St. Mary's Law Journal

Volume 6 | Number 2 Article 7

6-1-1974

# Reasonable Needs of the Business: The Section 537 Question.

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# REASONABLE NEEDS OF THE BUSINESS: THE SECTION 537 QUESTION

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A tax liability is imposed on the earnings and profits of corporations.[1] When these after-tax earnings and profits are distributed to the individual shareholders of the corporation, they are again taxed at the shareholder's marginal rate. This double taxation can be avoided to the extent that such earnings are retained by the corporation, and the shareholders can benefit through the appreciation of their stock, a redemption of their shares, or a distribution in liquidation of the corporation, bailing out these retained earnings at lower capital gains rates.[2]

To discourage such temptations, a penalty tax on unreasonable corporate accumulations was enacted in 1913,[3] which later became Section 102 of the Internal Revenue Code of 1939. With the enactment of the Internal Revenue Code of 1954,[4] the accumulated earnings tax took on substantially the same appearance it has today as sections 531-537.[5]

*Imposition of the Tax*

When the corporation's earnings and profits are accumulated beyond the "reasonable needs of the business,"[6] a penalty tax of 27.5 percent is imposed

1. INT. REV. CODE OF 1954, § 11.

2. For a good presentation of the public policy considerations behind the accumulated earnings tax, see Rudick, *Effect of the Corporate Income Tax on Management Policies*, 2 How. L.J. 232, 238-53 (1956).

3. Tariff Act of 1913, ch. 16, § II-A(2), 38 Stat. 166, which provided in part that the shareholders "of all corporations . . . formed or fraudulently availed of for the purpose of preventing the imposition . . . of [income tax on such shareholders] . . . through the medium of permitting such gains to accumulate instead of being divided or distributed . . ." must include such profits in their gross incomes. The Act further specified that "the fact that any such corporation . . . is a mere holding company, or that the gain and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax." Compare this language with INT. REV. CODE OF 1954, §§ 532(a), 533.

Similar language was used in the provisions of the 1916 Revenue Act, § 3, and the 1921 Revenue Act, § 220.

4. Act of Aug. 16, 1954, Pub. L. No. 83-591, 68A Stat. 179. All text references hereafter are to the Internal Revenue Code of 1954.

5. For an exhaustive treatment of the legislative ancestry of the tax, see 7 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 39.04, at 39-7 (Zimet & Barton rev. 1967).

6. INT. REV. CODE OF 1954, § 533(a).

on the first $100,000 of accumulated taxable income and 38.5 percent on the excess.[7] To avoid the imposition of the tax, or to minimize it if it is imposed, the corporation under attack must demonstrate that its accumulations for the years in question are for legitimate business purposes, or reasonably anticipated needs of the business, rather than for the avoidance of income tax with respect to the shareholders.[8] The mere fact that the shareholders would have paid more taxes, however, is not fatal to the question of tax avoidance.[9]

Should the tax be imposed, the first step in the determination of the tax liability is the calculation of the excess accumulation. Basically, the aggregate of the retained earnings accounts are reduced by the dividends paid deduction of section 561 and the accumulated earnings credit, and then adjusted in the manner prescribed by section 535(b).[10] The accumulated earnings credit of section 535(c) is the amount of retained earnings necessary for the financially sound continuation of the enterprise; that is, the reasonable needs of the business, minus the capital gains deduction of section 535(b)(6).[11] This amount is subtracted from the accumulated taxable income, and the remainder is the amount subject to tax liability at the rates

7. *Id.* § 531. Since the accumulated earnings tax is imposed *in addition to* the regular corporate income tax, the following are the effective tax rates on the unreasonable accumulation:

| Taxable Income | Effective Rate |
|---|---|
| Less than $25,000 | 43.45% |
| $25,000-180,000 | 62.30 |
| Over $180,000 | 68.02 |

Kidder, *Accumulating Surplus for Business Needs,* 17 CASE W. RES. L. REV. 724, 736 (1966).

8. This indicates why closely-held corporations are the most threatened: with substantially all of the stock in the hands of the directors of the corporation, the dividend policy can be controlled with respect to their personal tax consequences. Large publicly-held corporations normally do not formulate dividend policy with shareholder tax consequences as the prime consideration. A study made for the Brookings Institute concluded that public corporations base their dividend policy on cash flows rather than current earnings. J. BRITTIAN, CORPORATE DIVIDEND POLICY 196-97 (1966), *cited in* S. WEITHORN & R. NOALL, THE ACCUMULATED EARNINGS TAX 187 (1968).

The only reported cases in which the tax has been imposed against a publicly-held corporation are Trico Prods. Corp. v. Comm'r, 137 F.2d 424 (2d Cir. 1943), *cert denied,* 320 U.S. 799 (1946); Trico Prods. Corp. v. McGowan, 169 F.2d 343 (2d Cir.), *cert. denied,* 335 U.S. 899 (1948); and Golconda Mining Co., 58 T.C. 139 (1972), *appeal docket to 9th Cir.* In both cases, the stock was widely held (from 1700 to 2400 different shareholders), but the largest blocks were held by the small group of original investors who controlled dividend policy with respect to their personal income taxes.

9. Trico Prods. Corp., 46 B.T.A. 346, 364-65 (1942); R. Gsell & Co. v. Comm'r, 294 F.2d 321, 327 (2d Cir. 1961); Comm'r v. Young Motor Co., 316 F.2d 267, 269 (1st Cir. 1963).

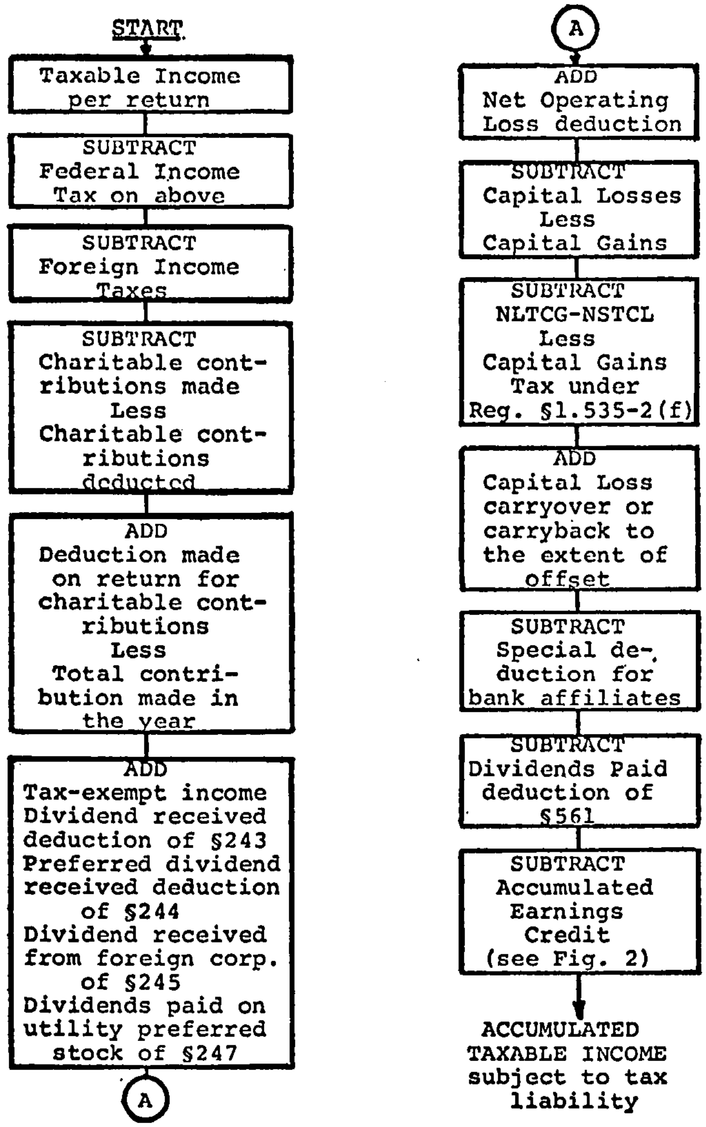
10. This procedure is expanded in the regulations. *See generally* Treas. Reg. § 1.535-2 (1973).

11. *See* Treas. Reg. § 1.535-3 (1973).

prescribed by section 531.[12]

12. For clarity, these calculations are presented as flow charts in Figures 1 and 2. These charts have abbreviated details necessary to calculation. They are included here only to visually present the basic scheme and flow of the computations to be made in accordance with Treas. Reg. § 1.535-2 (1973).

FIGURE 1



Since an accumulation of $100,000 is considered reasonable, the minimum accumulated earnings credit is that amount.[13] By splitting off several corporations, or forming new ones each owned at least 80 percent by the parent corporation, the accumulated earnings credit was formerly available to every member of the controlled group. Thus, $100,000 of accumulations could be made—*tax free*—by each entity. But the Tax Reform Act of 1969[14] has made only one $100,000 minimum accumulated earnings credit available for the controlled group.[15]

*Corporations Subject to the Tax*

The Code provides that the tax is to be levied against corporations which are "formed or availed of" avoiding income taxes with respect to their shareholders.[16] This proscribed purpose must be shown to exist before the tax will be assessed.[17] An unreasonable accumulation is prima facie evidence of the intent to avoid shareholder taxes,[18] and the corporation must, by a clear preponderance of the evidence, negate the existence of such intent.[19]

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FIGURE 2

Determine the accumulation necessary for the reasonable and reasonably anticipated needs of the business

↓

SUBTRACT
Net Long Term Capital Gains
Minus
Net Short Term Capital Losses
Less
Capital Gains Tax computed under Reg. §1.535-2(f)

↓

GREATER OF $100,000 OR THIS FIGURE IS ACCUMULATED EARNINGS CREDIT

13. INT. REV. CODE OF 1954, § 535(c)(2).

14. Act of Dec. 30, 1969, Pub. L. No. 91-172, § 401(a), 83 Stat. 599, *amending* INT. REV. CODE OF 1954, § 1561.

15. *See* INT. REV. CODE OF 1954, §§ 1551, 1561, 1564. For a discussion of consolidated corporations and controlled groups see generally Dreher, *Federal Income Tax Aspects of Multiple Corporations*, 9 HOUS. L. REV. 8 (1971).

16. INT. REV. CODE OF 1954, § 532(a).

17. *See, e.g.*, United States v. Donruss Co., 393 U.S. 297, 301 (1969).

18. INT. REV. CODE OF 1954, § 533(a).

19. *Id.* § 533(a). *See also* United States v. Duke Labs., Inc., 337 F.2d 280, 281-82 (2d Cir. 1964), *aff'g* 222 F. Supp. 400, 406 (D. Conn. 1963); James M. Pierce Corp., 38 T.C. 643, 653 (1952); Plant Shipping Co., 11 P-H Tax Ct. Mem. 529, 531 (1942); C.H. Spitzner & Sons, Inc., 37 B.T.A. 511 (1938), *nonacquiesced in* 1939-2 CUM. BULL. 47.

