



Case Western Reserve Law Review

Volume 15 | Issue 2

1964

Practical Aspects of Accumulated Earnings Tax

Robert S. Latham

Follow this and additional works at: <https://scholarlycommons.law.case.edu/caselrev>

 Part of the [Law Commons](#)

Recommended Citation

Robert S. Latham, *Practical Aspects of Accumulated Earnings Tax*, 15 W. Res. L. Rev. 363 (1964)

Available at: <https://scholarlycommons.law.case.edu/caselrev/vol15/iss2/15>

This Symposium is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

IV

PRACTICAL ASPECTS OF ACCUMULATED EARNINGS TAX

Robert S. Latham

For 25 years a contest has been waged throughout the country in behalf of the adoption of a national income tax as a permanent part of our fiscal system, and the sentiment in favor of this movement finally became so strong that the people overturned a decision of the Supreme Court of the United States by writing into the Constitution the first amendment within 40 years.¹

The Revenue Act created because of the strong sentiment mentioned in the foregoing Ways and Means Committee Report included the forerunner of section 102 of the Internal Revenue Code of 1939 and section 531 of the Internal Revenue Code of 1954. Section II(A)(2) of the Act of 1913 includes wording reasonably similar to that contained in the 1954 Code. In the following quotation, the *italicized* words appear in both the 1913 Act and the 1954 Code, the (bracketed words) appear only in the 1913 Act, and the balance only in the 1954 Code:

*formed or (fraudulently) availed of for the purpose of (preventing the imposition of such tax through the medium of) avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting (such gains) earnings and profits to accumulate instead of being divided or distributed . . .*²

The need for an accumulated earnings tax in 1913 was created by the fact that the corporate tax rate was 1%³ and the top individual tax rate was 6% on net income over \$500,000.⁴ Thus, individuals could realize a tax advantage by retaining income in the corporate enterprise rather than personally realizing taxable income. The penalty originally created to erase this advantage treated gains and profits which accumulated beyond the reasonable needs of the corporation as taxable income to the shareholders.⁵

Currently, the tax is applied to corporations. The rate is 27½% of the first \$100,000 of improperly accumulated surplus and 38½% of the balance.⁶

1. H.R. REP. NO. 5, 63d Cong., 1st Sess. 36-37 (1913).

2. 38 Stat. 166 (1913); INT. REV. CODE OF 1954, § 532(a) [hereinafter cited as CODE §].

3. 1 CCH 1964 STAND. FED. TAX REP. ¶ 149.

4. *Ibid.*

5. Revenue Act of 1913, § II (A) (2), 38 Stat. 166.

6. CODE § 531.

TABULATION OF CASES

The first case reported under the predecessor to section 531 of the 1954 Code involved taxable income for the year 1921 and was decided against the taxpayer in 1933.⁷ The number of cases decided by the courts remained fairly steady through 1957. Since that time there has been a decided increase in the number of cases. The percentage of times the accumulated earnings tax was approved also has increased.⁸

<i>Years</i>	<i>Against Taxpayer</i>	<i>For Taxpayer</i>	<i>Cases Per 5-Year Period</i>
1933-1952 -----	50	60	28
1953-1957 -----	9	16	25
1958-1962 -----	24	20	44
1963 to Oct. 7, 1963 --	6	7	

APPLICATION OF THE TAX

Closely-Held Corporations

The tax usually is applied to closely-held corporations whose shareholders have enough control over the corporations' policies to be able to avoid declaring dividends. Corporations whose stock is widely held have experienced somewhat of an immunity from the imposition of this tax. The tax has been assessed, however, against corporations where the majority of stock was held by a few individuals, although a large number of small shareholders owned the balance.⁹

In one instance in which the penalty was assessed, a majority of shareholders of the Trico Corporation was able to manipulate the earnings and profits to their own advantage, *i.e.*, preventing the payment of dividends because of their high individual tax brackets.¹⁰ Although there was a total of 2,000 shareholders, approximately 70% of the publicly traded stock of the corporation was in the hands of seven of them. The court found that the directors were acting primarily on behalf of a particular shareholder group by accumulating earnings to minimize its taxes.

Directors of corporations should realize that by causing their corpora-

7. *United Business Corp. of America v. Commissioner*, 62 F.2d 754 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933).

8. The 1933-1957 statistics were obtained from Tax Subject File 531/2 of Arthur Andersen & Co., 120 South LaSalle Street, Chicago, Illinois. The 1958-1963 statistics were obtained from a review of 3 CCH 1963 STAND. FED. TAX REP. ¶¶ 3301-21.

9. *Trico Prods. Corp. v. McGowan*, 169 F.2d 343 (2d Cir. 1948), *cert. denied*, 335 U.S. 899 (1949); *Trico Prods. Corp. v. Commissioner*, 137 F.2d 424 (2d Cir. 1943), *cert. denied*, 320 U.S. 799 (1944).

10. *Ibid.*

tion to incur an accumulated earnings tax they may justify a minority shareholder's suit against themselves for reimbursement to the corporation of the taxes paid. Wherever there is a small controlling shareholder group, the corporate directors should give the same careful consideration to the reasonableness of accumulating earnings as would the directors of a closely-held corporation.

Exempt Corporations

For obvious reasons the following corporations are not subject to the accumulated earnings tax:

- (1) personal holding companies,¹¹
- (2) foreign personal holding companies,¹²
- (3) charitable corporations and others exempt from tax under sections 501-504 of the Internal Revenue Code.¹³

BASIS FOR THE TAX

As noted previously, the accumulated earnings tax is imposed if it is determined that shareholders are avoiding individual income taxes by having a corporation accumulate rather than distribute income not required for the reasonable needs of the business. The fact that a corporation accumulates earnings and profits beyond the reasonable needs of the business, however, does not in itself cause the tax to be applied. The reasonableness of the business purpose for the accumulation is one of the most frequently used criteria. The courts reason that an accumulation made for an unreasonable business purpose indicates an intent to avoid income taxes. The Internal Revenue Code provides that the accumulation of corporate earnings and profits beyond reasonable needs, including reasonably anticipated needs,¹⁴ indicates the presence of such a forbidden purpose.¹⁵ The "determinative presumption" of indulgence in the forbidden activity can be overcome by a corporation only if it proves by a preponderance of the evidence that the activity is not a true reflection of the character of the accumulation.¹⁶

A basic premise of the accumulated earnings tax is that the corporation has sufficient earnings and profits to distribute. Furthermore, these earnings and profits must be represented by assets which are distributable, that is, those which are in excess of liquid assets essential to the opera-

11. CODE § 532(b) (1).

12. CODE § 532(b) (2).

13. CODE § 532(b) (3).

14. CODE § 537.

15. CODE § 533(a).

16. *Ibid.*

tion of the business. Thus, if the corporation's funds are invested in assets essential to the needs of the business, a surplus accumulation will not be taxable.

