first out" method. The taxable income of the year of such involuntary liquidation is adjusted by reducing it in the amount of the increased cost of the replacement units or increasing it in the amount of the decreased cost of the replacement units.[22] The replacement is to appear from the closing inventory of a subsequent taxable year, ending not more than three years after the end of the war.[23] (Section 22(d)(6)(A).) Election is required to be made at the time of filing the taxpayer's return for the year of liquidation. The Revenue Act of 1943[24] makes some changes in this relief provision. These are explained by the Senate Finance Committee Report on the Revenue Bill of 1943 under the heading "Section 106." Whereas the adjustment had been limited to taxable years beginning after December 31, 1941, it is changed to apply to years beginning after December 31, 1940.[25] Likewise the other amendments which will be described below are made retroactive to the same date.[26]

In connection with liquidation effected in 1942 the election had to be made at the time of filing the return but with respect to liquidations in 1941 the election may be made within six months after the enactment of the Revenue Act of 1943 (i.e. not later than August 24, 1944.)[27]

Whereas the adjustment is limited by prior law to income tax and excess profits tax, I.R.C., Section 22(d)(6)(E) is amended by striking out "Subchapter E of" so as to make the adjustment applicable to all taxes in Chapter 1 and Chapter 2 of the I.R.C. which includes the excess profits tax, declared value excess profits tax, surtax on personal holding companies, and unjust enrichment tax. The adjustment under former law was for the year of liquidation, the year of replacement, and intervening years. By amendments contained in Section 110(a)(2) and (4), provision is made for the adjustment for all taxable years affected, including those affected by carrybacks.

The items of inventory involved in the replacement are to be carried as items acquired at a cost equal to the base stock inven-

[22]I. R. C., Sec. 22 (d) (6)
[23]I. R. C., Sec. 22 (d) (6) (A)
[24]Sec. 110.
[25]Sec. 110 (a) (1).
[26]Sec. 110 (b).
[27]Sec. 110 (a) (1), amending I. R. C., Sec. 22 (d) (6) (A).
[28]Sec. 110 (a) (3).

tory cost of the item involved in the liquidation. While I.R.C., Section 22(d)(6)(C), as enacted by Revenue Act of 1942, was believed to accomplish this, it was clarified by amendment by the Revenue Act of 1943.[28]

The statute of limitations is kept open for three years by the Revenue Act of 1942 for the adjustment of the taxes affected. Since additional taxes are affected under the Revenue Act of 1943, this provision is amended to reflect this change.[29]

IX. Special Industries

Of the five features singled out for condemnation by the President in his veto message of February 22, 1944, one has been already discussed (under heading VI above), namely the permission for corporations reorganized in bankruptcy to retain the high excess profits credit and basis attributable to the contributions of the stockholders. The remaining four of the five features which are condemned consist of the privileges granted by the Revenue Act of 1943 to special industries, but not all of the privileges granted to special industries mentioned below are referred to in the veto message.

(a) *Strategic Minerals*

The Code prior to the Revenue Act of 1943 contained provisions for "percentage depletion" not only of oil and gas wells[30] but also of enumerated minerals such as coal, metal, fluorspar, etc.[31] The Revenue Act of 1943 adds certain minerals such as flake graphite[32] and defines "gross income from the property" rather minutely. Such gross income includes the "gross income from mining." Mining includes not only the extraction of the minerals from the ground, but the "ordinary treatment processes." These are defined in a specific manner which, incidentally, takes in a lot of territory The definition of gross income from the property is made retroactive to all taxable years beginning after December 31, 1931.[33] Those minerals which are allowed percentage depletion are excluded by name from discovery depletion.[34]

The changes made by the Revenue Act of 1943 and the Revenue Act of 1942 will not apply to any year beginning on or after the

[29]Sec. 110 (a) (5), amending I. R. C., Sec. 22 (d) (6) (E).
[30]I. R. C., Sec. 114 (b) (3).
[31]I. R. C., Sec. 114 (b) (4).
[32]Sec. 124, amending I. R. C., Sec. 114 (b) (4).
[33]Sec. 124 (d).
[34]Sec. 124 (b), amending I. R. C., Sec. 114 (b) (2).

termination of hostilities, but potash is an exception.[35] Therefore, oil, gas, coal, metal mines, sulphur and potash are the subjects on which the percentage depletion allowance will not be terminated by the end of the war.

I.R.C., Section 731, already exempts the income from the mining of antimony and certain other enumerated strategic minerals from the excess profits tax. The Revenue Act of 1943 adds to the list fluorspar, flake graphite, and vermiculite.[36] The amendment is made retroactive as to flake graphite to taxable years beginning after December 31, 1942. The regular time applies to the other minerals, i.e., taxable years beginning after December 31, 1943.

(b) *Timber*

Prior to the amendments by Section 127 of the Revenue Act of 1943 timber owners were at a disadvantage under the Federal income and excess profits tax laws. If the timber block were sold outright the gain would be considered a capital gain, but if the taxpayer cut his own timber, the gain would be considered ordinary income. Since the percentage treatment of capital gains applies to individuals and not to corporations,[37] the election to treat the increase in value of a timber block as capital gain even when cut by the taxpayer is not as important to corporations as it is to individuals. Nevertheless, it will be of importance to a corporation to have such gain considered capital gain since capital gains are now exempted from the declared value excess profits tax[38] and have been exempted from the excess profits tax right along.[39]

In general, the effect of the amendment by the Revenue Act of 1943 with respect to gain or loss from cutting timber is to permit the increase or decrease in value of the timber up to the first day of the taxable year in which cut to be treated as a capital gain or loss.[40]

(c) *Civil Aeronautics*

The amendments to Section 727(h) I.R.C. referring to compensation received from the United States for transportation of mail by aircraft[41] are not of general interest to corporations and would not be mentioned here but for the reference thereto in the

[35]Sec. 124 (e).
[36]Sec. 207 (a).
[37]I. R. C., Sec. 117 (b).
[38]Rev. Act of 1943, Sec. 510, amending I. R. C., Sec. 602.
[39]I. R. C., Sec. 711 (a) (1) (B).
[40]Sec. 127, adding subsection (k) to I. R. C., Sec. 117
[41]Rev. Act of 1943, Sec. 209.

President's veto message. The Code before the amendment provided for exempting such carriers from excess profits tax if, after excluding said compensation, the excess profits net income was zero. The amendment provides that such exclusion shall also be made in computing the unused excess profits credit for any other taxable year but only for the purpose of determining whether such corporation is exempted by the subsection from excess profits tax for the taxable year.

(d) *Natural Gas Pipe Lines*

The veto message under (d) states "Natural gas pipe lines are exempted from the excess profits tax without justification and in a manner which might well lead oil companies to request similar treatment for their pipe lines."

Section 208 of the Revenue Act of 1943 amends I.R.C., Section 735 so as to include a definition of "natural gas property" in Section 735(a). This includes natural gas pipe lines. However, that Section relates to *excess output* which is exempted rather than total output.[42] (See for example Sec. 735(b)(3) as amended.) Therefore the exemption of natural gas pipe lines from excess profits tax is qualified rather than absolute.

[42]See, e.g., Sec. 735 (b) (5), added by Rev. Act of 1943, Sec. 208 (c).