Thus, in a case in which the taxpayer corporation was unaware that it had an undue accumulation because of a bookkeeper's error, the court refused to uphold the deficiency determination.[20] Similarly, a corporation which postponed paying a dividend until a final audit of its books had been completed was held not to have the intention of tax avoidance.[21]

Although this *mens rea* is required, it does not have to be the sole purpose of the accumulation,[22] nor does it have to be shared by all of the stockholders.[23] It may be evidenced in many ways,[24] and denials of intent by the shareholders may be important, although not conclusive.[25]

Statutory corporations are not the only type of business organization which may be subject to the tax. The Code provides that some associations are taxable as corporations,[26] and the regulations define these associations as having three or more of the "corporate attributes" of centralized management, continuity of life, limited liability and free transferability of interest.[27] These may take the form of the so-called *Kintner* associations[28] or limited partnerships. Since these associations are subject to the corporate taxation provisions, they may be held liable for the accumulated earnings tax. This principle has also been held to include unreasonable accumulations by a common law trust.[29]

*When the Tax is Due*

Until recently, there was no clear authority for determining when the accumulated earnings penalty tax is due and payable. In *Motor Fuel Carriers, Inc. v. United States*,[30] one court held that the interest on a section 531 tax deficiency begins to run ten days after notice and demand for the

20. Florida Iron & Metal Co., 11 P-H B.T.A. Mem. 1015, 1018-19 (1942).
21. Gus Blass Co., 9 T.C. 15, 25 (1947).
22. United States v. Donruss Co., 393 U.S. 297, 309 (1969).
23. KOMA, Inc., 18 P-H Tax Ct. Mem. 919, 926 (1949), *aff'd*, 189 F.2d 390 (10th Cir. 1951); Trico Prods. Corp., 46 B.T.A. 346, 382 (1942).
24. *See, e.g.*, American Lawn Mower Co. v. United States, 12 Am. Fed. Tax R.2d 6162, 6165 (S.D. Ind. 1963) ("through its records, officers, directors . . . and agents").
25. *See, e.g.*, Corporate Inv. Co., 40 B.T.A. 1156, 1169-71 (1939), *nonacquiesced in* 1944 CUM. BULL. 46. *But see* Cecil B. DeMille, 31 B.T.A. 1161, 1175 (1935), where the court was quite impressed by the denials of proscribed intent by the directors that "remain[ed] unshaken on cross-examination."
26. INT. REV. CODE OF 1954, § 7701(a)(3) states: "The term 'corporation' includes associations, joint stock companies, and insurance companies."
27. Treas. Reg. § 301.7701-2 (1973); *see* Morrissey v. Comm'r, 296 U.S. 344, 359-60 (1935).
28. *See* United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), *aff'g* 107 F. Supp. 976 (D. Mont. 1952).
29. Olin Corp. v. Comm'r, 128 F.2d 185 (7th Cir. 1942), *aff'g* 42 B.T.A. 1203 (1940).
30. 420 F.2d 702 (Ct. Cl. 1970).

payment of the tax, not the date of the return.[31] In a contrary holding, a federal district court determined that the tax was to be paid on the due date of the return for the year in question, even though there is no mention of the accumulated earnings tax on the corporate tax return and no provision for the calculation or payment of such a tax is made thereon.[32] Exactly when the accumulation becomes unreasonable is a question of fact and not of law; to charge the directors and officers of the corporation in law to have knowledge of when they should pay the tax compounds the penalty. Further, although a corporation may consider its accumulations to be reasonable, the Internal Revenue Service may not agree and endeavor to persuade the court to follow its conclusions. It would be unfortunate in such instances to further penalize the corporation by determining that interest runs from the time of filing the return, which may have been several years earlier.

The problem is further complicated by the fact that the amount of working capital considered adequate is open to reasonable differences of opinion. Again, it would be unjust to run the interest from the date of the return in those instances where the Service does not agree with the corporation's determination of adequate working capital. The better reasoned approach was taken in *Motor Fuel Carriers, Inc. v. United States*,[33] where interest was held to run ten days from the date of the deficiency notice. This rule was finally adopted by Revenue Ruling 72-324.[34]

## REASONABLE NEEDS OF THE BUSINESS

### *Tax Not Imposed If the Accumulation Is For "Reasonable Needs of the Business"*

As previously stated, the accumulated earnings credit includes a computation of the reasonable needs of the business. The Code, at section 537, fails to define reasonable business needs,[35] except for the section 303 needs[36] and the excess business holdings redemption needs of the business.[37]

31. *Id.* at 708; *accord,* Bardahl Mfg. Corp. v. United States, 452 F.2d 604, 605 (9th Cir. 1972).

32. Bardahl Mfg. Corp. v. United States, 25 Am. Fed. Tax. R.2d 429, 431 (W.D. Wash. 1969), *rev'd per curiam*, 452 F.2d 604 (9th Cir. 1971).

33. 420 F.2d 702, 768 (Ct. Cl. 1970).

34. 1972-1 CUM. BULL. 399.

35. INT. REV. CODE OF 1954, § 537: Reasonable Needs of the Business.

(a) GENERAL RULE—For purposes of this part, the term "reasonable needs of the business" includes—

(1) the reasonably anticipated needs of the business,

(2) the section 303 redemption needs of the business, and

(3) the excess business holdings redemption needs of the business.

36. The section 303 needs refer to the liquidation of a deceased shareholder's interest in the corporation to pay death taxes and funeral expenses. *See* INT. REV. CODE OF 1954, § 537(b)(1).

37. The term "excess business holdings redemption needs" is defined in section 537(b)(2) as a redemption of the corporation's stock held by a private foundation.

The reasonably anticipated needs of the business are also included in the definition of business needs:

> It is intended that this provision [section 537] will make clear that there is no requirement that the accumulated earnings and profits be invested immediately in the business so long as there is an indication that future needs of the business require such accumulation. In any case where there exists a definite plan for the investing of earnings and profits, such corporation need not necessarily consummate these plans in a relatively short period after the close of the taxable year. However, where the future needs of the business are uncertain or vague, or the plans for the future use of accumulations are indefinite, the amendment does not prevent application of the accumulated earnings tax.[38]

The Code gives no specific tests by which to determine reasonable business needs (except the two limited instances cited above), and the regulations[39] give only "grounds which can be used under ordinary circumstances."[40] These include (1) expansion or replacement of capital assets;[41] (2) acquisition of another business enterprise;[42] (3) debt retirement sinking funds if required by the bond contract or loan agreement;[43] (4) provisions for working capital;[44] and (5) provisions for investment in or loans to suppliers in order that the business of the taxpayer may be maintained.[45] Other reasonable needs of the business are considered to include the use of retained earnings to finance expansion into a new field,[46] to provide funds to terminate a business relationship,[47] to expand such that large increases in business can be properly accommodated,[48] for possible antitrust liability,[49]

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38. S. Rep. No. 1622, 83d Cong., 2d Sess. 318 (1954).

39. Treas. Reg. § 1.537-2(b) (1973).

40. *Id.* § 1.537-2(a).

41. Ted Bates & Co., 34 P-H Tax Ct. Mem. 1476 (1965); Metal Office Furniture Co., 21 P-H Tax Ct. Mem. 952 (1952); Universal Steel Co., 5 T.C. 627 (1945); Dill Mfg. Co., 39 B.T.A. 1023 (1939), *nonacquiesced in* 1939-2 CUM. BULL. 47.

42. Schenuit Rubber Co. v. United States, 293 F. Supp. 280, 292-93 (D. Md. 1968); Alma Piston Co., 32 P-H Tax Ct. Mem. 1075, 1093 (1963).

43. Gazette Tel. Co., 19 T.C. 692, 707 (1953). *See also* p. 461, *infra.*

44. Delhar, Inc., 26 Am. Fed. Tax R.2d 5888, 5897 (S.D. Fla. 1970); Dielectric Materials Co., 57 T.C. 587, 598-99 (1972); Henry Van Hummel, Inc., 33 P-H Tax Ct. Mem. 1942, 1950 (1964), *aff'd,* 364 F.2d 746 (10th Cir. 1966), *cert. denied,* 386 U.S. 956 (1967); Penn Needle Art Co., 27 P-H Tax Ct. Mem. 434, 438 (1958); Wean Eng'r Co., 12 P-H Tax Ct. Mem. 1082, 1088 (1943). *See also* Bardahl Mfg. Co., 34 P-H Tax Ct. Mem. 1123, 1141 (1965), discussed p. 453, *infra.*

45. *Cf.* Factories Inv. Corp. v. Comm'r, 328 F.2d 781 (2d Cir. 1964).

46. Electric Regulator Corp. v. Comm'r, 336 F.2d 339, 345 (2d Cir. 1964) (development of a new, more expensive device); Fotocrafters, Inc., 29 P-H Tax Ct. Mem. 1554, 1562 (1960) (expansion into color photofinishing); Breitfeller Sales, Inc., 28 T.C. 1164, 1168 (1957), *acquiesced in* 1958-1 CUM. BULL. 4 (financing new auto dealership in growing territory).

47. Alma Piston Co., 32 P-H Tax Ct. Mem. 1075 (1963).

48. F.E. Watkins Motor Co., 31 T.C. 288, 298 (1958), *acquiesced in* 1959-1 CUM. BULL. 5.

49. Freedom Newspapers, Inc., 34 P-H Tax Ct. Mem. 1455, 1466 (1965).

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to finance protective suits against patent litigation,[50] to purchase "key-man" insurance,[51] to provide funds for anti-pollution equipment,[52] and for prior years' liabilities for the accumulated earnings tax.[53]

Conversely, unreasonable accumulations[54] are said to include (1) loans to or corporate expenditures for the benefit of shareholders;[55] (2) loans having no business purpose;[56] (3) loans to affiliated corporations whose business is not that of the taxpayer;[57] (4) unrelated business investment;[58] and (5) hedging against unreasonable hazards.[59]

50. Wean Eng'r Co., 12 P-H Tax Ct. Mem. 1082, 1088 (1943). A reasonable need may also be to finance other pending litigation. Jerome E. Casey, 26 P-H Tax Ct. Mem. 866, 874 (1957), *rev'd on other grounds*, 267 F.2d 26 (2d Cir. 1959); *cf.* J. Gordon Turnbull, Inc., 41 T.C. 358, 374 (1963).

51. Emeloid Co. v. Comm'r, 189 F.2d 230, 233 (3d Cir. 1951); General Smelting Co., 4 T.C. 313 (1944), *acquiesced in* 1945 CUM. BULL. 3.

52. Eberle Tanning Co., 29 Am. Fed. Tax. R.2d 1153, 1157 (M.D. Pa. 1971), *new trial denied*, 342 F. Supp. 1039 (M.D. Pa. 1972).

53. Rev. Rul. 70-301, 1970-1 CUM. BULL. 139.

54. Treas. Reg. § 1.537-2(c) (1973).

55. Cummins Diesel Sales, Inc. v. United States, 207 F. Supp. 746, 749 (D. Ore. 1962), *aff'd*, 321 F.2d 503 (9th Cir. 1963) (expenditures on behalf of other corporations controlled by sole stockholder of taxpayer corporation); Eastern Ry. & Lumber Co., 12 T.C. 869, 874 (1949) (purchases of timber). In Bahan Textiles Mach. Co. v. United States, 453 F.2d 1100, 1103 (4th Cir. 1972), *aff'g* 341 F. Supp. 962 (D.S.C. 1970), there were extensive corporate "gifts" to the shareholders and their families, which were held to be evidence of intent to avoid tax.

56. Kerr-Cochran, Inc., 24 P-H Tax Ct. Mem. 253, 258 (1955) (buying lots and erecting houses with profits inuring to shareholder); Wellman Operating Corp., 33 T.C. 162, 187 (1959) (loan to unrelated corporation to buy stock in another unrelated corporation); Stanton Corp., 44 B.T.A. 56, 67 (1941) (securities loaned to brokers because corporation had "substantial funds which were not needed in the business"). *See also* Nemours Corp., 38 T.C. 585, 603 (1962) (shareholder's cash requirements not a corporate business need).

57. Crawford County Printing & Publ. Co., 17 T.C. 1404, 1414-15 (1952); Stanton Corp., 44 B.T.A. 56, 82 (1941). *Contra*, Trico Sec. Corp., 41 B.T.A. 306, 316 (1940), *nonacquiesced in* 1944 CUM. BULL. 49 (subsidiary created solely as a market for parent); *see* Treas. Reg. § 1.537-3(b) (1973), where it is provided that if the parent owns 80 percent of its subsidiary's stock the business of the parent will be construed to include the business of the subsidiary. If the parent fails to pass the 80 percent ownership test, the particular circumstances of the case will prevail. *See also* Inland Oil & Chem. Corp. v. United States, 477 F.2d 836, 837 (4th Cir. 1973), *rev'g* 338 F. Supp. 1330 (D. Md. 1972), where the district court held that a subsidiary may not accumulate funds for its parent's needs.

58. Raymond I. Smith, Inc. v. Comm'r, 292 F.2d 470, 476 (9th Cir.), *cert. denied*, 368 U.S. 948 (1961) (liquor business had investment in farm land).

59. In T.C. Heyward & Co. v. United States, 18 Am. Fed. Tax R.2d 5775 (W.D.N.C. 1966), the taxpayer accumulated earnings because of his fear of another depression. The court stated, "The taxpayer's accumulations of income were fantastic. I do not believe that one bent on tax evasion would have the unmitigated gall to attempt it in such an obvious manner." *Id.* at 5775. The good faith but mistaken belief of the necessity of the accumulation prevented the imposition of the tax. The Government did not appeal.