In *Smoot Sand & Gravel Corp. v. Commissioner*¹⁷ the above result was explained as follows:

Thus, the size of the accumulated earnings and profits or surplus is not the crucial factor; rather, it is the reasonableness and nature of the surplus. Part of the surplus may be justifiably earmarked in the form of reserves, for specific, necessary business needs. Again, to the extent the surplus has been translated into plant expansion, increased receivables, enlarged inventories, or other assets related to its business, the corporation may accumulate surplus with impunity. . . . Where, on the other hand, the accumulation of surplus is reflected in liquid assets in excess of the immediate or reasonably foreseeable business needs of the corporation, there is a strong indication that the purpose of the accumulation is to prevent the imposition of income taxes upon dividends which would have been distributed to the shareholders.¹⁸

ADJUSTMENTS TO ACCUMULATED TAXABLE INCOME

The base for the tax — accumulated taxable income — is the taxable income of the current year increased or reduced by certain adjustments.¹⁹ Accumulated taxable income basically represents the year's accumulation of income. The adjustments reducing taxable income are:

- (1) income taxes,²⁰
- (2) contributions in excess of the 5% limitation,²¹
- (3) net capital losses,²²
- (4) excess of net long-term capital gains over net short-term capital losses, net of the tax effect,²³
- (5) amounts devoted to the acquisition of certain assets by bank affiliates,²⁴
- (6) dividend distributions of stock as a result of certain anti-trust orders, minus the income taxes thereon (the duPont divestiture of General Motors stock),²⁵
- (7) the accumulated earnings credit,²⁶
- (8) the dividends paid deduction,²⁷
- (9) recoveries of certain expenses of prior years.²⁸

17. 274 F.2d 495 (4th Cir.), cert. denied, 362 U.S. 975 (1960).

18. *Id.* at 500-01.

19. CODE § 535(a).

20. CODE § 535(b)(1).

21. CODE § 535(b)(2).

22. CODE § 535(b)(5).

23. CODE § 535(b)(6).

24. CODE §§ 535(b)(8), 601.

25. CODE § 535(b)(9).

26. CODE §§ 535(a), (c).

27. CODE §§ 535(a), 561.

28. CODE § 111(c)(2).

Adjustments increasing the base for the tax are:

- (1) partially tax exempt interest,²⁹
- (2) certain special deductions for dividends received,³⁰
- (3) the dividends paid deduction of certain preferred stock of utilities,³¹
- (4) net operating loss deduction,³²
- (5) the disposition of stock received as a result of certain anti-trust orders (the duPont divestiture of General Motors stock),³³
- (6) recoveries of certain expenses of prior years,³⁴
- (7) charitable contribution carry-overs deducted.³⁵

The Net Long-Term Capital Gain Adjustment

For accumulated taxable income purposes, capital losses and long-term capital gains which occur in that order in separate years are more valuable than if they occur in the same year. If they occur in the same year, they offset each other.³⁶ There is then no reduction of accumulated taxable income. If they occur in separate years, each will reduce the taxable base of that respective year. Thus, a corporation exposed to accumulated earnings tax problems could reduce the impact of the tax by causing net losses and net long-term capital gains to occur in different years.³⁷

Example:

	<i>Separate Years</i>		<i>Same Year</i>	
	<i>First</i>	<i>Second</i>	<i>First</i>	<i>Second</i>
Ordinary income	\$1,000	\$1,000	\$1,000	\$1,000
Capital (loss)	(100)	-	(100)	-
Capital gain	-	100	100	-
Taxable income	\$1,000	\$1,000	\$1,000	\$1,000
535(b)(5) adjustment	(100)	-	-	-
535(b)(6) adjustment	-	(100)	-	-
Accumulated taxable income	\$ 900	\$ 900	\$1,000	\$1,000
<u>Totals</u>		<u>\$1,800</u>		<u>\$2,000</u>

29. CODE § 535(b)(3).

30. *Ibid.*

31. *Ibid.*

32. CODE § 535(b)(4).

33. CODE § 535(b)(10).

34. CODE § 111(c)(2).

35. Treas. Reg. § 1.535-2(b) (1959) [hereinafter cited as Reg. §].

36. CODE § 1222(9)(A).

37. The deduction from taxable income to arrive at accumulated taxable income does not

The Accumulated Earnings Credit

Under the 1939 Code, the accumulated earnings tax was imposed on the entire undistributed section 102 net income.³⁸ One of the most significant statutory changes made by the 1954 Code was the creation of the accumulated earnings credit.³⁹ This change allows a substantial deduction to be taken in computing the taxable base for the accumulated earnings tax. Except as it applies to corporations which are "mere holding or investment" corporations,⁴⁰ the accumulated earnings credit is the larger of:

- (1) the portion of corporate earnings for the taxable year accumulated to meet *the reasonable needs of the business*,⁴¹
or
- (2) an accumulation of \$100,000.⁴²

The allowance for reasonable needs of the business must be reduced by the accumulated taxable income adjustment for long-term capital gains mentioned above.⁴³ The rationale of this requirement is that the satisfaction of reasonable business needs does not require recognition of the source of funds for such needs. The creation of income which is not subject to the improper accumulation tax does not isolate such income from use for reasonable business needs. Were this not so, a reduction of accumulated taxable income by this item could create accumulations for "improper" purposes.

The minimum credit of \$100,000 is reduced by earnings and profits accumulated at the close of the preceding taxable year. This provision allows a minimum *accumulated* credit of \$100,000.⁴⁴ A corporation is not allowed a \$100,000 accumulation from each year's income.

Accumulated earnings and profits at the close of the preceding taxable year must be reduced by dividends paid within the first 2½ months of the taxable year. One can *not* elect to do otherwise.⁴⁵

The Dividends Paid Deduction

Taxable income is further reduced by the dividends paid deduction.⁴⁶ This deduction may include amounts which were not distributed, but

include any long-term capital gain created by the disposal of coal. Nor does the tax adjustment to the long-term capital gain include the tax on such coal disposal. CODE § 631(c).