*See also* J. Gordon Turnbull, Inc. v. Comm'r, 373 F.2d 87 (5th Cir.), *cert. denied*, 389 U.S. 842 (1967), where the remote possibility of liability on a tort claim, which

Since neither objective tests[60] nor empirical criteria are given by the regulations,[61] each case must be decided on its merits. Accordingly, the courts have taken the position that the directors and officers of the corporation are the most qualified to determine the needs of the business.[62] In *Hardin's Bakeries, Inc. v. Martin*,[63] the court said: "The business judgment of these experienced people [officers and directors] as to their business requirements for the proper and safe and sound conduct for such business is entitled to great weight."[64] This notion has become so strong that the Tax Court suggested almost a presumption of bona fide business purpose when it noted, "we should be hesitant to attribute a sinister or ulterior motive to the corporation unless such a factual situation clearly appears."[65]

The weight given by the courts to the professional businessman's judgment is indicated by the fact that accountants, business analysts, investment bankers and loan officers are often called as expert witnesses to substantiate the purposes for which the accumulations were made.[66] The regulations neither prescribe nor suggest statistical techniques which may be applied to a corporation's financial statements, so the courts have been forced to derive their own formulae. Items included in the calculations vary from court to court, often because of the different factors stressed by the aforementioned expert witnesses. The most varied instance is to be found in the judicial approach to the operating cycle of the business.

was adequately covered by insurance, was not sustained as a reason to accumulate earnings.

60. One of the financial ratios used by businessmen is the current ratio, the ratio of current assets to current liabilities. The size of this ratio that is considered "optimum" varies from industry to industry and from financial analyst to financial analyst. Cases which have held current ratios excessive are: Cheyenne Newspapers, Inc., 42 P-H Tax Ct. Mem. 235 (1973) (current ratio of 5:1); American Metal Prods. Corp., 34 T.C. 89 (1960), *aff'd*, 287 F.2d 860 (8th Cir. 1961) (21:1 to 106:1 for years in question); R. Gsell & Co., 34 T.C. 41 (1960), *rev'd on other grounds*, 294 F.2d 321 (2d Cir. 1961) (5:1 to 20:1); Federal Ornamental Iron & Bronze Co., 38 P-H Tax Ct. Mem. 414 (1969) (17:1). In Fotocrafters, Inc., 29 P-H Tax Ct. Mem. 1554 (1960) (2.87:1 to 1.87:1), the ratio was held not excessive.

61. One writer has suggested that the Internal Revenue Service adopt, by regulation or ruling, for retention as working capital reserves an amount equal to (a) 120 percent of that determined under operating cycle formulas, plus (b) the amount of current liabilities. Ziegler, *The "New" Accumulated Earnings Tax: A Survey of Recent Developments*, 22 TAX L. REV. 77, 102 (1966).

62. Sterling Distribs., Inc. v. United States, 313 F.2d 803 (5th Cir. 1963); Bremerton Sun Publ. Co., 44 T.C. 566 (1965); F.E. Watkins Motor Co., 31 T.C. 288 (1958), *acquiesced in* 1959-1 CUM. BULL. 5; Dill Mfg. Co., 39 B.T.A. 1023 (1939); Bradford-Robinson Printing Co. v. United States, 1 Am. Fed. Tax R.2d 1278 (D. Colo. 1957); Halby Chem. Co. v. United States, 19 Am. Fed. Tax R.2d 1589 (Ct. Cl. 1967).

63. 293 F. Supp. 1129 (S.D. Miss. 1967).

64. *Id.* at 1131.

65. Crawford County Printing & Publ. Co., 17 T.C. 1404, 1414 (1952), *acquiesced in* 1955-1 CUM. BULL. 4. However, there is a converse presumption against the taxpayer; *see* p. 465, *infra*.

66. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.03, at 8-13 (3d ed. 1971).

*The Operating Cycle Approach*

The difficulty of defining working capital[67] has plagued the courts in their attempts to determine what is a reasonable accumulation "to provide necessary working capital for the business" within the meaning of Treasury Regulation Section 1.537-2(b)(4). The Tax Court adopted the operating cycle approach in *Bardahl Manufacturing Corp.*[68] in 1965. In that case, net working capital was determined as follows:

*ADD:*

Cash

Notes and accounts receivable

Inventories

Government securities

Securities convertible to cash upon demand

*SUBTRACT:*

Accounts payable

Mortgages payable in one year

Accrued liabilities

Federal income taxes payable

Dividends payable

Prepaid expenses were not included in current assets but unrelated loans were included in accounts receivable.

The unreasonable accumulation was computed as follows:

*START WITH:*

Net working capital (*i.e.*, current assets minus current liabilities)

*ADD:*

Unrelated investments

Loans to unrelated businesses

67. Working capital is the difference between current liabilities and current assets. The difficulty is not just what to include as current assets and current liabilities, but just how much working capital is enough. For three different views of working capital adequacy, see J. COHEN & E. ZINBARG, INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 379-81 (1967); P. HUNT, C. WILLIAMS & C. DONALDSON, BASIC BUSINESS FINANCE 535-36 (4th ed. 1971); G. WELSCH, C. ZLATKOVICH & J. WHITE, INTERMEDIATE ACCOUNTING 1046 (3d ed. 1972).

68. 34 P-H Tax Ct. Mem. 1123 (1965). Not all courts are willing to follow the operating cycle approach. In R.C. Tway Co. v. United States, 23 Am. Fed. Tax R.2d 596 (W.D. Ky. 1968), the court declined to base its reasoning on operating cycle computations even though it did use such computations to collaborate its conclusions. *But see* Apollo Indus. v. Comm'r, 358 F.2d 867 (1st Cir. 1966), where it was held that failure to use operating cycle calculations is reversible error.

*SUBTRACT:*

Ordinary operating expenses for one business cycle

Anticipated extraordinary expenses[69]

The ordinary operating cycle was calculated on the basis of one operating cycle, which is the period of time required to convert cash into raw materials, raw materials into marketable inventory, inventory into sales and accounts receivable, and the time necessary to collect the outstanding accounts.[70]

Working capital requirements for the years in question were determined by the following formula:

$$\begin{array}{l}\text{Operating Expenses}\\ \text{(less depreciation and}\\ \text{federal income tax)}\end{array} + \left[\begin{array}{c}\text{Cost of}\\ \text{Goods}\\ \text{Sold}\end{array} \times \begin{array}{l}\text{Operating Cycle}\\ \text{(expressed as a}\\ \text{percent of the year)}\end{array}\right]$$
$$= \begin{array}{c}\text{Ordinary Operating Expenses For}\\ \text{One Business Cycle}\end{array}$$

The *Bardahl* approach was subsequently modified by *Magic Mart, Inc.*[71] The Tax Court held that peak inventory should be used in the *Bardahl* formula rather than average inventory. Magic Mart made all its sales on the cash basis, so the question of receivables was not determined until *Kingsbury Investments, Inc.*[72] There, peak receivables were used, but in a modified form. Because peak receivables occurred in January and peak inventory occurred in March, the court rejected the taxpayer's contention that peak figures should be used even though they do not occur simultaneously. Similarly, the Tax Court rejected the Commissioner's theory of average inventory and receivables, noting that the average method "does not reflect the demands upon petitioner's actual working capital."[73] Instead, it selected a month in which the sum of inventory plus accounts receivable exceeded that sum for any other month.[74] Presumably, if peak inventory and peak receivables occurred in the same month, then both absolutes could be used for

69. The reasonably anticipated extraordinary needs included contingencies for raw materials shortages, expansion of facilities, contemplated acquisitions and capitalization needs of foreign subsidiaries. Bardahl Mfg. Corp., 34 P-H Tax Ct. Mem. 1123, 1143 (1965).

70. *Id.* at 1130.

71. 51 T.C. 775, 793 (1969), *acquiesced in* 1969-2 CUM. BULL. 24 (in result only).

72. 38 P-H Tax Ct. Mem. 1174 (1969). The peak period operating cycle approach has its appeal in that it takes the position that the corporation needs working capital sufficient to finance its longest cycle during the year, not just its average operating cycle. Seasonal fluctuations will therefore not find the corporation short of cash. Additionally, the peak period approach requires the corporation to keep monthly inventory and accounts receivable balances. Most businesses do not.

73. *Id.* at 1180.

74. *Id.* at 1181.

computational purposes, particularly since this was the case in *Apollo Industries, Inc. v. Commissioner.*[75]

*Apollo* represents a second theory of computation. The Court of Appeals for the First Circuit found that the operating cycle included purchased materials needed in inventory and operating costs incurred during the period needed to collect outstanding receivables.[76] Working capital was therefore computed as follows to adjust for these factors:

$$\text{Raw Materials Inventory} + \left[ \frac{\text{Accounts Receivable}}{\text{Sales}} \times \begin{matrix} \text{Operating Expenses} + \\ \text{Cost of Goods Sold} - \\ \text{Raw Materials Cost} \end{matrix} \right]$$

Although the court used an average of the beginning and ending balances of the raw materials inventory during the year and the average of the beginning and ending accounts receivable balances, it stated that the ending balances alone would be acceptable.[77]

In the formula, the remainder of cost of goods sold, after reduction by the amount of raw materials consumed, was included with operating expenses because the figure was insignificant.[78] By extension, therefore, the *Apollo* formula may be reduced to the following where that figure is not minor in amount:

$$\text{Raw Materials Inventory} + \left[ \frac{\text{Accounts Receivable}}{\text{Sales}} \times \text{Operating Expenses} \right]$$

Curiously, depreciation is not included as an operating expense, as in *Bardahl.* The *Bardahl* formula does not, however, include advertising expenses,[79] and it is not clear if this is properly includable in the *Apollo* formula.

Although remanded to the Tax Court for further findings of fact on anticipated extraordinary expenses, the case was settled out of court before those additional determinations were made. It is not clear why materials and manufacturing costs were excluded during the collection period and operating expenses ignored during inventory turnover. Perhaps this was because of the court's use of a de novo approach rather than the established *Bardahl* method.

Prepaid expenses, which were left out in both *Bardahl Manufacturing* and *Apollo,* were finally included in the calculation of working capital in *Bardahl International Corp.*[80] Thus, an inclusion of prepaid expenses will increase

75. 358 F.2d 867 (1st Cir. 1966), *rev'g sub. nom.* Alles & Fischer, Inc., 44 T.C. 1 (1965).
76. *Id.* at 872.
77. *Id.* at 872.
78. *Id.* at 872.
79. Bardahl Mfg. Corp., 34 P-H Tax Ct. Mem. 1123, 1142 (1965).
80. 35 P-H Tax Ct. Mem. 1051, 1061-62 (1966).

the size of the necessary working capital, thereby lowering the tax liability of the corporation if the accumulated earnings tax should be imposed.

The question of the inclusion of federal income taxes in the formula was not settled until much later. Federal income taxes for the previous year but unpaid (and therefore a current liability) were included in the *Bardahl* formula.[81] Although estimated income taxes paid during the year were included as an operating expense by the Tax Court in *Empire Steel Castings, Inc.*,[82] the Court of Appeals for the Tenth Circuit refused to allow their inclusion where this resulted in a double deduction.[83]

*The Operating Cycle Illustrated*

By assuming some hypothetical data (Figures 3 and 4) for Widget Corporation,[84] the operating cycle computations of the *Bardahl* formula may be

81. Bardahl Mfg. Corp., 34 P-H Tax Ct. Mem. 1123, 1129 (1965).

82. 43 P-H Tax Ct. Mem. 144 (1974).

83. Cheyenne Newspapers, Inc. v. Comm'r, 494 F.2d 429 (10th Cir. 1974), *aff'g* 42 P-H Tax Ct. Mem. 235 (1973).

> The government does not contend, and the Tax Court did not hold, the appropriate federal income tax payments may not be used to reduce an asserted accumulated earnings surplus. Taxpayer's surplus was, in fact, reduced by the above amounts which apparently were considered to be part of 'current expenses.' Taxpayer, however, asserts that such sums should be considered 'reasonably anticipated business expenses' as well as 'current expenses.' The result would be a double income tax reduction from accumulated earnings for each year in issue.
>
> Taxpayer is attempting to gain an advantage it is not entitled to receive. A corporation may not take a double reduction for federal income taxes in justifying accumulated earnings.

*Id.* at 435.

84. FIGURE 3

WIDGET CORPORATION
COMPARATIVE BALANCE SHEET
FOR YEAR ENDED DEC. 31, 1973

ASSETS

| | 1972 | 1973 |
|---|---|---|
| Cash | $275,000 | $300,000 |
| Accounts Receivable | 95,000 | 125,000 |
| Inventory | 95,000 | 105,000* |
| Prepaid Expenses | 43,000 | 50,000 |
| Government Securities | 100,000 | 150,000 |
| Marketable Securities | 35,000 | 40,000 |
| Current Assets | $593,000 | $770,000 |
| Building and Plant (net of accumulated depreciation) | 478,000 | 500,000 |
| Furniture and Fixtures | 137,000 | 125,000 |
| Investment in Subsidiary | 150,000 | 150,000 |
| Other Assets (patents, goodwill, etc.) | 58,750 | 52,000 |
| TOTAL ASSETS | $1,416,750 | $1,597,000 |

illustrated. The inventory turnover ratio is determined by the average of the beginning and ending inventories[85] divided by the cost of goods sold:

| | | |
|---|---|---|
| **LIABILITIES** | | |
| Accounts Payable | $ 6,000 | $ 5,000 |
| Mortgages Payable within one Year | 4,000 | 3,500 |
| Accrued Liabilities | 38,000 | 42,000 |
| Federal Income Taxes Payable | 150,000 | 173,000 |
| Dividends Payable | 40,000 | 50,000 |
| Current Liabilities | $238,000 | $273,500 |
| Mortgages and other Long-Term Debt | 148,500 | 145,000 |
| Debentures Payable | 100,000 | 100,000 |
| Total Liabilities | $486,500 | $518,500 |
| **EQUITY** | | |
| Capital Stock, Issued and Outstanding | $100,000 | $100,000 |
| Paid-In Capital | 20,500 | 20,500 |
| Retained Earnings: | | |
| Appropriated for Plant Expansion | 300,000 | 325,000 |
| Unappropriated | 509,750 | 633,000 |
| Total Equity | $930,250 | $1,597,000 |
| TOTAL LIABILITIES AND EQUITY | $1,416,750 | $1,597,000 |

* Includes a loan of $2,000 to an unrelated business

FIGURE 4

WIDGET CORPORATION
INCOME STATEMENT
FOR YEAR ENDED DEC. 31, 1973

| | | |
|---|---|---|
| Net Sales | | $1,200,000 |
| Less: Cost of Goods Sold: | | |
| Materials | $335,000 | |
| Direct Labor | 150,000 | |
| Manufacturing Overhead | 50,000 | 535,000 |
| Gross Margin on Sales | | 665,000 |
| Interest Income | | 12,500 |
| Rental Income | | 9,500 |
| Other Income | | 4,000 |
| Gross Income | | $691,000 |
| Salaries and Wages (other than mfg.) | $125,000 | |
| Depreciation and Amortization | 31,750 | |
| Advertising | 94,000 | |
| Interest Expense | 19,500 | |
| Contributions to Pension Plan | 15,000 | |
| Other Expenses | 12,500 | |
| Operating Expenses | $297,750 | |
| Charitable Contributions | 25,000 | 322,750 |
| Income before Taxes | | $368,250 |
| Less: Federal Income Tax | | 173,000 |
| NET INCOME | | $195,250 |

85. The fiscal year of many corporations ends at a time when inventories and accounts receivable are their lowest. The corporation should use the figures for the

| | |
|---|---|
| Inventory, Dec. 31, 1972 | \$ 95,000 |
| Inventory, Dec. 31, 1973 | 105,000 |
| | \$200,000 |
| Average Inventory | \$100,000 |

$$\frac{\text{Average Inventory}}{\text{Cost of Goods sold}} \times 365 \text{ days} = \frac{\$100{,}000}{\$535{,}000} \times 365 = \underline{\underline{68.2 \text{ days}}}$$

The collection period is similarly calculated:

| | |
|---|---|
| Accounts Receivable, Dec. 31, 1972 | \$ 95,000 |
| Accounts Receivable, Dec. 31, 1973 | 125,000 |
| | \$220,000 |
| Average Accounts Receivable | \$110,000 |

$$\frac{\text{Average Receivables}}{\text{Sales}} \times 365 \text{ days} = \frac{\$110{,}000}{\$1{,}200{,}000} \times 365 = \underline{\underline{33.5 \text{ days}}}$$

The length of the operating cycle is the sum of the inventory turnover period and the collection period, or 101.7 days. This figure is then used to determine the working capital reserve:

$$\frac{\text{Operating Cycle}}{\text{365 days per year}} \times \left[\begin{array}{l}\text{Cost of Goods Sold} + \text{Operating} \\ \text{Expenses} - \text{Depreciation}\end{array}\right]$$

$$= \frac{101.7}{365} \times [\$535{,}000 + \$297{,}750 - \$31{,}750] = \underline{\underline{\$223{,}183}}$$

Here, the working capital requirement for one operating cycle is \$223,183. When the corporation's available working capital is determined from the balance sheet by subtracting current liabilities from current assets (\$770,000 — \$273,500 = \$496,500), it is apparent that the corporation already has adequate working capital, and the amount of the accumulation over and above the working capital requirement must be justified on other grounds.

The working capital requirement necessary to carry the corporation through one operating cycle computed under the *Apollo* formula is much less:

$$\text{Inventory} + \left[\frac{\text{Accounts Receivable}}{\text{Sales}} \times \text{Operating Expenses}\right]$$

$$= \$105{,}000 + \left[\frac{\$125{,}000}{\$1{,}200{,}000} \times \$297{,}000\right] = \underline{\underline{\$135{,}937}}$$

*Some Valuation Problems*

Since asset valuations for financial accounting purposes and actual market values usually differ, the question of which measure should be used in cal-

month in which the sum of outstanding accounts and inventory exceed that sum for all other months. *See* Kingsbury Invs., Inc., 38 P-H Tax Ct. Mem. 1174, 1181 (1969), discussed, p. 454, *supra*.

culating working capital must be determined. The most apparent problem is that of the valuation of appreciated marketable securities.

Most courts, including the Supreme Court, have held that such securities must be valued at market for section 531 tax computational purposes.[86] Although the Court of Appeals for the Fifth Circuit recently held that the correct figure would be the fair market value of such securities less the costs that would be incurred in converting them to cash,[87] the Tax Court will not take these conversion costs into consideration.[88]

The Tax Court originally held that when the value of the securities is depressed, and the corporation would realize a loss if they were sold, shrinkage in market value should be considered.[89] The Supreme Court, in *Helvering v. National Grocery Co.*,[90] has indicated that depressed securities should be carried at cost.[91] The unfairness of this result can be seen by analyzing the concept behind valuing appreciated securities at fair market value. If the test of excess corporate accumulations is the amount of liquid assets that *would be available* if needed, then clearly marketable securities should be valued at what they would bring if liquidated, irrespective of the gain or loss that might be realized.

*Accumulations for a Specific Purpose—Capital Asset Expansion*

Quite frequently an expansion of corporate balance sheets will disclose various sinking funds listed as assets and retained earnings appropriated for various purposes in the capital section. Typically, these sinking funds, which are basically savings accounts and often are administered by trustees, are established to repay debt as required by the bond contract or loan agreement, and retained earnings are appropriated for plant expansion or for some contingency.

Mere balance sheet appropriations are not enough, however.[92] The tax-

86. Helvering v. National Grocery Co., 304 U.S. 282, 291 (1938); *accord,* Golconda Mining Corp., 58 T.C. 736, 737-38 (1972).

87. Ivan Allen Co. v. United States, 493 F.2d 426, (5th Cir. 1974), *rev'g and rem'g* 349 F. Supp. 1075, 1077 (N.D. Ga. 1972); *see* American Trading & Prod. Corp. v. United States, 29 Am. Fed. Tax. R.2d 1301, 1307 (D. Md. 1972); Harry A. Koch Co. v. Vinal, 228 F. Supp. 782, 784 (D. Neb. 1964); Golconda Mining Co., 58 T.C. 736, 739-40 (1972). Brokerage fees would be an example of these conversion costs.

Similarly, where a construction company received municipal special assessment warrants as an advance fee they were marketable securities to be valued at fair market value, not accounts receivable as the taxpayer contended. Ready Paving & Constr. Co., 9 CCH 1974 STAND. FED. TAX REP. ¶ 7310, 61 T.C. —, No. 86 (1974).

88. *See* Golconda Mining Corp., 58 T.C. 736 (1972).

89. C.H. Spitzner & Son, Inc., 37 B.T.A. 511, 529-39 (1938), *nonacquiesced in* 1938-2 CUM. BULL. 58. *Contra,* Nipoch Corp., 36 B.T.A. 662, 668-69 (1937).

90. 304 U.S. 282 (1938).

91. *Id.* at 291.

92. *See, e.g.,* American Metal Prods. Corp. v. Comm'r, 287 F.2d 860, 863 (8th Cir. 1961).

payer corporation must show something more than a vague desire to expand the plant and capital assets.[93] The fact that a corporation has planned an expansion program in good faith,[94] even though it may be delayed for bona fide business reasons,[95] is important evidence in favor of the taxpayer. But the fact that the plan was never carried out is strong evidence against the corporation.[96] Abandonment of the plan, however, is not fatal when the evidence is clear that the plan was real and not a mere excuse to support the taxpayer's case.[97]

Because the reasonable needs of the business include the reasonably anticipated needs of the business,[98] the expansion plans need not be carried out immediately,[99] but there still must be indications that they will be carried

93. Dixie, Inc. v. Comm'r, 277 F.2d 526, 528 (2d Cir.), *cert. denied*, 350 U.S. 894 (1960) (possibility of purchase of competing hotel); I.A. Dress Co. v. Comm'r, 273 F.2d 543, 544 (2d Cir. 1960) (possibility that lessee might purchase building from lessor); Fenco, Inc. v. United States, 234 F. Supp. 317, 323-24 (D. Md. 1964), *aff'd per curiam*, 348 F.2d 456 (4th Cir. 1956) (building plans "vague and indefinite"); Novelart Mfg. Co., 52 T.C. 794, 806 (1969), *aff'd*, 434 F.2d 1011, 1012 (6th Cir. 1970), *cert. denied*, 403 U.S. 918 (1971) (corporation considered various acquisitions, none of which were consummated).

94. Hardin's Bakeries, Inc. v. Martin, 293 F. Supp. 1129, 1131 (S.D. Miss. 1967); American Lawn Mower Co. v. United States, 12 Am. Fed. Tax R.2d 6162, 6167-68 (S.D. Ind. 1963); Independent Laundry & Linen Serv., Inc. v. United States, 10 Am. Fed. Tax. R.2d 5992, 5993 (S.D. Ind. 1962); Freedom Newspapers, Inc., 34 P-H Tax Ct. Mem. 1455, 1463 (1965); Frank H. Ayres & Son, 23 P-H Tax Ct. Mem. 886, 887 (1954); Central Motors, Inc., 23 P-H Tax Ct. Mem. 741, 743-44 (1954); Columbus Die, Tool & Mach. Co., 21 P-H Tax Ct. Mem. 940, 949, 951 (1952); National Yarn Corp., 19 P-H Tax Ct. Mem. 551, 557 (1950); General Smelting Co., 4 T.C. 313, 323 (1944); Wean Eng'r Co., 12 P-H Tax Ct. Mem. 1082, 1089 (1943).

95. Knoxville Iron Co., 28 P-H Tax Ct. Mem. 220, 229-30 (1959) (6 years); Thomas S. Lee Enterprises, Inc., 22 P-H Tax Ct. Mem. 660 (1953) (2 years); J.L. Goodman Furniture Co., 11 T.C. 530, 535 (1948) (12 years); Universal Steel Co., 5 T.C. 627 (1945) (more than 3 years).

96. Oyster Shell Prods. Corp. v. Comm'r, 313 F.2d 449 (2d Cir. 1963). "The Tax Court's conclusion that this alleged fear of flooding [of the Mississippi River and therefore the necessity to relocate the plant] was conjured up when it learned of the Commissioner's intention to impose the surtax is well supported by the record." *Id.* at 453; *accord*, Novelart Mfg. Co., 52 T.C. 794, 809 (1969), *aff'd*, 434 F.2d 1011 (6th Cir. 1970), *cert. denied*, 403 U.S. 918 (1971); Youngs Rubber Corp., 31 P-H Tax Ct. Mem. 1766, 1773 (1962), *aff'd per curiam*, 331 F.2d 12 (2d Cir. 1964).

97. The accumulated earnings tax was not imposed where a corporation accumulated its earnings and profits for certain projects which it started but did not finish because other, more important, projects had to be completed first. The court, in holding immaterial that the projects were not carried through to completion, did not want to "second guess" management on which projects were of the highest priority. Empire Steel Castings, Inc., 43 P-H Tax Ct. Mem. 144 (1974); *see* Frank H. Ayres & Son, 23 P-H Tax Ct. Mem. 886, 890 (1954); Lane Drug Co., 13 P-H Tax Ct. Mem. 430, 431 (1944); Howard Flint Ink Co., 11 P-H Tax Ct. Mem. 1019, 1025 (1942).

But the unexecuted plan runs the risk of being characterized as an afterthought to justify the accumulation. *See* Walton Mill, Inc., 41 P-H Tax Ct. Mem. 77, 91 (1972); Henry Van Hummell, Inc., 33 P-H Tax Ct. Mem. 1942, 1956 (1964), *aff'd*, 364 F.2d 746 (10th Cir. 1966), *cert. denied*, 386 U.S. 956 (1967).