38. CODE § 102(d).

39. CODE § 535(c).

40. CODE § 535(c)(1).

41. *Ibid.*

42. CODE § 535(c)(2).

43. CODE § 535(c)(1).

44. CODE § 535(c)(2).

45. CODE §§ 535(c)(4), 563(a).

46. CODE §§ 535(a), 561.

which the shareholders consent to treat as undistributed dividends.⁴⁷ The shareholders must then report such amounts in their personal income tax returns for the taxable year. The amounts are to be treated as undistributed dividends. The shareholders' consent is evidenced by a form filed no later than the due date of the corporation's income tax return for the year in which the dividends paid deduction is claimed.⁴⁸ These consent dividends can neither be created by preference dividends nor be derived from sources other than earnings and profits.⁴⁹

The deduction includes the dividends paid during the last 9½ months of the taxable year and within the first 2½ months of the following taxable year.⁵⁰ The 2½ month provision springs from the fact that taxable income generally cannot be determined until after the close of a taxable year. If the accumulated earnings credit will eliminate accumulated taxable income in a particular year, dividends during the first 2½ months of the following year will not reduce accumulated taxable income, since it is already zero. If the accumulated earnings and profits at the end of the following year exceed the accumulated earnings credit, dividends during the first 2½ months of that year will not reduce accumulated taxable income in *that* year. Thus, if there is a possible penalty tax exposure, a corporation whose accumulated earnings and profits are approaching the accumulated earnings credit should exercise care concerning the time of the year when dividends are paid. By postponing payment of dividends until the last 9½ months of a year and paying dividends in the first 2½ months of the following year, a one-time benefit of the extra dividend for penalty tax purposes is obtained. If payment of dividends is continued during the first 2½ months of each year, a permanent retention of the benefit will result.

EVIDENCE OF PURPOSE

The accumulation of earnings and profits beyond the reasonable needs of the business will demonstrate a purpose to avoid income tax, unless there is a preponderance of evidence to prove otherwise.⁵¹ This is not the only circumstance, however, which will evidence an intent to avoid income taxes and thus invoke the accumulated earnings tax. There are other practices which, without any independent showing of the unreasonableness of an accumulation, indicate an improper intent.

47. CODE §§ 561(a)(2), 565(a).

48. Reg. § 1.565-1(b)(3) (1958).

49. Reg. § 1.565-2(a) (1958).

50. CODE §§ 561(a)(1), 561(b)(1), 563(a); Reg. § 1.563-1 (1958).

51. CODE § 533(a).

Shareholder Loan and Borrowing

Improper dealings between the corporation and its shareholders frequently become evidence of a purpose to avoid income tax.⁵² Corporate loans to shareholders without adequate corporate business reasons and without adequate security have been held to be evidence of a purpose to avoid the penalty tax.⁵³

However, loans evidenced by interest-bearing notes which were at all times intended to be paid have been held to be proper dealings between a corporation and its shareholders.⁵⁴ In another case, advances and non-interest bearing notes, repaid after the years involved, were held not to require application of the penalty tax.⁵⁵ Nor was the penalty tax applied where loans were repaid in the year made⁵⁶ or in the following year.⁵⁷ Loans amply secured and interest bearing have been held proper.⁵⁸

Investments in assets having no reasonable connection with the business of the corporation might be construed as evidence of a purpose to avoid income tax.⁵⁹

Without the old 70% rule of thumb, which will be discussed below, the Internal Revenue Service now holds that the extent to which a corporation has distributed its earnings and profits will be considered when reviewing the evidence of purpose to avoid income tax.⁶⁰

Holding or Investment Companies

The fact that a corporation is a mere holding or investment company is *prima facie* evidence of a purpose to avoid income tax to the shareholders.⁶¹

A corporation having practically no activities except holding property and collecting the income therefrom or investing therein shall be considered a holding company within the meaning of Section 533(b). If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property

52. Reg. § 1.533-1(a)(2)(i) (1959).

53. *Latchis Theatres, Inc.*, 19 T.C. 1054 (1953), *aff'd*, 214 F.2d 834 (1st Cir. 1954); *M. Greenspun*, 3 CCH Tax Ct. Mem. 341 (1944); *William C. deMille Productions, Inc.*, 30 B.T.A. 826 (1934).

54. *Corporate Inv. Co.*, 40 B.T.A. 1156 (1939), *nonacq.*, 1940-1 CUM. BULL. 6.

55. *F. E. Watkins Motor Co.*, 31 T.C. 288 (1958), *acq.*, 1959-1 CUM. BULL. 5.

56. *Walkup Drayage & Warehouse Co.*, 4 CCH Tax Ct. Mem. 695 (1945).

57. *Coca Cola Bottling Works v. United States*, 53 F. Supp. 992 (M.D. Tenn. 1944).

58. *R. C. Reynolds, Inc.*, 44 B.T.A. 356 (1951), *acq.*, 1941-2 CUM. BULL. 10, *nonacq.*, 1941-2 CUM. BULL. 22.

59. Reg. § 1.533-1(a)(2)(ii) (1959), as amended, T.D. 6449, 1960-1 CUM. BULL. 310, as amended, T.D. 6652, 1963-1 CUM. BULL. 110.

60. Reg. § 1.533-1(a)(2)(iii) (1959), as amended, T.D. 6449, 1960-1 CUM. BULL. 310, as amended, T.D. 6652, 1963-1 CUM. BULL. 110.

61. CODE § 533(b).

(whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, a corporation shall be considered an investment company within the meaning of Section 533(b).⁶²

All holding or investment companies, however, do not qualify as "mere holding or investment" companies. In *Industrial Bankers Securities Corp. v. Higgins*,⁶³ the Court of Appeals for the Second Circuit held that while the corporation concerned was "primarily" a holding and investment company, it was not a "mere holding and investment" company. The court noted that "the plaintiff, as thus controlled, proceeded to direct and control, as well as to finance, the business of its subsidiaries, as Mr. Noteman had previously done as an individual."⁶⁴ Similarly, a holding and investment company which controlled or otherwise actively participated in the management of companies in which it had invested was held not a "mere holding or investment" company.⁶⁵ Concerning this question, the Court of Appeals for the Seventh Circuit held:

[P]etitioner was engaged in no business except to hold the securities and assets transferred to it by the Olins; to collect dividends from the corporations whose stock it held, and which stock otherwise would have been held by the Olins and the dividends paid directly to them; to loan money to the Olins; to invest the funds of the trust; and to provide funds from the Olins to promote the business enterprises they were interested in.⁶⁶

Nevertheless, the court did not refute the Board of Tax Appeals' previous statement in the same case that:

(2) Likewise in our findings of fact we have found that during the taxable years 1932 and 1933 petitioner was not a mere holding or investment company. There is much evidence in the record bearing upon petitioner's business activities, both during the taxable year and prior years. We think that this evidence shows that petitioner was primarily a holding and investment company. Cf. *Almours Securities, Inc.*, 35 B.T.A. 61; *Rands, Inc.*, 34 B.T.A. 1094. But while we think that the facts show that the petitioner was primarily a holding and investment company, we would be unwilling to say that it was a *mere* holding or investment company, within the meaning of the applicable statute. Cf. *Industrial Bankers Securities Corporation v. Higgins*, 104 Fed. (2d) 177.⁶⁷

Small business investment companies are not mere holding or investment companies if they comply with the Small Business Investment Act

62. Reg. § 1.533-1(c) (1959), as amended, T.D. 6449, 1960-1 CUM. BULL. 310, as amended, T.D. 6652, 1963-1 CUM. BULL. 110.