98. INT. REV. CODE OF 1954, § 537(a)(1).

99. KOMA, Inc. v. Jones, 44 Am. Fed. Tax. R. 1267, 1269-70 (W.D. Okla. 1953),

out in a reasonable time. A mere possibility that expansion will be carried out at some future indefinite date is inadequate.[100]

In *Bardahl Manufacturing Corp.*,[101] the Tax Court sustained the taxpayer's contention that part of the earnings were being accumulated for plant expansion. Architect's renderings of proposed buildings were introduced into evidence as were references made to the plans in the corporate minutes.[102] Similarly, a proposed modernization program was held a valid reason for the accumulation of earnings even though the plans had been delayed for six years.[103]

If retained earnings are appropriated for asset replacement, the taxpayer must be particularly careful in his planning and documentation. Since depreciation reserves are a charge against current earnings, and would therefore not be included in a calculation of the unreasonable accumulation, replacement reserves would constitute a double accumulation for the same asset. Thus, it will have to be shown that the replacement reserve is justified by the inadequacy of the depreciation reserve.[104]

*Accumulations for a Specific Purpose—Debt Retirement and Internal Financing*

Commercial lenders often require dividend restrictions and minimum working capital levels of their corporate borrowers, while banks often require compensating balances.[105] Similarly, bond covenants may have dividend restrictions and sinking fund requirements.[106] Because of the frequency of such restrictions on the distribution of earnings to the shareholders, accumulations for debt retirement purposes are legitimate and meet the reasonable needs of the business test.[107] The bond covenants or loan restrictions, how-

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*aff'd*, 218 F.2d 530 (10th Cir. 1955); *accord*, Gazette Tel. Co., 19 T.C. 692, 707 (1953); Crawford County Printing & Publ. Co. v. Comm'r, 17 T.C. 1404, 1414 (1952); Little Rock Towel & Linen Supply Co., 21 P-H Tax Ct. Mem. 34, 38 (1952).

100. World Publ. Co. v. United States, 72 F. Supp. 886, 895 (N.D. Okla. 1947), *aff'd*, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949); *accord*, Havens & Martin, Inc. v. United States, 15 Am. Fed. Tax R.2d 1140, 1146 (D. Va. 1965); Al Goodman, Inc., 23 T.C. 288, 303 (1954); Frank H. Ayres & Son, 23 P-H Tax Ct. Mem. 886, 890 (1954); E.L. Bride, 22 P-H Tax Ct. Mem. 1089, 1093 (1953), *aff'd*, 224 F.2d 39 (8th Cir. 1955); Korick's, Inc., 22 P-H Tax Ct. Mem. 313 (1953); KOMA, Inc., 18 P-H Tax Ct. Mem. 919, 923 (1949), *aff'd*, 189 F.2d 390 (10th Cir. 1951); Colonial Amusements Corp., 17 P-H Tax Ct. Mem. 471, 474 (1948).

101. 34 P-H Tax Ct. Mem. 1123 (1965).

102. *Id.* at 1130-31.

103. Knoxville Iron Co., 34 P-H Tax Ct. Mem. 220, 229-30 (1959).

104. Rev. Rul. 67-64, 1967-1 CUM. BULL. 150; *see* Smoot Sand & Gravel Corp. v. Comm'r, 274 F.2d 495 (4th Cir. 1960).

105. P. HUNT, C. WILLIAMS & G. DONALDSON, BASIC BUSINESS FINANCE 241 (4th ed. 1971). Such restrictive conditions are often imposed when the loan is not secured by a mortgage.

106. *Id.* at 347-48, 439-41.

107. Treas. Reg. § 1.537-2(b)(3) (1973).

ever, must be reasonable in light of the borrower's financial status.[108] An agreement with a bank not to make dividend distributions until the outstanding loan has been repaid is not controlling, but is simply a factor to be considered in determining whether there is an unreasonable accumulation.[109] If the debt holders are also the owners of a substantial amount of the corporation's stock, such restrictions are especially vulnerable.[110]

If the debt can be refinanced or refunded at more advantageous terms, and the corporation fails to do so, the Supreme Court has suggested that the corporation should become liable for imposition of the accumulated earnings tax.[111] This approach has not been followed, however, because of the general policy of giving great weight to the judgment of the corporate directors[112] and the reluctance of the courts to send a corporation to the bank.[113]

Dicta in *Helvering v. Chicago Stock Yards Co.*[114] has also raised the question of equity financing versus internal financing through retention of earnings.[115] It was suggested that the corporation pay a dividend to the shareholders, who would then reinvest the earnings by additional stock purchases. The similarity in result to a stock dividend cannot be ignored; in both capitalization techniques, a reduction in retained earnings is offset by an increase in the common stock and capital surplus accounts. A stock dividend is generally non-taxable, whereas the payment of a cash dividend is taxable to the shareholders.[116] The reinvestment advocated by the Supreme Court would be reduced by the amount of income taxes paid on the dividend and would therefore be economically inefficient from the corporation's point of view.[117]

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108. Trico Sec. Corp., 41 B.T.A. 306, 318 (1940), *nonacquiesced in* 1940-1 CUM. BULL. 9.

109. Gazette Tel. Co., 19 T.C. 692, 707 (1953).

110. Smoot Sand & Gravel Corp. v. Comm'r, 241 F.2d 197, 204 (4th Cir. 1957).

111. Helvering v. Chicago Stockyards Co., 318 U.S. 693 (1943).

112. *See, e.g.*, Hardin's Bakeries, Inc. v. Martin, 293 F. Supp. 1129, 1131 (S.D. Miss. 1967).

113. *See, e.g.*, General Smelting Co., 4 T.C. 313, 323 (1944), *acquiesced in* 1945 CUM. BULL. 3.

114. 318 U.S. 693 (1943).

115. *Id.* at 701-702.

116. INT. REV. CODE OF 1954, § 305(a); *see* p. 465, *infra*.

117. Strict application of this approach would virtually eliminate the retention of earnings for business needs in those cases where the after-tax divided proceeds would meet those needs if reinvested by the shareholder. The Supreme Court's suggestion therefore appears to be in direct conflict with, and probably overruled by, the policy established by INT. REV. CODE OF 1954, § 533(a).

The following cases hold that business needs may be properly financed by retained earnings: United States v. Duke Labs., Inc., 337 F.2d 280 (2d Cir. 1964); Electric Regulator Corp. v. Comm'r, 336 F.2d 339 (2d Cir. 1964); John P. Scripps Newspapers, 44 T.C. 453, 465 (1965); Gazette Tel. Co., 19 T.C. 692 (1953), *aff'd*, 209 F.2d 926 (10th Cir. 1954), *acquiesced in* 1954-2 CUM. BULL. 4.

Two recent cases upholding equity rather than debt financing are: Faber Cement Block Co., 50 T.C. 317, 323 (1968), *acquiesced in* 1968-2 CUM. BULL. 2; Adolph Coors Co., 37 P-H Tax Ct. Mem. 1477, 1487 (1968).

*Accumulated Earnings and Winding Up the Business*

If a corporation chooses to wind up its business by selling its assets and reducing everything to cash or securities, it must have definite plans to enter into another business or be liable for the accumulated earnings tax. Where a clothing business sold all its assets in 1968 and left part of the proceeds in cash and the remainder in marketable securities, its failure to distribute the assets in liquidation or make plans to enter another business before the end of its fiscal year rendered it liable for the penalty tax.[118] This was true even though the delay between the sale of the assets and the eventual distribution to the shareholders was only five months.[119] In *John P. Lynch Co. v. United States*,[120] the court said: "The mere fact of cessation of the [taxpayer's] business does not in and of itself provide a basis for avoiding the accumulated earnings tax."[121]

*The Ability to Pay Dividends Test*

Since the accumulated earnings tax is imposed as a penalty to punish corporations who fail to distribute their earnings and profits to their shareholders, the Commissioner places great emphasis on the taxpayer's ability to pay dividends. If dividend payments are restricted for valid reasons or accumulations are being made for reasonable business needs, then the test may not be met. But, since the taxpayer corporation must give its balance sheet in Schedule L of its corporate income tax return, high cash balances[122] and high balances in sinking funds and appropriated retained earnings accounts operate as a red flag for closer scrutiny. The theory is that a high cash balance is indicative of the ability to pay dividends, and that sinking funds and retained earnings appropriations may be excessive.

At one time, the Treasury closely examined returns of corporations not distributing at least 70 percent of their current earnings. Although this procedure was discontinued in 1959,[123] dividend payout ratios[124] are factors considered by the courts.[125]

118. Alex Brown, Inc., 60 T.C. 364 (1973), *aff'd per curiam*, 496 F.2d 621 (6th Cir. 1974).

119. *Id.*

120. CCH 1974 STAND. FED. TAX. REP., U.S. Tax Cas. (74-1, at 83,567) ¶ 9273 (C.D. Cal. Feb. 27, 1974).

121. *Id. Contra,* Florida Iron & Metal Co., 11 P-H B.T.A. Mem. 1015 (1942).

122. Cash, as used here, includes near-cash items such as Treasury bonds, marketable securities, and other liquid assets.

123. T.D. 6378, 1959-1 CUM. BULL. 680. This change was prompted by the Senate Finance Committee's finding that "[s]ome of the standards informally employed in the past, such as the distribution of 70 percent of earnings, have been erroneous or irrelevant." S. Rep. No. 1622, 83d Cong., 2d Sess. 69 (1954).

124. The dividend payout ratio is computed by dividing dividends paid for the year by the year's net income.

125. The payout ratios for the taxable years in question were as follows in these

Courts have consistently held that a corporation is not guilty of unreasonably accumulating earnings if it did not have sufficient cash or other distributable assets with which to pay dividends,[126] or if it would have been forced to borrow to cover costs of subsequent operations if such dividends were paid.[127] A corporation, however, cannot invest its cash in various assets such as unmarketable securities[128] and claim it is unable to pay dividends, since the stock or other property can be distributed as a dividend in kind[129] under section 301. The tax consequences of the distribution of appreciated property as a dividend in kind is shown in the following example.

*Example.* X Corporation has an adjusted taxable income of $500,000. During its taxable year it distributes common stock of another corporation to its shareholders, fair market value of which on the date of distribution is $400,000. The stock has a basis to X Corporation of $100,000. The reasonable needs of the business are such that the accumulated earnings credit computed under section 535(c) is $130,000. The accumulated taxable income is computed as follows:

| | | |
|---|---|---|
| Adjusted taxable income | | $500,000 |
| Less: Dividends paid deduction of section 561 | $100,000 | |
| Accumulated earnings credit | $130,000 | 230,000 |
| Accumulated Taxable Income | | $270,000 |

The shareholders will include $400,000 (the fair market value of the stock)

cases won by the taxpayers: John P. Scripps Newspapers, 44 T.C. 453 (1965) (25-33%); Carolina Rubber Hose Co., 34 P-H Tax Ct. Mem. 1268 (1965) (27-29%); Bremerton Sun Publ. Co., 44 T.C. 566 (1965) (27-28%); James M. Pierce Corp., 38 T.C. 643 (1962), *rev'd on other grounds*, 326 F.2d 67 (2d Cir. 1964) (41-44%). The following cases were decided for the Commissioner: Shaw-Walker Co., 34 P-H Tax Ct. Mem. 1872 (1965) (31-43%); Bardahl Mfg. Corp., 34 P-H Tax Ct. Mem. 1123 (1965) (18%); Henry Van Hummell, Inc., 33 P-H Tax Ct. Mem. 1942 (1964), *aff'd*, 364 F.2d 746 (10th Cir. 1966), *cert. denied*, 386 U.S. 956 (1967) (54%); J. Gordon Turnbull, Inc., 41 T.C. 358 (1963) (15%). The dividend record was a factor emphasized by the court in each of these cases. The *Van Hummell* decision is particularly significant since it shows that a corporation which pays out more than half its current earnings may nevertheless be liable for the tax if it is unable to justify the accumulation.

126. But if the corporation has rendered itself illiquid or otherwise unable to pay a dividend because of its use of funds for purposes unrelated to the corporate business, then such illiquidity is not a defense since a dividend could have been paid had the corporation not engaged in such unrelated investing. *See* Nemours Corp., 38 T.C. 585 (1962), *aff'd per curiam*, 325 F.2d 559 (3d Cir. 1963); Whitney Chain & Mfg. Co., 3 T.C. 1109 (1944), *aff'd per curiam*, 149 F.2d 936 (2d Cir. 1945).

127. *See* General Smelting Co., 4 T.C. 313 (1944), *acquiesced in* 1945 CUM. BULL. 3; Sauk Inv. Co., 34 B.T.A. 732 (1936).

128. *But see* Treas. Reg. § 1.537-2(b)(5) (1973).

129. INT. REV. CODE OF 1954, § 317(a). *But see* Sterling Distribs. Inc. v. United States, 313 F.2d 803, 807-808 (5th Cir. 1963), where the court rejected the Government's contention that unsuitable land could be distributed in kind to the shareholders. The court did agree, however, that it could be sold and the proceeds distributed as a dividend.

in gross income, pursuant to section 301(c), and the corporation will be liable for the accumulated earnings tax on $270,000.

A corporation's distribution of its own stock as a dividend is an entirely different matter. Under this procedure, a charge is made against retained earnings for the fair market value of the stock distributed, and the capital stock accounts are credited. Qualified stock dividends are non-taxable in the hands of the shareholders,[130] and this appears to be quite a neat solution to the imposition of the accumulated earnings tax. In spite of the fact that the circuit court felt such a capitalization of earnings was not a factor leading to the conclusion of unreasonable accumulations,[131] the Tax Court will probably continue to hold otherwise. In *Harry A. Koch Co. v. Vinal*,[132] the district court held that since section 312(d) provides that the distribution of a non-taxable stock dividend has no effect other than concealment on earnings and profits, a stock dividend is not to be considered in determining whether there has been an unreasonable accumulation of earnings.[133] Although the Commissioner did not appeal, he will not follow this case.[134] Another district court refused to follow *Koch*, finding that stock dividends have no effect on earnings and profits for *section 531 tax purposes*.[135]

## ESTABLISHING THE REASONABLENESS OF THE ACCUMULATION: BURDEN OF PROOF

### *Presumptions Against the Taxpayer*

When the earnings of the corporation are permitted to accumulate beyond the reasonable needs of the business, a statutory presumption arises that the purpose is to avoid income tax with respect to the shareholders,[136] but the presumption is rebuttable upon the contrary showing by a clear preponderance of the evidence.[137] If the Commissioner, however, can show that the corporation is a mere holding or investment company, he has made out a prima facie case of this tax-avoidance purpose.[138]

130. INT. REV. CODE OF 1954, § 305(a). The non-taxability of such dividends is the general rule, but if stock is taken in lieu of cash (or if that option is given), or if the stock dividends are disproportionate with respect to the interests of the stockholders, then the dividend is includable in gross income. *Id.* § 305(b).

131. Sears Oil Co. v. Comm'r, 359 F.2d 191, 196 (2d Cir. 1966), *rev'd*, 34 P-H Tax Ct. Mem. 229 (1965). The tax was imposed anyway.

132. 228 F. Supp. 782 (D. Neb. 1964).

133. *Id.* at 784-85. The court's reasoning was based on the unavailability of such recapitalized funds for dividend distribution under Nebraska law.

134. Rev. Rul. 65-68, 1965-1 CUM. BULL. 246.

135. E-Z Sew Enterprises, Inc. v. United States, 260 F. Supp. 100, 123 (E.D. Mich. 1966).

136. INT. REV. CODE OF 1954, § 533(a).

137. *Id.* § 533(b).

138. *Id.* § 534.

The Supreme Court, in *Welch v. Helvering*,[139] further aided the Commissioner by finding a presumption of the correctness of his determinations.[140] This device merely requires the introduction of legally sufficient contrary evidence by the taxpayer; the presumption of correctness is no longer a factor and is not to be weighed as evidence in determining the outcome.[141] But if both the taxpayer and the Commissioner introduce legally sufficient evidence on a fact issue such that the weight of evidence is equally balanced in the mind of the finder of fact, the taxpayer must lose.[142] Hence the taxpayer also has the burden of persuasion in addition to the burden of going forward with the evidence created by the presumption of correctness.[143] It has been said that where the taxpayer has both burdens of proof, then the existence of a presumption against him with respect to those burdens adds nothing to his burden of proof.[144]

### *Shifting the Burden of Proof*

The Code provides some relief for the taxpayer by allowing him to shift the burden of proof in the Tax Court to the Commissioner.[145] This burden may shift under two circumstances. First, if the Commissioner should fail to notify the taxpayer corporation that he proposes to issue a deficiency no-

139. 290 U.S. 111 (1933).

140. *Id.* at 115; *accord*, J.M. Perry & Co. v. Comm'r, 120 F.2d 123, 124 (9th Cir. 1941); Helvering v. Talbot's Estate, 116 F.2d 160, 162 (4th Cir. 1940); Wiget v. Becker, 84 F.2d 706, 707 (8th Cir. 1936).

141. *See* J.M. Perry & Co. v. Comm'r, 120 F.2d 123, 124 (9th Cir. 1941); Helvering v. Talbot's Estate, 116 F.2d 160, 162 (4th Cir. 1940); Wiget v. Becker, 84 F.2d 706, 707-708 (8th Cir. 1936).

142. *See* Lawrence v. Comm'r, 143 F.2d 456 (9th Cir. 1944); Dayton Co. v. Comm'r, 90 F.2d 767 (8th Cir. 1937); Uncasville Mfg. Co. v. Comm'r, 55 F.2d 893 (2d Cir.), *cert. denied*, 286 U.S. 545 (1932).

143. The burden of persuasion and the burden of going forward with the evidence are sometimes called the burden of proof, but the two were distinguished in R. Gsell & Co. v. Comm'r, 294 F.2d 321, 326 (2d Cir. 1961).

144. Chicago Stock Yards Co. v. Comm'r, 129 F.2d 937, 948 (1st Cir. 1942), *rev'd sub. nom. on other grounds*, Helvering v. Chicago Stock Yards Co., 318 U.S. 693 (1943) (statutory presumptions as to unreasonable accumulations "would seem not to amount to much"); United Business Corp. v. Comm'r, 62 F.2d 754, 755 (2d Cir. 1933), *cert. denied*, 290 U.S. 635 (1935) ("presumption does no more than make the taxpayer show his hand"); Williams Inv. Co. v. United States, 3 F. Supp. 225, 236-37 (Ct. Cl. 1937) (concurring opinion) (the presumption "simply places the burden of proof upon plaintiff, just where it is in all tax cases" and is therefore "entirely unnecessary"). *But see* Treas. Reg. 1.533-1(b) (1973), where it is said that if earnings and profits are allowed to accumulate beyond the reasonable needs of the business "then section 533(b) adds still more weight to the Commissioner's determination." Thus, there may be some psychological addition of weight in the burden of persuasion. *See also* Ness, *The Role of Statutory Presumptions in Determining Federal Tax Liability*, 12 TAX L. REV. 321 (1957); McBaine, *Presumptions: Are They Evidence?* 26 CALIF. L. REV. 519 (1938).

145. INT. REV. CODE OF 1954, § 534. The burden may be shifted only in the Tax Court.

tice based partly or wholly on the accumulated earnings tax before such deficiency notice is sent, the burden on the reasonable needs issue falls on the Commissioner.[146] Second, the burden may accrue to the Commissioner if the corporation submits a statement of the grounds for the accumulation "together with sufficient facts to show the basis thereof."[147] To be timely, the statement must be filed within 60 days of the date of the deficiency notice,[148] and an additional 30 days may be granted for good cause.[149]

*The Section 534 Statement and Its Effects*

This statement, known unofficially as the section 534 statement, shifts the burden only on those grounds which it contains.[150] The Commissioner may attack the sufficiency of the statement by showing that the grounds relied upon by the corporation are legally insufficient as a business need,[151] or the grounds given are so vague and indefinite that a dollar amount of the corporation's claimed needs cannot be determined.[152] It is said that the grounds for the accumulation are legally sufficient when they would support, if true, the finding that the accumulation was for the reasonable needs of the business.[153]

Although the section 534 statement might be adequate to shift the burden, it was only recently that it actually had that effect. Prior to *Chatham Corp.*,[154] the Tax Court refused to rule on the sufficiency of the statement and the burden of proof issues on pretrial motion. Rather, the court made its decision based on all of the evidence introduced by the ad-

146. If a jeopardy assessment is made before the mailing of the deficiency notice then there is no requirement of advance notice of the section 531 tax assessment. INT. REV. CODE OF 1954, § 534(d); Treas. Reg. § 1.534-3 (1973).

147. INT. REV. CODE OF 1954, § 534(c).

148. Treas. Reg. § 1.534-2(d) (1973).

149. *Id.* There is a third way the burden may shift—if the Commissioner pleads the accumulation of earnings penalty in his answer. *See* TAX CT. R. 142(a).

150. Treas. Reg. § 1.534-2(a)(2) (1973). It has been held that the statement may be sufficient to shift the burden on some issues and leave the taxpayer with the burden on the rest. *See* Shaw-Walker Co. v. Comm'r, 390 F.2d 205 (6th Cir. 1968), *rev'd on other grounds*, 393 U.S. 478 (1969); Bremerton Sun Publ. Co., 44 T.C. 566 (1965). Nor will the burden of proof shift for a taxable year not specified in the statement. Oman Constr. Co., 34 P-H Tax Ct. Mem. 1968 (1965).

151. Vuono-Lione, Inc., 34 P-H Tax Ct. Mem. 556, 567 (1965); Electric Regulator Corp., 40 T.C. 757, 764 (1963), *rev'd on other grounds*, 336 F.2d 339 (2d Cir. 1964).

152. Nodell Motors, Inc., 36 P-H Tax Ct. Mem. 1126, 1134 (1967); Dixie, Inc., 31 T.C. 415, 427-28 (1958), *aff'd*, 277 F.2d 526 (2d Cir. 1960). But in Ted Bates & Co., 34 P-H Tax Ct. Mem. 1476, 1491 (1965), the court specifically stated that an exact dollar amount does not have to be stated in each case, pointing out that some needs could only be adequate if the corporation apprised the Commissioner of the amount which it believed reasonable.

153. John P. Scripps Newspapers, 44 T.C. 453, 466 (1965).

154. 48 T.C. 145 (1967). After *Chatham*, the court ruled on the burden of proof issue in Nodell Motors, Inc., 36 P-H Tax Ct. Mem. 1126, 1134 (1967), but the taxpayer's attempt to shift the burden was not sustained.

versary parties.[155] Although this practice "agitated the bar,"[156] Judge Tannenwald granted a motion to rule on the burden of proof issue before the trial on the merits began in *Chatham* and sustained the taxpayer's move to shift the burden. As a result, the case was settled without trial on the merits, and the Commissioner dropped a deficiency claim of almost $40,000.[157]

If the burden is shifted to the Commissioner, he must try to meet that burden and show the accumulation to be unreasonable. If he is successful in this, the burden of proof does not shift back to the taxpayer. Rather, the corporation has the burden of going forward with the evidence just as in any other type of trial.

Even though the section 534 statement has the potential to shift the burden,[158] there may be compelling reasons for not trying to shift the burden of proof. The statement requires that the corporation disclose all (or at least most) of its case before the trial and thus "show its hand."[159] This is particularly advantageous to the Commissioner since the taxpayer has no way to discover the Commissioner's case.[160] If the statement is filed before the deficiency notice is mailed, however, the Commissioner will give it careful consideration and may decide to drop the matter.[161]

## ESTABLISHING THE REASONABLENESS OF THE ACCUMULATION: PLANNING CONSIDERATIONS

### *Complete and Detailed Minutes*

The importance of the corporate minute book must not be overlooked by the careful tax planner, for it provides the opportunity to fully and accur-

155. *See, e.g.*, Pelton Steel Casting Co., 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir. 1958).

156. Altman, *Corporate Accumulation of Earnings*, 36 TAXES 933, 937 (1958).

157. Because such motions must be ruled on by the judge who hears the case, the taxpayer may wish to wait until as near the date as is feasible to file his motion.

158. An example of a statement held sufficient to shift the burden of proof by the circuit court in Shaw-Walker Co. v. Comm'r, 390 F.2d 205 (6th Cir. 1968), *vac. and rem'g* 34 P-H Tax Ct. Mem. 1872 (1965), *vac. and rem'd*, 393 U.S. 478 (1969), can be found in Monograph, *The Tax on Accumulated Earnings*, CCH TAX ANALYSIS SERIES 93 (April 1968). An inadequate statement is reproduced in Dixie, Inc., 31 T.C. 415, 425-28 (1958).

159. United Business Corp. v. Comm'r, 62 F.2d 754, 755 (2d Cir. 1933), *cert. denied*, 290 U.S. 635 (1935); Ted Bates & Co., 34 P-H Tax Ct. Mem. 1476, 1491 (1965).