63. 104 F.2d 177 (2d Cir. 1939).

64. *Id.* at 179.

65. *Olin Corp. v. Commissioner*, 128 F.2d 185 (7th Cir. 1942), *affirming* 42 B.T.A. 1203 (1940).

66. *Id.* at 186-87.

67. *Olin Corp.*, 42 B.T.A. 1203, 1214 (1940), *aff'd*, 128 F.2d 185 (7th Cir. 1942).

of 1958 and actively engage in the business of providing funds to small business concerns.⁶⁸ These funds can be made available through convertible debentures or long-term loans.⁶⁹

REASONABLE NEEDS OF THE BUSINESS

As noted earlier, the accumulation of corporate earnings and profits beyond reasonable corporate needs indicates an intent to avoid income taxes, which will cause the accumulated earnings tax to be imposed. Thus, accumulations should be based upon the reasonable needs of the business. Among such needs are plant expansion,⁷⁰ acquisition of a business,⁷¹ retirement of a trade or business debt,⁷² or any other purpose that a reasonably prudent businessman would consider to be appropriate.⁷³ It is sometimes necessary to invest in or make loans to an unrelated party to ensure an uninterrupted supply of that party's products or to ensure the continuance of the other party's demand for one's own product. Investments in or loans made to such suppliers or customers are reasonable needs of the business.⁷⁴ However, in *Factories Inv. Corp.*,⁷⁵ where a borrower was successful and did not need the loans, the Tax Court held that the loans were not for reasonable needs of the business.

In *Trico Sec. Corp.*,⁷⁶ accumulations of earnings and profits made pursuant to a loan agreement which restricted the payment of dividends until the loan was paid were held to have been made for reasonable business purposes. The loan agreement must be transacted at arm's length and not to avoid the accumulated earnings tax.

A type of investment specifically mentioned in the Regulations as being for the reasonable needs of a business is one where stock is purchased in a "subsidiary" company.⁷⁷ This type of investment is treated as if the funds were invested in the taxpayer's own business. A "subsidiary" relationship exists if the investing corporation owns 80% or more of the voting stock of the acquired company. The investment will also be con-

68. Reg. §§ 1.533-1(d) (1), (2) (1959), as amended, T.D. 6449, 1960-1 CUM. BULL. 310, as amended, T.D. 6652, 1963-1 CUM. BULL. 110.

69. Reg. § 1.533-1(d) (2) (1959), as amended, T.D. 6449, 1960-1 CUM. BULL. 310, as amended, T.D. 6652, 1963-1 CUM. BULL. 110.

70. Reg. § 1.537-2(b) (1) (1959).

71. Reg. § 1.537-2(b) (2) (1959).

72. Reg. § 1.537-2(b) (2) (1959).

73. Reg. § 1.537-1(a) (1959).

74. Reg. § 1.537-2(b) (5) (1959).

75. 39 T.C. 908 (1963), *on appeal* to Second Circuit, June 14, 1963.

76. 41 B.T.A. 306 (1940), *nonacq.*, 1940-1 CUM. BULL. 9.

77. Reg. § 1.537-3(b) (1959); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 53 (1954); S. REP. NO. 1662, 83d Cong., 2d Sess. 70 (1954).

sidered for the reasonable needs of a business if the surrounding circumstances indicate that the acquired corporation was a "mere instrumentality" of the taxpayer-corporation, even though less than 80% of the stock was held.

Reasonably Anticipated Needs of the Business

The reasonable needs of the business include the reasonably anticipated needs.⁷⁸ Such reasonably anticipated needs must be specific, definite, and feasible.⁷⁹ Past allowance of a retention of reasonable funds for possible expansion may have lulled many taxpayers into a false sense of security. Recently courts have become extremely strict in this regard.

In *Burrow Mfg. Co.*,⁸⁰ it was not doubted that the taxpayer had a plan for erecting a modern new plant. The purchase of adjoining land was not questioned as evidence of a purpose to erect a future plant. Yet the Tax Court stated:

Nevertheless, the plan was quite general, not only as to the type of plant, but also as to the time of implementation, which was quite indefinite, and not within the reasonably calculable future. At the time of trial in 1959, no steps toward implementation were begun or decided upon. It is our view that such a vague, generalized project, with no definite plan, and no substantial active move toward implementation, cannot be taken to create a reasonable need of a business to accumulate 90 per cent or more of its earnings after taxes for at least 3 years and, as indicated in the record before us, an indefinite period thereafter.⁸¹

This is not an isolated indication of a need for definiteness. In *Motor Fuel Carriers, Inc. v. United States*,⁸² a case involving taxation during 1956 and 1957, a taxpayer had considered the advisability of a proposal to purchase property on which to construct a building. The land was purchased in 1956. Plans submitted as evidence of the proposed construction were dated 1961, more than a year after the tax suit was instituted. In holding for the government, the District Court for the Northern District of Florida stated: "[I]t does not appear that any substantial steps were taken by the taxpayer toward development of the waterfront property in the years 1956 and 1957."⁸³

The Minnesota District Court indicated in *Fine Realty, Inc. v. United States*⁸⁴ that in its opinion a general undetailed program of purchasing

78. CODR § 537.

79. Reg. § 1.537-1(b)(1) (1959); S. REP. NO. 1622, 83d Cong., 2d Sess. 277 (1954).

80. 19 CCH Tax Ct. Mem. 195 (1960), *aff'd*, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962).

81. *Id.* at 205.

82. 202 F. Supp. 497 (N.D. Fla. 1962), *vacated and remanded on other grounds*, 322 F.2d 576 (5th Cir. 1963).

83. *Ibid.*

84. 209 F. Supp. 286 (D. Minn. 1962).

new land does not meet the standards of definiteness and specificity required in the Eighth Circuit.

The Tax Court held in *Young's Rubber Corp.*⁸⁵ that vague and unsupported premonitions of future needs for technical progress could not be accepted as reasonable needs of the business. Moreover, in this case the taxpayer also failed to present facts or plans about building additional manufacturing space, even though a four-acre tract had been purchased two years before the taxable year. The fact that the land was sold subsequent to the taxable year may have had some influence on the court's decision that the plans were not definite enough.