160. *See* Unistruct Corp. v. United States, 65-1 U.S. Tax Cas. ¶ 9349, at 95,256 (E.D. Mich. 1965), where an attempt to use federal discovery procedures against the Commissioner failed.

161. Rev. Proc. 56-11, 1956-1 CUM. BULL. 1029, provides:

> As a general rule, the deficiency notice will not be issued until the period of time, including any extensions thereof, for submission of the statement has elapsed. . . . [T]he statement shall be carefully considered and, if the conclusion is reached that the taxpayer has successfully demonstrated that its earnings and profits had not been accumulated beyond the reasonable needs of the business, the proposed allegation shall be abandoned.

ately record the details of expansion plans, loan restrictions, contingencies for unexpected and extraordinary events, acquisition proposals, etc.[162] In both *Bardahl Manufacturing Corp.*[163] and *Knoxville Iron Co.*,[164] the court quoted extensively from the minutes. The numerous discussions of the directors relating to the necessity for expanded facilities, types of facilities needed, and the resolution authorizing the hiring of an architect led the court to find Bardahl Manufacturing's accumulations to be reasonable.[165] In *Knoxville Iron Co.*,[166] the factors causing delay in expansion plans were clearly spelled out and led the court to find for the taxpayer.[167] But in *Faber Cement Block Co.*,[168] the Tax Court noted that tax-oriented minutes will not in and of themselves avoid liability for the penalty tax.

Recently, the Tax Court found that a closely-held corporation is not to be held to the same standards of reporting prospective projects in their minutes as publicly-held corporations, thus failure to do so is not conclusive evidence that the projects were not conceived in the year under scrutiny.[169] The court was persuaded because these projects were begun the following year, even though they were not completed. This decision would appear to be especially helpful in the instance where the practitioner must attempt to aid a corporation whose minutes are scant or hopelessly confused.

*Loans to Shareholders*

The weight of holdings has almost created a presumption that loans to shareholders indicate the intent to unreasonably accumulate earnings.[170] If this factor is present, it is very difficult for the taxpayer to convincingly assert that the loan was not a disguised dividend[171] and avoid imposition of

162. However, one authority cautions that a small closely-held corporation that normally keeps only scant minutes but then goes into lengthy explanations of proposed uses of retained earnings may provoke an inquiry rather than avoid one. T. NESS & E. VOGEL, TAXATION OF THE CLOSELY-HELD CORPORATION § 5.5, at 5-31 (rev. ed. 1972). This is one more reason why prudent counsel should advise detailed corporate minutes on all matters, not just tax problems.

163. 34 P-H Tax Ct. Mem. 1123 (1965).

164. 28 P-H Tax Ct. Mem. 220 (1959).

165. Bardahl Mfg. Corp., 34 P-H Tax Ct. Mem. 1123, 1130-31 (1965).

166. 28 P-H Tax Ct. Mem. 220 (1959).

167. *Id.* at 230.

168. 50 T.C. 317 (1968), *acquiesced in* 1968-2 CUM. BULL. 2. "Mere words in corporate minutes, if unsupported by further evidence of actual implementation, or the likelihood thereof, will carry little weight." *Id.* at 332.

169. Empire Steel Castings, Inc., 43 P-H Tax Ct. Mem. 144 (1974).

170. *See, e.g.*, Bahan Textile Mach. Co. v. United States, 453 F.2d 1100 (4th Cir. 1972). A presumption has been created by the regulations. *See* Treas. Reg. § 1.537-2 (c)(1) (1973).

171. Walker v. Comm'r, 362 F.2d 140, 145 (7th Cir. 1966), *aff'g* 34 P-H Tax Ct. Mem. 154 (1965); A.D. Saenger, Inc., v. Comm'r, 84 F.2d 23, 24-25 (5th Cir. 1936), *cert. denied*, 299 U.S. 577 (1936); Times Publ. Co. v. United States, 11 Am. Fed. Tax. R.2d 1228 (W.D. Pa. 1963); Faber Cement Block Co., 50 T.C. 317 (1968), *acquiesced*

the tax.[172] This is especially true if the loan is to a dominant shareholder,[173] or to a corporation which he controls.[174] Some cases which have been decided against the Commissioner have pointed out that their reasoning was based at least in part on the absence of loans to shareholders.[175]

Loans to shareholders are of little importance, however, if they are promptly repaid,[176] and interest paid on the indebtedness has also been a factor in the taxpayer's favor.[177] Loans which are made to further the corporation's best interests have been approved,[178] but loans to shareholders have been held to be inconsistent with accumulations for an expansion program,[179] unless promptly repaid.[180]

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*in* 1968-2 CUM. BULL. 2; Oman Constr. Co., 34 P-H Tax Ct. Mem. 1968 (1965).

In some cases loans have been held not to be dividends. Charleston Lumber Co. v. United States, 20 F. Supp. 83 (S.D.W. Va.), *appeal dismissed*, 93 F.2d 1018 (4th Cir. 1937); Al Goodman, Inc., 23 T.C. 288 (1954); Corporate Inv. Co., 40 B.T.A. 1156 (1939), *nonacquiesced in* 1944 CUM. BULL. 36; J.E. Baker Co., 8 P-H B.T.A. Mem. 437 (1939).

172. Faber Cement Block Co., 50 T.C. 317 (1968); *acquiesced in* 1968-2 CUM. BULL. 2.

173. Walker v. Comm'r, 362 F.2d 140, 145 (7th Cir. 1966), *aff'g* 34 P-H Tax Ct. Mem. 154 (1965); New England Wooden Ware v. United States, 289 F. Supp. 111 (D. Mass. 1968); McCutchin Drilling Co., 12 P-H Tax Ct. Mem. 1155 (1943); Wilkerson Daily Corp., 42 B.T.A. 1266 (1940), *aff'd*, 125 F.2d 998 (9th Cir. 1942).

174. Cummins Diesel Sales, Inc. v. United States, 207 F. Supp. 746 (D. Ore. 1962); Medical Arts Hosp., 12 P-H Tax Ct. Mem. 580 (1943), *aff'd*, 141 F.2d 404 (5th Cir. 1944).

175. Inland Oil & Chem. Corp. v. United States, 338 F. Supp. 1330, 1335 (D. Md. 1972); American Trading & Prods. Corp. v. United States, 29 Am. Fed. Tax R.2d 1301, 1303 (D. Md. 1972), *aff'd without opinion*, 474 F.2d 1341 (4th Cir. 1973); Bremerton Sun Publ. Co., 44 T.C. 566, 588 (1965); Carolina Rubber Hose Co., 34 P-H Tax Ct. Mem. 1268, 1283 (1965); Knoxville Iron Co., 28 P-H Tax Ct. Mem. 220, 230 (1959); Lannom Mfg. Co., 21 P-H Tax Ct. Mem. 133, 140 (1952); Little Rock Towel & Linen Supply Co., 21 P-H Tax Ct. Mem. 34, 38 (1952); Lion Clothing Co., 8 T.C. 1181, 1191 (1947); General Smelting Co., 4 T.C. 313, 323 (1944); Lane Drug Co., 13 P-H Tax Ct. Mem. 430, 432 (1944); C.R. Burr & Co., 9 P-H B.T.A. Mem. 354, 355 (1940); Dill Mfg. Co., 39 B.T.A. 1023, 1033 (1939), *nonacquiesced in* 1939-2 CUM. BULL. 47; Cecil B. DeMille, 31 B.T.A. 1161, 1176 (1935), *aff'd*, 90 F.2d 12 (9th Cir. 1937).

176. *See, e.g.*, Coca Cola Bottling Works v. United States, 53 F. Supp. 992, 993 (M.D. Tenn. 1944) (loans repaid in less than a year).

177. Al Goodman, Inc., 23 T.C. 288, 301 (1954); R.C. Reynolds, Inc., 44 B.T.A. 356, 366 (1941); Corporate Inv. Co., 40 B.T.A. 1156, 1176 (1939), *nonacquiesced in* 1944 CUM. BULL. 36.

178. Al Goodman, Inc., 23 T.C. 288, 301 (1954) (loan to shareholder to pay back income taxes so that his penitentiary sentence for tax evasion could be reduced and he could return to the corporation); Walkup Drayage & Warehouse Co., 14 P-H Tax Ct. Mem. 801, 808-09 (1945) (loan to subsidiary to acquire property for parent); California Motor Transp. Co., 12 P-H Tax Ct. Mem. 605, 611 (1943) (loan to shareholder to buy equipment which the corporation could not buy without approval of state authorities).

179. Kerr-Cochran, Inc., 30 T.C. 69, 82 (1958), *acquiesced in* 1959-1 CUM. BULL. 4; Kerr-Cochran, Inc., 24 P-H Tax Ct. Mem. 253, 259 (1955), *aff'd*, 253 F.2d 121 (8th Cir. 1958); KOMA, Inc., 18 P-H Tax Ct. Mem. 919, 928 (1949), *aff'd*, 189 F.2d

*It May be Cheaper to Pay the Tax*

If the shareholders of the corporation are in a very high tax bracket, it may be cheaper for the corporation to pay the penalty tax. The usual instance will be where a shareholder is just a passive investor and has little or no earned income,[181] although the shareholder may also receive a salary from the accumulating corporation or another entity. Even though the accumulated earnings tax is imposed, that amount plus the capital gains tax that must be paid when the earnings are bailed out through a non-dividend technique may be less than the shareholder's marginal bracket.

This possibility is illustrated in Tables 1-3.[182] Three arbitrary levels of

390 (10th Cir. 1951); Christmann Veneer & Lumber Co., 14 P-H Tax Ct. Mem. 578, 580 (1945).

180. Coca Cola Bottling Works v. United States, 53 F. Supp. 992, 993 (M.D. Tenn. 1944). Again an opportunity to record all details and relevant factors in the minutes is presented, in order that intent may be established if such loans are challenged.

181. INT. REV. CODE OF 1954, § 1348 provides a maximum tax rate of 50 percent on income earned as salary and wages.

182.

TABLE 1
RETENTION OF EARNINGS

| | Situation 1 | Situation 2 | Situation 3 |
|---|---|---|---|
| Shareholder's other taxable income | $ 25,000 | $ 50,000 | $ 75,000 |
| Corporation's taxable income | $100,000 | $100,000 | $100,000 |
| Less: Corporate income tax | 41,500 | 41,500 | 41,500 |
| Available for distribution | $ 58,500 | $ 58,500 | $ 58,500 |
| Less: Accumulated earnings tax | 16,087 | 16,087 | 16,087 |
| Net to corporation | $ 42,413 | $ 42,413 | $ 42,413 |
| Less: Capital gains tax to shareholder upon sale or liquidation | 10,603 | 10,603 | 10,603 |
| Net to shareholder | $ 31,800 | $ 31,800 | $ 31,800 |

*Note*—The capital gains tax is figured at the 25% alternative rate. The reader should be aware that different rates may apply to different taxpayers.

TABLE 2
DISTRIBUTION AS A DIVIDEND

| | Situation 1 | Situation 2 | Situation 3 |
|---|---|---|---|
| Shareholder's other taxable income | $ 25,000 | $ 50,000 | $ 75,000 |
| Corporation's taxable income | $100,000 | $100,000 | $100,000 |
| Less: Corporate income tax | 41,500 | 41,500 | 41,500 |
| Available for distribution | $ 58,500 | $ 58,500 | $ 58,500 |
| Less: Tax on dividend to shareholder | 29,350 | 33,390 | 36,850 |
| Net to shareholder | $ 29,150 | $ 25,110 | $ 21,650 |

*Note*—All of the corporation's after-tax earnings are distributed to its sole shareholder. The tax on the dividend is computed as the additional tax the shareholder would have to pay because of the dividend.

income for the hypothetical corporation's sole stockholder, $25,000, $50,000 and $75,000, respectively, have been assumed, and in all situations the corporation has earned $100,000 in taxable income. None is personal holding company income. These illustrative computations assume that all accumu-

TABLE 3
ELECTION OF SUBCHAPTER S

| | Situation 1 | Situation 2 | Situation 3 |
|---|---|---|---|
| Shareholder's other taxable income | $ 25,000 | $ 50,000 | $ 75,000 |
| Corporation's taxable income | $100,000 | $100,000 | $100,000 |
| Less: Tax on shareholder's distributive share | 54,760 | 59,920 | 64,410 |
| Net to shareholder | $ 45,240 | $ 40,080 | $ 35,590 |

*Note*—All earnings and profits of a subchapter S corporation are considered, for tax purposes, to have been distributed to the shareholder, whether actually distributed or not. The corporation itself pays no tax.