In an earlier (1957) Tax Court decision, *Breifeller Sales, Inc.*,⁸⁶ a taxpayer was not assessed the accumulated earnings tax because the accumulation was held to be for reasonable needs. In that case a retail automobile dealer accumulated \$288,267 for the following purposes:

- | | |
|--|-----------|
| (1) possible franchise acquisition | \$250,000 |
| (2) additional facilities | 36,945 |
| (3) deficiency in working capital agreements | 1,885 |

The franchise acquisition might have been made necessary to stop competition in an adjoining territory which the taxpayer previously had relinquished. Apparently, however, the automobile dealer would not have acquired the franchise unless there was a possibility of another dealer requesting it. Tax Court decisions subsequent to 1957 lead one to believe that indefinite plans, as illustrated in this case, currently might not receive the blessing of the court.

Indefinite plans referred to briefly in corporate minutes may be treacherous opiates to taxpayers. If the courts continue to hold that the aspirin being relied upon is only a little sugar pill, the resultant headaches may be disastrous.

One Year's Operating Expenses

In 1958 the Tax Court stated, "This Court has consistently held that the accumulation of funds to meet operation expenses for at least one year is reasonable."⁸⁷ Not until 1960 did an appellate court consider this point. In *Dixie, Inc. v. Commissioner*,⁸⁸ the Court of Appeals for the Second Circuit stated, "The rule of thumb so stated may be one proper for administrative convenience but should rise to no higher level. The

85. 21 CCH Tax Ct. Mem. 1593 (1962), *on appeal to* Second Circuit, March 14, 1963.

86. 28 T.C. 1164 (1957), *acq.*, 1958-2 CUM. BULL. 4.

87. F. E. Watkins Motor Co., 31 T.C. 288, 299 (1958), *acq.*, 1959-1 CUM. BULL. 5, *citing* J. L. Goodman Furniture Co., 11 T.C. 530 (1948), *acq.*, 1941-1 CUM. BULL. 2.

88. 277 F.2d 526 (2d Cir.), *cert. denied*, 364 U.S. 827 (1960), *reversing* 31 T.C. 415 (1958).

search must always be concerned with the needs of the particular business as they existed during the particular year.”⁸⁹

During 1963 the Fifth Circuit Court of Appeals had two occasions on which to consider this Tax Court rule of thumb. In one case it referred to the Second Circuit court’s feeling as expressed in *Dixie, Inc.*, but went on to say:

It has been said that the Tax Court rule is a rule of thumb and one which does not necessarily control with respect to the needs of a particular business. *Dixie, Inc. v. Commissioner*, 2d Cir. 1960, 277 F. 2d 526. Yet it would seem that the rule of thumb would have some weight when the surplus was less than two-thirds of the annual operating cost.⁹⁰

In a decision seven months later the same court ruled against the taxpayer and stated:

It is contended by the taxpayer that the decision in *Sterling Distributors* requires a holding here that the taxpayer was entitled to a cash reserve of an amount sufficient to cover one year’s operating expense. This rule of thumb, announced by the Tax Court in *J. L. Goodman Furniture Co. v. Commissioner*, 11 T.C. 530, and *F. E. Watkins Motor Co. v. Commissioner*, 31 T.C. 288, is not a controlling principle and each case must be decided by the needs of the business of the particular taxpayer in the determinative year or years. *Barrow Manufacturing Co. v. Commissioner . . . Dixie, Inc. v. Commissioner*, 2d Cir. 1960, 277 F.2d 526, *cert. den.* 364 U.S. 827, 81 S. Ct. 62, 5 L. Ed. 2d 54. The taxpayer had no inventory, it had no doubtful receivables and the receivables it had were paid promptly. If its business had declined it would have had a comparable decline in operating expense. The taxpayer in this case during the tax years here involved had no need for a cash accumulation equal to a year’s cost of operation.⁹¹

The Second and Fifth Circuit Courts’ remarks cast considerable doubt upon whether an accumulation of 100% of prior annual operating expenses can be relied upon to be reasonable per se. Thus, rather than merely entering evidence of prior yearly expenses, a taxpayer should consider providing additional information indicating what accumulations would be necessary to cover operating expenses if a decline in business were to take place.

Life Insurance

Funds accumulated to finance key-man life insurance plans generally are considered to be for a reasonable business purpose. *General Smelting Co.* was one of the first cases where the Tax Court recognized this prin-

89. *Id.* at 528.

90. *Sterling Distrib., Inc. v. United States*, 313 F.2d 803, 808 (5th Cir. 1963).

91. *Motor Fuel Carriers, Inc. v. United States*, 322 F.2d 576, 579 (5th Cir. 1963).

92. 4 T.C. 313 (1944), *acq.*, 1945 CUM. BULL. 3.

inciple. In that case the founder of the corporation owed the corporation approximately \$145,000. The corporation had settled with him for \$500 and had written the remainder off the books as a bad debt in a prior year. In 1936, the founder-debtor assigned a life insurance policy to the corporation to make amends for the bad debt loss he felt obligated to repay. The corporation continued the premium payments on the policy. The Commissioner contended that such payments were not for a reasonable business purpose. Holding to the contrary, the Tax Court stated:

But we think the facts show that petitioner made its investment in these insurance policies in the exercise of sound business judgment. The facts show that petitioner is the assignee of these life insurance policies . . . and that the moneys which it paid out in 1939 and 1940 were paid by it in good faith in an effort to obtain the ultimate equity in these policies for its own account in order to recoup the debt which T. Lewis Thomas [the founder] owed to petitioner, for which he had in 1936 assigned these policies to petitioner. . . . However, while the loans were not made for business purposes, we think it was clearly a business purpose for petitioner to salvage as much as possible out of the loans when they became bad, and this it was endeavoring to do when it took the assignment of the insurance policies in 1936 and made payments on them in subsequent years, including the years 1939 and 1940, to protect them and keep them in force.⁹³

Although *Emeloid Co. v. Commissioner*⁹⁴ dealt with the excess profits tax, it reinforced the theory mentioned above. Premium payments for insurance coverage which would permit the corporation to redeem the stock of the first of the corporation's two 50% shareholders to die were held to have been made for a reasonable business purpose. The insurance coverage was required to guarantee the continuity of the business entity under essentially the same managerial guidance. Finding that such expenditures were not for a reasonable business purpose would have meant forcing a public sale of this stock and possibly destroying the entity. The prevention of such an occurrence was held to be a reasonable business purpose.

*Bradford-Robinson Printing Co. v. United States*⁹⁵ gives the broadest precedent for justifying accumulations to finance key-man life insurance. In this case a separate trust had been established to provide an insurance-type coverage on the lives of certain key employees. The plan was a self-insuring one. The corporation paid to the trust premium amounts comparable to the premiums which would have been required to be paid by a commercial insurance company. The premiums were invested by

93. *Id.* at 324.

94. 189 F.2d 230 (3d Cir. 1951), *reversing* 14 T.C. 1295 (1950) (not a 1939 § 102 case).

95. 1 Am. Fed. Tax. R.2d 1278 (D. Colo. 1957).

the trust, but the investments, together with income the investments yielded, were to be paid to the corporation upon the death of the insured employee. The court held the accumulations were made for a reasonable business purpose.

Life insurance proceeds are not included in accumulated taxable income — the tax base to which the accumulated earnings tax rates are applied.⁹⁶ Neither the Internal Revenue Code nor the Regulations define earnings and profits for accumulated earnings tax purposes. It would appear, therefore, that general tax rules apply. Premiums on officer's life insurance are deductible, and the proceeds are included in computing earnings and profits.⁹⁷ This relates both to the determination of whether the corporate form was utilized to avoid income taxes and to the computation of the amount of the accumulated earnings credit.

Stock Redemptions

Not many guideposts relating to application of the accumulated earnings tax are available in instances involving redemptions of stock. Nevertheless, the few cases on record appear to allow accumulations if bona fide corporate business reasons, rather than shareholder reasons, prompt the redemption. Shareholder reasons for redemptions are not reasonable business needs of the corporation.

Fear on the part of a 20% shareholder that the balance of the stock would be sold to another steel company was held in *Pelton Steel Casting Co.*⁹⁸ not to create a reasonable corporate business need for accumulation. Therefore, accumulations to redeem the 80% shareholders' interests were held improper. The court found that the sale price of the 80% interest undoubtedly would have been reduced by 80% of any dividends declared. Whether dividends or a redemption, the result would have been the same to the corporation. The 80% shareholders would have received the same amount for their stock. The dividend route, however, would have created more tax to the shareholders. Since the plan was for the shareholders' benefit, the accumulation was held improper.

In *Hedberg-Friedheim Contracting Co.*,⁹⁹ a case where dissension arose between the two 50% shareholders of a gravel business, each of whom had tried to buy the other's stock, accumulations for the purpose of redeeming one of the shareholder's stock were held to be unreasonable.

96. Life insurance proceeds received by a corporation are excluded from gross income and therefore from taxable income. CODE § 101(a)(1); Reg. § 1.101-1(a) (1957).

97. Rev. Rul. 230, 1954-1 CUM. BULL. 114.

98. 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir. 1958), *cert. denied*, 356 U.S. 958 (1958).

99. 15 CCH Tax Ct. Mem. 1433 (1956), *aff'd*, 251 F.2d 839 (8th Cir. 1958).

Friedheim, one of the shareholders, held the controlling vote on the decision whether to accumulate funds. He had forced the corporation to accumulate funds to redeem part of its outstanding stock. The Tax Court noted that since the other stockholder, Hedberg, never intended to get rid of the gravel business, it was quite obvious that Friedheim's actions were not taken for the benefit of the business. They were initiated to allow Friedheim to be able to sell his shares at a higher price, the gain being taxable at lower capital gains rates.

These cases seem to preclude *any* redemptions without the application of the penalty tax. If the price of the shares would be reduced by the amount of the dividend, gross income to the retiring shareholder would be the same by either the redemption route or the dividend-sale route. A redemption would always create less tax and thus be suspect.

Except for the adverse decision in *Hedberg-Friedheim Contracting Co.*,¹⁰⁰ the courts reviewing 50% or less redemptions have ruled that the accumulations for the redemptions were not improper.¹⁰¹ Possibly, the courts view a 50% or less interest in a closely-held corporation as being unmarketable. The dividend-sale route might not be feasible for a 50% or less interest. Generally, a 50% or less interest cannot control dividend policy. Control as to dividends rests in the hands of the majority shareholders.

The Board of Tax Appeals in the *Dill Mfg. Co.*¹⁰² case refused to apply the penalty tax on a 20% redemption. Syndicate members owning 20% wished to sell the business or to merge it with a larger concern. The 80% operating group opposed this action, since the company had been successful and it represented their life work. Except for two points, this situation was almost repeated in the *Pelton Steel Casting Co.*¹⁰³ case. *Pelton* was decided in 1957, while *Dill* was reviewed in 1939. *Pelton* redeemed the 80% shareholders, *Dill* redeemed the 20% shareholders. The shareholders being redeemed in *Pelton* had control of the firm, whereas those in *Dill* did not. An unfortunate result of *Pelton* is the precedent that a shareholder having no control over the firm has the legacy of the penalty tax, being the remaining 100% shareholder of the corporation.

An accumulation was held reasonable in the case of *Mountain State Steel Foundries, Inc. v. Commissioner*,¹⁰⁴ in which a schism had arisen

100. *Ibid.*

101. See cases cited notes 102, 104-06 *infra*.

102. 39 B.T.A. 1023 (1939), *nonacq.*, 1939-2 CUM. BULL. 47.

103. 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

104. 284 F.2d 737 (4th Cir. 1960), *reversing* 18 CCH Tax Ct. Mem. 306 (1959).

between the 50% shareholder groups. The inactive group desired distribution of earnings as dividends. The active group planned to accumulate the earnings and expand the business. The corporation ultimately redeemed the inactive shareholder's stock. The Court of Appeals for the Fourth Circuit held that the redemption of stock was for a reasonable business purpose because it allowed free managerial decisions to be made for the benefit of the corporation rather than the satisfaction of the desires of certain shareholders for income.

Penn Needle Art Co.,¹⁰⁵ involving a 50% shareholder, and *Gazette Publishing Co. v. Self*,¹⁰⁶ involving a 20% shareholder, were held to encompass proper redemptions where disagreements as to corporate policies developed. The courts found that the funds used to redeem stock resulted from accumulations made for another purpose. Yet this fact did not indicate an intent to avoid income taxes. A business emergency had occurred and payments from accumulated funds did not evidence the presence of excessive accumulated earnings.

The facts in the *Gazette* case were similar to those in the *Pelton* case. The general manager, a 21% shareholder, proposed to sell his stock to outsiders. The remaining inactive shareholders feared that the corporation's editorial and business policies might change in a manner adverse to the interest of the corporation and its shareholders. The district court refused to approve the imposition of the penalty tax.

The courts' toleration of redemptions up to 50% without the application of the penalty tax permits another generalization. Business reasons for an accumulation appear to be suspect if the redemption is of the stock of a majority shareholder. Conversely, business reasons which would be suspect in a majority redemption situation appear to be acceptable in a minority redemption. However, a caution must be added at this point. The number of cases upon which these conclusions about redemptions of stock and the applicability of the penalty tax are based is small enough that they may not stand the test of time.

UNREASONABLE NEEDS

Unreasonable accumulations are indicated if there are:

- (1) loans to shareholders,¹⁰⁷
- (2) expenditures for the personal benefit of shareholders,¹⁰⁸
- (3) nonbusiness loans made to relatives or friends of shareholders,¹⁰⁹

105. 17 CCH Tax Ct. Mem. 504 (1958).