TABLE 4
RETENTION OF EARNINGS

| | Situation 1 | Situation 2 | Situation 3 |
|---|---|---|---|
| Shareholder's other taxable income | $ 25,000 | $ 50,000 | $ 75,000 |
| Corporation's taxable income | $200,000 | $200,000 | $200,000 |
| Less: Corporate income tax | 51,000 | 51,000 | 51,000 |
| Available for distribution | $149,000 | $149,000 | $149,000 |
| Less: Accumulated earnings tax | 46,365 | 46,365 | 46,365 |
| Net to corporation | $102,635 | $102,635 | $102,635 |
| Less: Capital gains tax to shareholder upon sale or liquidation | 25,659 | 25,659 | 25,659 |
| Net to shareholder | $ 76,976 | $ 76,976 | $ 76,976 |

*Note*—The capital gains tax is figured at the 25% alternative rate. The reader should be aware that different rates may apply to different taxpayers.

TABLE 5
DISTRIBUTION AS A DIVIDEND

| | Situation 1 | Situation 2 | Situation 3 |
|---|---|---|---|
| Shareholder's other taxable income | $ 25,000 | $ 50,000 | $ 75,000 |
| Corporation's taxable income | $200,000 | $200,000 | $200,000 |
| Less: Corporate income tax | 51,000 | 51,000 | 51,000 |
| Available for distribution | $149,000 | $149,000 | $149,000 |
| Less: Tax on dividend to shareholder | 87,080 | 93,230 | 98,410 |
| Net to shareholder | $ 61,920 | $ 55,770 | $ 50,590 |

*Note*—All of the corporation's after-tax earnings are distributed to its sole shareholder. The tax on the dividend is computed as the additional tax the shareholder would have to pay because of the dividend.

lations made now and in the future cannot be justified, and that prior years' accumulations have exhausted the minimum accumulated earnings credit of section 535(c). Further, the sole stockholder is married and files a joint return, and the 50 percent maximum tax rate on earned income has been ignored at all income levels. It is assumed that the base income includes all the taxpayer's deductions, exclusions and exemptions.

Clearly, subchapter S[183] treatment affords the lowest tax cost to the corporation. Under that election, the accumulated earnings tax is inapplicable because all earnings and profits of the corporation are deemed to be distributed to the shareholders, whether actually distributed or not, and taxes are paid accordingly. The corporation may not be able to elect subchapter S, so the savings of accumulating earnings and paying the tax can be seen by comparing Tables 1 and 2.

The advantages of accumulating earnings and paying the tax outweigh even subchapter S election if these earnings exceed $100,000. In Tables 3-6,[184] the same basic assumptions are made except that the corporation's taxable income is assumed to be $200,000. By comparing the tables with the shareholder's income levels, the optimal game plan can be determined.

Should the corporation decide to accumulate its earnings and pay the penalty tax, these profits can only be realized by the shareholder by declaring a dividend (which would result in *triple* taxation) or through capital gains. Since techniques which may be utilized and their pitfalls are the subjects of considerable literature,[185] only a few of the options open to the shareholder are summarized below.

1. *Sale of Stock.* The simplest solution is for the shareholder to find a purchaser for his stock. The practical problem is locating a buyer for the stock willing to pay a price that properly reflects the corporation's value.

TABLE 6
ELECTION OF SUBCHAPTER S

| | Situation 1 | Situation 2 | Situation 3 |
|---|---|---|---|
| Shareholder's other taxable income | $ 25,000 | $ 50,000 | $ 75,000 |
| Corporation's taxable income | $200,000 | $200,000 | $200,000 |
| Less: Tax on shareholder's distributive share | 122,460 | 128,920 | 134,110 |
| Net to shareholder | $ 77,540 | $ 71,080 | $ 65,890 |

*Note*—All earnings and profits of a subchapter S corporation are considered, for tax purposes, to have been distributed to the shareholder, whether actually distributed or not. The corporation itself pays no tax.

183. INT. REV. CODE OF 1954, § 1372; *see* Treas. Reg. § 1.1372-2, 3 (1973).

184. *See* tables cited note 182, *supra.*

185. *See generally,* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ch. 9, 11, 14 (3d ed. 1971).

2. *Liquidation.* The shareholder may liquidate his corporation under the so-called one-month liquidation and recognize no gain or loss on the transaction if it meets certain statutory tests.[186] Cash and marketable securities will be treated as a dividend and the shareholder will recognize a capital gain upon sale of the assets. He will, however, have to find someone willing to purchase his building, machinery, and other assets. By contrast, if the corporation has considerable cash, it would be to the shareholder's advantage to elect the general liquidation provisions of section 331 and realize a capital gain immediately.[187]

3. *Redemption.* If he is not the sole shareholder, he may have the corporation redeem his stock. He must redeem all of it, or the redemption will be treated as a dividend,[188] and he must not subsequently acquire more stock or be an officer, employee, or director of the corporation for a period of ten years.[189]

4. *Tax-Free Reorganization.* If the stockholder is able to find another corporation interested in and able to acquire his business, he can consider a merger. The net effect of this technique is that the selling stockholder exchanges his corporation's stock for shares in the acquiring company without recognizing a taxable gain.[190] His capital gains will be recognized at a later date when he sells his new, and often more marketable, shares. The disadvantage here is that the selling shareholder generally cannot take cash or other property as part of the transaction without jeopardizing its tax-free status.[191]

*Elections as a Tax-Option Corporation*

By electing to be taxed under the provisions of subchapter S of the Code,[192] the corporation will exempt itself from the accumulated earnings tax. All of the earnings and profits of the corporation, as well as its net operating loss, if any, are taxed directly to the shareholders rather than to the corporation. Because the entity resembles a partnership, it is sometimes called a "pseudo-corporation." This label, although perhaps descriptive for tax purposes, is misleading. The subchapter S corporation is as much a corporation as any other, with the same existence apart from its shareholders. The election of subchapter S treatment, then, effects only the tax treatment and none of the other corporate characteristics.

186. *See* INT. REV. CODE OF 1954, § 333.
187. He will still be faced with selling the operating assets.
188. INT. REV. CODE OF 1954, § 302.
189. *Id.* § 302(c)(2).
190. *Id.* § 354. The various types of reorganizations are specified in § 368(a).
191. *Id.* §§ 354, 356.
192. *Id.* §§ 1371-1377; *cf.* Rev. Rul. 72-152, 1972-1 CUM. BULL. 272, where a corporation elected subchapter S treatment after it had accrued $100,000 in excess earnings for which it would have been liable for the penalty tax.

Not all corporations are eligible to elect subchapter S. The corporation may not have more than ten shareholders[193] who must be individuals or estates only,[194] and all must consent to the election as a tax-option corporation.[195] The ban against corporate ownership of the subchapter S stock implies the inability of the electing entity to be part of an affiliated group for consolidated returns purposes.[196] The subchapter S corporation may not have more than one class of stock.[197] This provision is especially important in light of the fact that debt in the corporate capital structure may be held to be a second class of stock,[198] thereby disqualifying the election.

If the accumulating corporation can qualify for the election, its shareholders may expect results similar to those shown in Tables 3 and 6. Because of the distinct advantages, the shareholders should consider the election of subchapter S as part of their tax planning.

*Directors' Liability: Stockholders' Derivative Suits*

If the accumulated earnings tax of section 531 is imposed, the taxpayer corporation's directors may be personally liable for the tax collected. Minority shareholders, interested in dividend distributions rather than capital appreciation of their stock, may bring derivative actions in an effort to hold the directors personally liable for the tax.[199]

As already noted,[200] one of the only two cases in which the accumulated earnings tax was imposed against a publicly-held corporation was *Trico Products Corp. v. Commissioner*.[201] There, 74 percent of the stock was held

193. INT. REV. CODE OF 1954 § 1371(a). For the purposes of subchapter S qualification, stock held by a husband and wife as joint tenants, tenants by the entirety, tenants in common or community property is treated as being owned by only one person. *Id.* § 1371(c). Joint tenants or tenants in common who are not husband and wife are treated as separate shareholders. Treas. Reg. § 1.1371-1(d)(1) (1973).

194. INT. REV. CODE OF 1954, § 1371(a); *see* Treas. Reg. § 1.1371-1 (1973).

195. INT. REV. CODE OF 1954, § 1372; *see* Treas. Reg. § 1.372-2, 3 (1973).

196. INT. REV. CODE OF 1954, §§ 1371, 1504. An exception to this rule is granted to a subsidiary that has not engaged in business and has no taxable income for a specified period. *Id.* § 1371(d). Thus, it is used for corporations which desire subsidiaries in other states to protect against appropriation of the corporate name.

197. INT. REV. CODE OF 1954, § 1371(a).

198. *See generally*, Comment, *Debt as a Second Class of Stock in Subchapter S Corporations*, 51 TEXAS L. REV. 531 (1973).

199. Since the declaration of dividends is within the exclusive pervue of the board of directors, a suit by a minority shareholder to compel a dividend declaration can be sustained only on showing an abuse of power by the directors. 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 477 (1955). One indicia of bad faith in the failure to pay dividends is the exposure of the corporation to the accumulated earnings tax to avoid taxation with respect to the controlling group of shareholders. Mahler v. Trico Prods. Corp., 72 N.E.2d 622 (N.Y. 1947).

200. *See* p. 445, *supra*.

201. 137 F.2d 424 (2d Cir. 1943), *cert. denied*, 320 U.S. 799 (1944); *see* Trico Prods. Corp. v. McGowan, 169 F.2d 343 (2d Cir.), *cert. denied*, 335 U.S. 899 (1948).

by six people, and the remaining stock was in the hands of about 2,000 shareholders. In two derivative suits, minority shareholders sued the directors (who were the principal shareholders) to recover damages suffered by the corporation. The directors settled for $2,400,000, the amount of penalty tax imposed on the corporation, and the corporation also declared and paid an extra dividend.[202]

The possibility of this kind of litigation makes planning especially important should the corporation decide to accumulate its earnings rather than distribute them as outlined in one of the tax-saving plans discussed previously. If the corporation is small enough, all shareholders should give their consent in advance. This scheme, however, is clearly evidence of the proscribed purpose and the corporation would be able to avoid imposition of the tax with only the greatest difficulty.

## CONCLUSION

The accumulated earnings tax is a fair tax. Before it will be imposed, the proscribed purpose of tax avoidance must be shown to be the intent of the taxpayer.[203] If the corporation can show legitimate business purposes behind the accumulations, rather than mere shams, the section 531 tax will not be assessed. But certain aspects of the computation of the unreasonable accumulation must be clarified.

The confusion over the application and calculation of the operating cycle has been discussed. Its approach is sound both from the accounting and financial analysis points of view, and it has been approved by the Tax Court. Therefore, regulations should be promulgated specifying the exact factors to be used in its calculations.

Such regulations would keep the courts from having to specify calculations to be used through judicial legislation. The non-standard formulae applied by different courts—particularly different circuits—would be eliminated. The items which should and should not be included in operating cycle computations would be established so that tax planners, corporate directors and revenue agents would not have to second-guess the results of unadjudicated litigation.

202. Mahler v. Trico Prods. Corp., 72 N.E.2d 622 (N.Y. 1947); Mahler v Oishei, Sup. Ct. N.Y. Co., Special Term Part I (order entered Dec. 23, 1947) (settled before trial); *see* Note, *Derivative Actions Arising from Payment of Penalty Taxes Under Section 102*, 49 COLUM. L. REV. 394 (1949); Note, *Personal Liability of Shareholder-Directors for Accumulating Earnings Which Led to Subjection of the Corporation to § 102 Taxes*, 61 HARV. L. REV. 1058 (1948).

203. *See, e.g.*, Apollo Indus., Inc. v. Comm'r, 358 F.2d 867 (1st Cir. 1966). Caveat—the Supreme Court has ruled that tax avoidance need be only *one* of the reasons behind the accumulation, not just the principal reason, in United States v. Donruss Co., 393 U.S. 297 (1969).

The use of peak inventories and peak receivables has already been mentioned.[204] Prepaid expenses should also be included, as should advertising costs and income tax installments. Although the inclusion of these factors would be most favorable to the taxpayer, the difficulty of defining the level of optimum working capital urges the more conservative approach. There is an important policy consideration in assuring the taxpayer corporation adequate working capital so it may be a contributing entity in the economy rather than having its growth stifled by imposing too large a penalty tax.

204. Magic Mart, Inc., 51 T.C. 775 (1969); Kingsbury Inv., Inc., 38 P-H Tax Ct. Mem. 1174 (1969).