106. 103 F. Supp. 779 (E.D. Ark. 1952).

107. Reg. § 1.537-2(c) (1) (1959).

108. *Ibid.*

109. Reg. § 1.537-2(c) (2) (1959).

- (4) nonbusiness loans made to affiliated corporations,¹¹⁰
- (5) nonbusiness investments,¹¹¹
- (6) retentions for unrealistic hazards.¹¹²

Loans to shareholders do not automatically indicate an unreasonable accumulation. Difficulties arise, however, if there is a withdrawal of corporate funds without a recognition of the need that the transaction be at arm's length and evidenced by notes, interest payments, and a provision for repayment.¹¹³ Advances to provide funds for payment of a deceased shareholder's federal estate taxes, have been held to be improper.¹¹⁴

PRIOR YEARS' ACCUMULATIONS

For purposes of determining the amount required to be accumulated for reasonable business purposes, accumulated earnings and profits of prior years are taken into consideration.¹¹⁵ Should the accumulated earnings and profits of prior years be sufficient, any earnings and profits for the current year which are retained will be considered to be unreasonable accumulations.

[W]e . . . must first ascertain what are the reasonably anticipated needs of the business; next we must ascertain whether the accumulated earnings and profits of prior years are sufficient in amount to cover those needs; and finally, if the prior years' earnings and profits are found to be sufficient in amount, then did the taxpayer-corporation have sufficient liquid assets to meet the reasonable needs and still permit a distribution as a dividend to its shareholders.¹¹⁶

THE 70 PER CENT RULE

From 1939 through 1958 the Internal Revenue Service used a 70% rule of thumb.¹¹⁷ Instructions were issued that every corporate return which indicated that less than 70% of the corporation's earnings had been distributed as taxable dividends was to be inspected closely to determine whether the accumulated earnings tax was applicable. Thus, an accumulation of 30% or less of a year's earnings would seem to have been allowable, for there was no requirement that the revenue agent con-

110. Reg. § 1.537-2(c) (3) (1959).

111. Reg. §§ 1.537-2(c) (4), 1.537-3 (1959).

112. Reg. § 1.537-2(c) (5) (1959).

113. *Oyster Shell Prods. Corp. v. Commissioner*, 313 F.2d 499 (2d Cir. 1963), *affirming* 20 CCH Tax Ct. Mem. 1668 (1961); *Cummins Diesel Sales, Inc. v. United States*, 207 F. Supp. 746 (D. Ore. 1962), *aff'd*, 321 F.2d 503 (9th Cir. 1963).

114. *Youngs Rubber Corp.*, 21 CCH Tax Ct. Mem. 1593 (1962), *on appeal to Second Circuit*, March 14, 1963.

115. CODE § 535(c) (2).

116. *Electric Regulator Corp.*, 40 T.C. No. 81 (July 31, 1963).

117. T.D. 4914, 1939-2 CUM. BULL. 108, *as amended*, T.D. 5398, 1944 CUM. BULL. 194.

sider the reasonableness of the accumulation. This directive was amended in 1959 to make the rule inapplicable to 1954 Code years.¹¹⁸

USE OF FINANCIAL RATIOS TO DETERMINE REASONABLENESS OF ACCUMULATIONS

Various financial ratios are used to determine the reasonableness of a corporation's accumulations. Comparisons of certain of the taxpayer's financial ratios with those of competitors sometimes are made. In *Pelton Steel Casting Co.*,¹¹⁹ the taxpayer entered as evidence the corporation's ratios of working capital to sales, current assets to current liabilities, and cash items to current liabilities as compared to the same ratios of five area corporations which manufactured the same product. The taxpayer's ratios were average in relation to the ratios of these companies. These same ratios were compared with those of seven larger companies listed in *Standard & Poor's Listed Stock Reports* or *Moody's Manual of Investments*. The taxpayer's ratios were less favorable than the ratios of the seven listed corporations. The Tax Court held:

We have gone beyond the bare amounts of the ratios and have given consideration to their derivative components so as to gain an insight into the actual financial conditions purportedly evidenced thereby. . . .

[W]e note (a) that with respect to each of the ratios considered, petitioner's condition improved in 1946 over 1945, and (b) that such improvement appears to have been, if anything, healthier than that of a majority of the 5 other Wisconsin companies, all but one of which showed a substantial decrease in net sales in 1946, while petitioner's net sales were maintained at almost as high a level in 1946 as in 1945. With respect to the 7 very large companies selected by petitioner's expert witness and listed in Standard & Poor's reports or Moody's Manual, the ratios of working capital to sales and current assets to current liabilities are more favorable than those of petitioner. It seems clear, however, that these companies are not in any realistic sense comparable to petitioner. We do not think that their more favorable ratios demonstrate either that petitioner was in an unhealthy financial condition in 1946 or that petitioner was required to retain all of its earnings for that year in order to maintain its competitive position in its own particular field.¹²⁰

The fact that in this case another factor existed which was detrimental to the taxpayer may make a ready conclusion from this statement unjustified. The funds accumulated were *not* used for improving financial ratios. They were, in fact, used to redeem 80% of the outstanding stock.¹²¹ Nevertheless, it would appear that emphasis should be placed

118. T.D. 6378, 1959-1 CUM. BULL. 680.

119. 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

120. *Id.* at 177-78.

121. See p. 378 *infra*.

on financial ratios of other companies of comparable size. Unfortunately, the taxpayers most likely to face the impact of an accumulated earnings tax are smaller in size than those from which financial ratios are readily available.

Working Capital Ratios

The ratio of current assets to current liabilities frequently is used to measure the financial strength of a business.

This is the traditional current or working capital ratio that gives the number of times current assets will pay off current liabilities. The "two-to-one" minimum ratio is perhaps one of the most universal yard sticks carried in the minds of businessmen. Nevertheless, a company can have a two-to-one working capital ratio and still be a financial cripple.¹²²

Care should be exercised in arriving at generalizations about ratios. They vary a great deal and depend upon the individual circumstances. In *Wellman Operating Corp.*,¹²³ the corporation had been a going concern for six years. During that time, it had never paid a dividend. The Tax Court compared the corporation's current asset ratio in 1950 of 11 to 1 to its 1953 ratio of 31 to 1. It found that the increase in the ratio was a graphic illustration of an accelerated accumulation of earnings and profits accompanied by increased liquidity, particularly in the cash account.

In *Alma Piston Co.*,¹²⁴ accumulations were made to provide working capital required because of substantial accounts receivable owing from Ford Motor Company, which was essentially the supplier's only customer. The Tax Court determined that such accumulations were needed by the business because at year-end 1956 the taxpayer had current assets of \$634,643.90 to cover current liabilities of \$718,117.51, exclusive of the tax liability. At year-end 1957, the current assets were \$769,544.60 and current liabilities were \$844,544.60, exclusive of the income tax liability. The current ratio in both years was less than 1 to 1.

In *F. E. Watkins Motor Co.*,¹²⁵ the taxpayer produced an expert witness. The expert testified that a ratio of current assets to current liabilities of 3.5 to 1 or 4 to 1 was required during the two years involved. The actual ratios were 2.26 to 1 and 2.91 to 1. The court held that the expert witness had proved that the accumulations were not unreasonable.

One taxpayer used authoritative sources as standards for determining the reasonableness of a corporation's current ratio in determining working

122. CORPORATE TREASURER'S AND CONTROLLER'S HANDBOOK 859 (Doris ed. 1957).

123. 33 T.C. 162 (1959).

124. CCH Tax Ct. Mem. No. 195 (1963).

125. 31 T.C. 288 (1958), *acq.*, 1959-1 CUM. BULL. 5.

capital requirements. The ratio was 1.09 to 1. It was compared for reasonableness to a 2 to 1 ratio suggested by Glenn G. Munn in *Encyclopedia of Banking and Finance*.¹²⁶ Comparison also was made to the currently accepted standard applicable to the corporation's trade of 1.7 to 1 found in a work by Robert Morris Associates.¹²⁷ The court found that measured by the working capital ratio test a finding of unreasonable accumulations would not be justified.¹²⁸

The 2 to 1 palliative is losing its general appeal.

A ratio of 200% or 2 to 1 was long considered satisfactory irrespective of the particular industry or the nature and proportions of the various items included in the totals. In recent years, however, indiscriminate use of this standard as a measure of short-term debt paying ability has been criticized.

The development of *standard ratios* for individual industries had led to comparison of the individual company with the industry average. Working capital requirements also vary between enterprises and between periods in the particular concern. At the same time recognition has been given to the importance of the distribution of current assets as a measure of current financial strength.¹²⁹

Another comparison currently of interest has come to be known as the "acid test." This is the ratio of cash, marketable securities, and receivables as compared to current liabilities. If this ratio is less than 1, a current weakness as to ability to pay liabilities is indicated.

The Appendix of *Practical Financial Standard Analysis*¹³⁰ includes a table of 14 important financial ratios for 72 lines of manufacturing, wholesale, and retail business activities. Comparisons of taxpayer's ratios with statistics of this sort may lead to some enlightenment which the 2 to 1 ratio might not disclose.

In using ratios, one should be certain to take into account all the particular circumstances of the business being considered. As an example, "a current ratio that might be suitable for a well-established, soundly managed business concern might not be so safe for a relatively new, poorly managed, or rapidly expanding enterprise."¹³¹

Year-End Ratios

If a corporation has selected a natural business year-end, the working capital ratios are most favorable at year-end. Inventories, accounts receivable, and other working capital requirements generally are higher at

126. MUNN, *ENCYCLOPEDIA OF BANKING AND FINANCE* 217 (5th ed. 1949).

127. ROBERT MORRIS ASSOCIATES, 1961 *STUDIES* 109.

128. *Sterling Distrib., Inc. v. United States*, 313 F.2d 803 (5th Cir. 1963).

129. *ACCOUNTANT'S HANDBOOK* 3.8 (Wixon ed. 1960).

130. FOULKE, *PRACTICAL FINANCIAL STATEMENT ANALYSIS* (5th ed. 1961).

131. FOULKE, *op. cit. supra* note 130, at 179.

other times during the year. Thus, a measurement of ratios and working capital needs at year-end does not truly reflect the condition of the company. A dividend declared only upon the year-end facts easily could embarrass the operations of the corporation during other periods of the year.

The accumulated earnings tax takes dividend policy into account. The Regulations allow accumulations which a prudent businessman would consider appropriate for present business purposes and for the reasonably anticipated future needs of the business.¹³² A reasonably prudent businessman would consider working capital needs for the following year in determining a dividend policy.

SUBCHAPTER S

The accumulated earnings tax can be avoided by electing under Subchapter S¹³³ to have the corporate income taxed to the shareholders. This election might be advantageous if the accumulated earnings and profits exceed the accumulated earnings credit, and if the excess will likely cause the imposition of the accumulated earnings tax. Of course, this election should not be made merely to escape the accumulated earnings tax, without giving consideration to other effects of becoming a small business corporation. This election probably would not be advisable, for example, for corporations which have substantial net operating loss carry-overs. The tax advantages relating to the carry-over would be deferred and might be even lost.¹³⁴

If a corporation previously has been a small business corporation, the undistributed taxable income accumulated during the application of the election is not included in accumulated earnings and profits for purposes of the accumulated earnings tax.¹³⁵

EFFECTIVE RATES IF PENALTY TAX IS PAID

The accumulated earnings penalty tax should be compared with the tax which the remaining income would create if distributed to shareholders. The following table shows the computation of the effective tax rates on corporate income if the penalty tax is applied — 61.2% on the first \$100,000 and 70.5% on the balance. No additional tax is payable on that same income if the corporation is liquidated into the shareholders' hands after the stock passes through an estate. If the corporation is liquidated before the step-up in basis created by the stock passing through an estate, the effective rates are increased to 70.9% and 77.8%, respectively.

132. Reg. § 1.537-1(a) (1959).

133. CODE §§ 1371-77.

134. Reg. § 1.1374-1(a) (1959).

135. CODE § 1377(a).

	<i>On First</i> <u>\$100,000</u>	<i>On Balance</i>
Taxable income -----	\$100,000	\$100,000
Income tax (1963 rates) -----	46,500	52,000
	<hr/>	<hr/>
Accumulated taxable income -----	\$ 53,500	\$ 48,000
Penalty tax— 27.5% -----	14,713	
— 38.5% -----		18,480
	<hr/>	<hr/>
Net income to corporation -----	\$ 38,787	\$ 29,520
Effective tax rate if corporation liquidated after passing through an estate -----	61.2%	70.5%
25% maximum capital gain tax (1963 rates) -----	\$ 9,697	\$ 7,380
	<hr/>	<hr/>
Net income to shareholders -----	\$ 29,090	\$ 22,140
Effective tax rate if corporation liquidated before passing through an estate* -----	70.9%	77.8%

*Assuming fair market value in estate increased by amount of retained earnings.

CONCLUSION

Because of the increase in incidents of application of the accumulated earnings tax, corporations should be alert to the rules and should be careful to build a record as the facts are developing. Subsequent events may erase the memory of reasons for accumulations unless the trail is plainly marked. Today's record is the basis for tomorrow's possible disagreement with the Internal Revenue Service.